

Chicago Fed Letter

China up close: Understanding the Chinese economy and financial system

by Michael H. Moskow, vice chairman and senior fellow for the global economy, Chicago Council on Global Affairs, and former president and chief executive officer, Federal Reserve Bank of Chicago, and Cathy Lemieux, senior vice president, Supervision and Regulation

In March 2007, the authors paid a weeklong visit to Beijing and Shanghai, China. In this article, they summarize some of the most striking impressions from their visit concerning the Chinese economy and financial system.

There are major differences between macroeconomic policy and central banking in China and in the U.S.

The specific occasion for our visit to China in March 2007 was a series of lectures on monetary policy that Michael delivered to three leading Chinese universities: Tsinghua University, Fudan University, and the Central Party School of the Communist Party. The broader purpose of the trip was to enhance mutual understanding between U.S. and Chinese officials concerning economic and financial conditions in both countries.¹

As part of the visit, we met with officials of government agencies, including the People's Bank of China (the central bank), the China Securities Regulatory Commission, and the Shanghai Metropolitan Government Financial Services Office. We also met with senior representatives of leading manufacturing companies (BorgWarner, Caterpillar, and General Motors) and financial services companies (Citigroup, Deutsche Bank, JPMorgan Chase, Northern Trust, and Tianan Insurance). Finally, we visited two key financial markets: the Shanghai Stock Exchange and the Shanghai Futures Exchange.

China has made huge progress in achieving high rates of economic growth, lifting hundreds of millions of people out of poverty, developing its manufacturing sector, producing impressive rates of savings and investment, and building export growth. It has been an amazing success story,

and the signs of this success were visible throughout our visit.

Our trip highlighted some major differences between macroeconomic policy and central banking in China and in the U.S. We were also struck by some of the challenges China faces as it continues to modernize its economy and improve its business processes and the functioning of its financial markets in the context of its existing political system. These challenges include corporate governance, market infrastructure, and economic efficiency. Finally, we address some issues that may affect China's future economic development, including concerns about unmet needs of certain population segments and the environment.

Macroeconomic policy and central banking

Economic growth in China has been very different from that in the U.S. Since economic reform began in 1978, China has averaged gross domestic product (GDP) growth of almost 10% per year—the fastest in the world over this period. Not only is China's growth much faster than that of the U.S., but it has also been largely driven by investment. Investment represents approximately 40% of GDP in China, compared with about 20% in the U.S. The downside of this impressive investment performance is that the

consumption sector in China is underdeveloped, with significant unmet needs. In per capita terms, China is still a lower-middle-income country, with 130 million Chinese falling below international poverty lines.² Moving toward a growth path that relies more on domestic consumption demand is part of China's current five-year plan. China also wants to promote faster development of the service sector, including the small- and medium-sized enterprises that are so important to

bank deposits are also maintained at artificially low rates. Nonetheless, the increases in foreign reserves are not fully neutralized. Over the last five years, Chinese M2 (the broad money supply, which includes cash and bank deposits) has been growing above 15% per annum, while real economic growth has averaged about 10.5%.

Against the background of China's fast-growing economy, it is difficult for the

classical "socialist" economy, private ownership of the means of production is dominant in China and may represent as much as two-thirds of the economy. China's economy (including its so-called state-owned enterprises) represents a continuum of various mixes of public and private ownership. In addition to the complex and ever-shifting boundary between the public and private sectors, the relative power of the central government versus the provincial governments shifts over time as well.

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the U.S. economy. To increase consumption of goods, such as televisions, refrigerators, and washing machines, China has completed rural water and electrification projects. Another positive sign is that consumer loans are increasing.

China's central bank also functions quite differently compared with the U.S. model. Unlike our Federal Reserve System, the People's Bank of China is not politically independent. It reports directly to the State Council, which serves as China's cabinet as well as its highest executive body. Monetary policy in China aims at limiting the appreciation of mainland China's official currency, the renminbi (RMB),³ while keeping economic growth at a sustainable pace and inflation under control and preserving a fragile banking system. In contrast, the Federal Reserve's monetary policy has a dual objective of maximum employment and price stability.

There is large and ongoing demand for RMB because China runs a high current account surplus—nearly \$330 billion expected for 2007.⁴ To maintain RMB at the desired level, the Chinese central bank issues RMB to meet this demand, thereby increasing the money circulating in China. To keep economic growth and inflation under control, the central bank sterilizes its foreign exchange market interventions; i.e., it buys back some of the RMB that it issued to buy dollars. In particular, it does so by selling low-yield government securities to state-owned banks. So far, banks have been able to absorb those low-yield bonds in part because the interest rates paid on

central bank to evaluate the economy's maximum potential pace of noninflationary growth—in other words, a sustainable level that would be associated with a strong, but not overheating, economy. Unlike more-developed market economies, China is reluctant to raise domestic interest rates to slow its domestic growth. To do so might mean attracting more capital inflows, which would, in turn, require further money issuance to stabilize the exchange rate. This is why the Chinese central bank instead raises levels of bank reserve requirements (the amount of money a bank is required to keep on its account at the central bank) on an ongoing basis to slow the expansion of money and credit.

