ECONOMIC AND SOCIAL PROGRESS IN THE PEOPLE'S REPUBLIC OF CHINA DURING 2011
A Review of News and Commentaries on China During the Year

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This review of news and commentary during the past year was motivated by a generally known but often forgotten comment that was made in a recent article in *The Economist*:[1]

> Data points sometimes change faster than debating points. It is conventional wisdom that China's export-led growth squeezes consumers at home and competitors abroad, even as it adds inexorably to the country's huge foreign-exchange reserves. But figures released this month complicate these arguments.

Several key themes, obtained from various commentaries on China's economic and social concerns, are examined here with a view to evaluating China's progress within the past year, and, at the same time, briefing readers who have not followed recent events closely. These themes, in the form of questions, include the following:

1. Based on 2011 economic indicators, is China more likely to experience a soft landing or a hard landing in the near future?
2. Did China make progress in restructuring the economy away from its reliance on exports during 2011?
3. Are wages in China rising at a rate that suggests China will soon cease to be a low-wage nation?

This is followed by a brief overview of the major economic and social changes during 2012. Placing it at the end, rather than at the beginning as an "executive summary", seemed appropriate in order to preface it with some basic background information.

1. Soft Landing versus Hard Landing

Soft landing is a term used for an overheated economy to describe the rate of descent that is needed to avoid both inflation and high interest rates without experiencing a recession. A hard landing therefore *anticipates* a recession, but in the case of China a rate of growth of 5 per cent is frequently taken as a "near recession", owing to the social impact that a positive but much slower-than-normal rate of growth is likely to have. Such a lower boundary is

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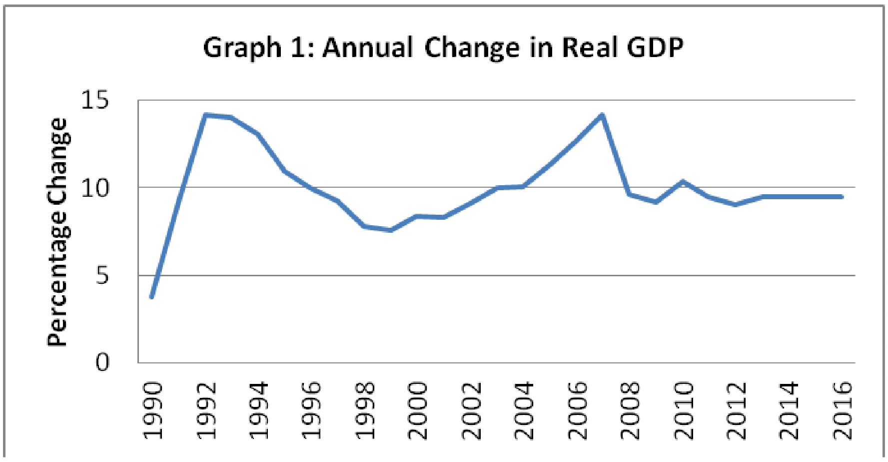
[1] No author cited, "Two Twists in the Dragon's Tail: China's Consumption Ratio Is No Longer Falling. Its Reserves Are No Longer Rising", *The Economist*, 21 January 2012. Available at: http://www.economist.com/node/21543176.

somewhat conjectural for China, however, since in 1990 that nation experienced a rate of economic growth of only 3.8 per cent, which is obviously in the “near recession” range as described above, but achieved an unemployment rate of 2.3 per cent,[2] which is not associated with a hard landing. This contrast in landings could consequently be more hypothetical than real, but it is nevertheless useful as a set of reference points.

China’s Previous Experiences in Overheating

A backdrop for an analysis of a probable rate of retrenchment for the Chinese economy should include a brief look at previous episodes of economic overheating. Graph 1 below indicates that since 1990 China experienced two peaks in the growth rate of GDP as expressed in constant prices – in 1992 and in 2007. Both of these boom periods were associated with a growth rate of 14.2 per cent per annum.[3] Total investment as a per cent of GDP peaked at 44.5 per cent in 1993 and continued to decline until it reached a low point of 35.2 in the year 2000 (Graph 2, on the next page). The sharp rise in investment in 1992 was facilitated by a series of credit expansions and resulted in rapid increases in the money supply. The rate of inflation, as measured from end-of-period consumer prices, reached 24 per cent in 1993. Inflation fell to a zero rate in 1997 and became negative in several of the years following (Graph 3).