Over the long run, such practices as setting higher reserve requirements and asking banks to buy low-yield bonds could have a distorting effect on banks' balance sheets and the overall economy. Also, under this system, China must impose capital controls (restrict the flows of capital transactions between residents and nonresidents) to avoid a massive inflow of speculative portfolio investment that would cause the currency to appreciate and put pressure on its export sectors. These capital controls also prevent a run on domestic banks that are not offering yields that would match those offered by international financial markets.

A hybrid political economy

China has a complex political economy that represents a hybrid of private ownership and state control. In contrast to a

Corporate governance

Observers accustomed to a U.S. or Western European context note a number of weaknesses in corporate governance at Chinese firms. Chinese officials themselves have identified embezzlement by majority shareholders and the neglect of duties by directors as fundamental issues. In addition, many senior executives of Chinese companies come from government, and many reportedly retain a political mind-set. As we observed on one occasion, a phone call from the Communist Party can put all "business as usual" on hold. We were also told the party retains considerable control over human resource decisions at many firms, such as hiring and compensation. Finally, the Chinese legal system lacks the range of civil and criminal penalties for corporate malfeasance that we have in the U.S.

A key challenge is the continuing role of state-owned enterprises. The stake that the government holds in these firms has been reduced sharply. In addition, government is making a transition from complete control to providing direction. However, many companies are hybrids—publicly traded on the stock exchange but still majority-owned by the government. It is very difficult to implement Western-style corporate governance in such a context. For example, what exactly does "shareholders' rights" mean when the largest shareholder is the government, with at least a 51% stake?

According to one expert we spoke with, China's state-owned enterprises are hindered by the structural problems that characterize its bureaucracy in general.⁵ In particular, senior officials are often required to do jobs for which they are unprepared. For example, one official

was directed by the central government to privatize several hundred state-owned firms within two years, even though he had never privatized a business before and had very little idea how to proceed. In addition, many senior government officials are moved from one assignment to another too quickly, which limits their effectiveness.

Chinese officials are taking steps to improve corporate governance. For example, the China Securities Regulatory Commission has hosted meetings to promote better governance practices. In addition, the Shanghai Stock Exchange has implemented strong governance rules for listed companies. These include requirements that one-third of corporate directors be independent and that the role of chairman be separated from that of chief executive officer.

It should be noted that these same corporate governance issues exist in a number of other countries where partially state-owned enterprises are publicly traded. However, they are especially acute in China, which is still in a transition toward a market economy.

Market infrastructure

As in other developing countries, China faces several challenges in creating a strong financial market infrastructure. It was only very recently that bankruptcy laws covering private firms went into effect. In addition, although stock markets were reopened in the early 1990s, China's stock market capitalization as a share of GDP is very small compared with that of other developing countries.

Financial markets are still in the early stages of development. China's corporate bond market is small relative to GDP and is dominated by large state-owned enterprises. In addition, even profitable small and medium-sized businesses find it hard to borrow from Chinese banks.⁶ China's government bond market offers a narrow range of products, with a very limited secondary market. Finally, financial innovations, such as trade in derivatives, are being introduced only slowly.

Efficiency

A number of barriers stand in the way of greater efficiency in the Chinese

economy. One of these barriers is a heavy emphasis on high employment. This leads to jobs being defined very narrowly and other inefficiencies, such as a government policy of splitting road construction contracts into two-mile increments to support small construction companies.

Another barrier is the reliance on older accounting systems that focus on flows of funds, not earnings. Similarly, lending to a state-owned enterprise does not require analyzing whether the company will be able to repay the loan in the future. In the past, managers have been compensated for completing projects and for high employment, but not for profitability.

Looking toward the future

Looking ahead, the Chinese economy will face challenges in correcting imbalances stemming from its current pattern of economic growth. We have already mentioned the challenge to balance consumption and investment. Unmet needs and the societal costs of growth, such as health and environmental concerns, will also need to be addressed to sustain China's high rate of economic growth.

So far, China's economic growth has been very uneven across regions and provinces. Drastic differences in the rate of development remain between urban and rural areas. Average disposable per capita income in rural areas is less than one-third of that in urban areas. Disparities are even worse in the poorest rural areas. There is also a geographical dimension to these gaps—most investment is on the east coast. Formerly, people were not allowed to move from one region to another to get better jobs, which enhanced the power of the regional governments.

Social welfare programs—pensions, health care, and education—are potential sources of unrest. Pensions cover only city workers, who make up approximately 28% of the population. Chinese officials acknowledge that pension funds are basically insolvent. Affordability of health care is also an issue. There is a huge gap between health care in the cities and in the rural areas, where the former system of free clinics has disintegrated. The vast majority of the rural population is now uninsured, but most urban residents have some kind of health coverage, which is

supplied by their employers. Finally, there are gaps in education. While literacy is high overall, many Chinese do not have access to the high-quality education they need to thrive in today's global economy.

China's rapid industrialization and overall rate of economic growth have had a severe impact on the environment. Its pattern of growth has been highly energy-intensive, with a heavy reliance on coal. Coal provides about 70% of China's energy needs, and in 2006 the country consumed more coal than the U.S., Japan, and the UK combined.⁷ In addition, rapid industrialization has led to water shortages and urban congestion. China's leaders plan to relocate 400 million people to newly developed urban centers between 2000 and 2030. All these environmental impacts have led observers to question whether China's high rates of economic growth are sustainable. On the positive side, the government is increasingly open to acknowledging environmental problems and developing interim solutions.

At the Communist Party's recent twice-a-decade National Congress, held in October 2007, China's leadership outlined goals for the next few years that addressed some of the imbalances and concerns we have just mentioned.

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Chinese leader Hu Jintao indicated that growth will continue to be the top priority, with the government's goal being to double per capita GDP by 2020 and "basically eliminate" absolute poverty. However, the government will also try to reduce the impact of growth on resource consumption and on the environment. Hu proposed a restructuring of the economy to emphasize technology rather than heavy industry, services rather than manufacturing, and consumer spending rather than exports. Hu also said the government will raise minimum wages, expand health care and the social safety net, and stimulate job creation in the private sector.⁸

In addition, a new group of top officials, whose experience in local government could help Beijing strengthen its authority over local interests, emerged at the National Congress. Up to now, local governments have thwarted many of

the central government's initiatives related to narrowing income gaps, improving environmental protections, and creating a stronger social safety net.⁹

After the National Congress, the government announced new antipollution regulations for the export industry. Export manufacturers that violate China's pollution laws would be forced to close for one to three years. In the past, such companies have only received small fines. A significant portion of China's air pollution is due to the production of goods for export.¹⁰

Despite such reform efforts, one analyst has expressed skepticism about the promises made at the National Congress about broadening prosperity, expanding the social safety net, and increasing education subsidies. He noted that, despite recent increases in social welfare spending, made possible by surging government

revenues, peasants and workers continue to be excluded from positions of power in the Communist Party.¹¹

Conclusion

China continues to engineer high rates of economic growth, using an economic system that has never been seen before in history. However, the country faces enormous challenges because of its sheer size, its rapid rate of social and economic change, the conflicts between its traditional political and cultural institutions and the dynamism of the market, and the massive unmet needs of its population and the environment. China's leadership has been focusing intently on these challenges and is studying how other countries are addressing similar issues. Clearly, the solutions must fit the unique circumstances in China.

¹ Many of our conclusions derive from a mixture of personal observations and interviews with experts who were speaking "off the record," so specific sources cannot be provided in many instances. However, where possible, we have provided publicly available sources for our most significant points. We would like to thank Steven VanBever and Benoît Mojon, both of the Federal Reserve Bank of Chicago, for assistance with this article.

² U.S. Central Intelligence Agency, 2007, *The World Factbook*, report, Washington, DC, available at <https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html>, accessed on November 12, 2007.

³ The renminbi is the name of the currency, while the yuan is one unit of the currency.

⁴ A country has a current account surplus when its exports of goods and services exceed its imports.

⁵ John L. Thornton, 2006, "China's leadership gap," *Foreign Affairs*, November/December, pp. 133–140.

⁶ Janet L. Yellen, 2007, "China's banking sector," *Asia Focus*, Federal Reserve Bank of San Francisco, March.

⁷ Elizabeth C. Economy, 2007, "The great leap backward?," *Foreign Affairs*, September/October, available at www.foreignaffairs.org

20070901faessay86503/elizabeth-c-economy/the-great-leap-backward.html, accessed on November 1, 2007.

⁸ Andrew Batson and Jason Leow, 2007, "China puts growth atop agenda," *Wall Street Journal*, October 16, p. A4.

⁹ Andrew Batson and Jason Leow, 2007, "Hu's big challenge: Getting provinces on board," *Wall Street Journal*, October 23, p. A6.

¹⁰ Jane Spencer, 2007, "China shifts pollution fight," *Wall Street Journal*, November 1, p. A15.

¹¹ Willie Lam, 2007, "Hu Jintao's hollow pledges," *Far Eastern Economic Review*, November, pp. 27–29.