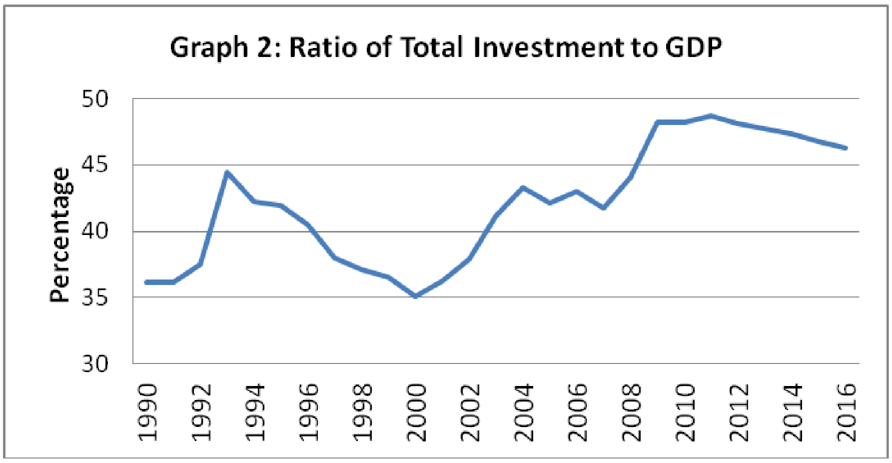


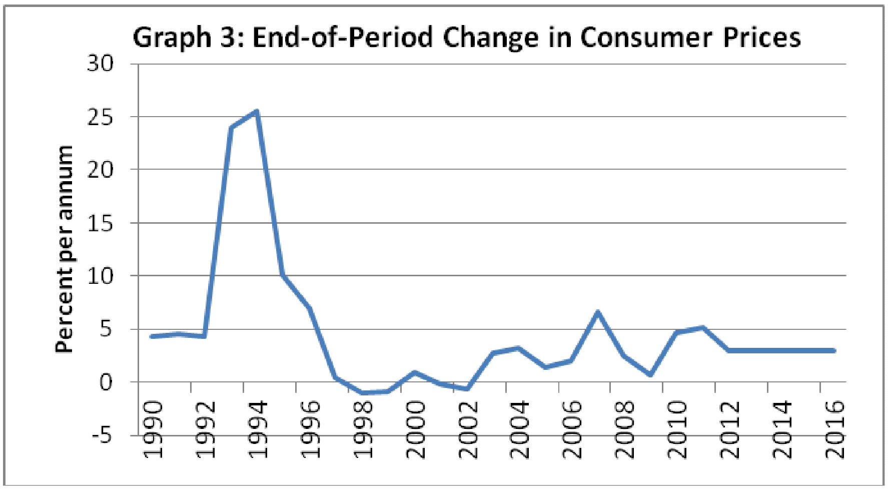
In 2007 the investment ratio remained relatively high (41.7 per cent of GDP, again from Graph 2), and increased further in subsequent years, while consumer prices peaked at slightly more than 5 per cent in 2007. A major difference between the two boom-bust periods was extensive use in the 2007-2008 period of government investment in the form of

[2] This and the data from Graphs 1-3 are taken from the International Monetary Fund (IMF) *World Economic Outlook Database*, September 2011. Data points after 2011 are IMF projections. It is available at: http://www.imf.org/external/pubs/ft/weo/2011/02/weodata/index.aspx.

[3] An additional period of overheating in 2004 was identified by Eve Cary on the basis of a macroeconomic warning index. Eve Oleta Cary, “Explaining Overheating in China Through Institutional Analysis (1992-210)”, *Asian Survey*, Vol. 51, No. 3 (May/June) 2011, p. 542-558. Available by subscription, or for purchase of the article, at: http://www.jstor.org/pss/10.1525/as.2011.51.3.540.

a stimulus package to prevent a substantial decline in GDP growth. The earlier episode was characterised as an effort to contract the money supply by controlling credit, beginning in 1994.[4] This only partially succeeded, for reasons that will be discussed in the next sub-section, and prolonged the period between the peak of overheating (1992) and recovery of GDP growth (2000).





To combat overheating in 2007, the Chinese government raised interest rates and reserve requirements for commercial banks, abolished or cut export tax rebates on certain products and imposed tariffs on some exports. These monetary actions were effective and the rate of growth of GDP fell gradually to 11.5 per cent in the third quarter of 2007 and 11.2 per cent in the in the fourth from 11.9 per cent in the first quarter. The slowing of the economy can be attributed to a decline in total fixed asset investment during the second half of 2007,[5] and to a similar decline in the quarter-to-quarter contribution of net exports during

[4] Justin Yifu Lin, "Is China's Growth Real and Sustainable?", *Asian Perspective*, Vol. 28, No. 4 (2004), p. 6. Available at: http://www.asianperspective.org/articles/v28n3-a.pdf.

[5] This can be seen from the chart in the top right-hand position of Figure 1 in IMF, "China Economic Outlook", 6 February 2012. Available at: http://www.imf.org/external/country/CHN/rr/2012/020612.pdf.

the same period. The impact on GDP from net exports for the full year was nevertheless greater than in the previous years, but less than the contribution of private consumption. In 2007 government and private consumption combined made a greater contribution in percentage terms to GDP growth than investment (Table 1).

Table 1: Contributions to growth (demand) in percentage points

	GDP	Net exports	Investment	Government consumption	Private consumption
2003	10.0	0.1	6.3	0.9	2.7
2004	10.1	0.6	5.7	1.1	2.7
2005	10.4	2.6	3.9	1.2	2.8
2006	11.1	2.3	4.6	1.5	2.7
2007	11.4	2.7	4.2	1.8	2.7

Sources: Table from the Asian Development Bank, *Asian Development Outlook 2008*, http://www.adb.org/Documents/Books/ADO/2008/PRC.pdf, with initial data from the National Bureau of Statistics of China.

Recent Developments in China's Housing Market and Its Role in Overheating the Economy

From the beginning of economic reform near the end of 1978 until now, the supply of housing in China generally lagged behind demand. This can be attributed partly to the emphasis during the pre-reform period on building factories and equipping them, thus creating employment, before allocating scarce financial capital to public housing. Another contributing factor was the desire of municipal governments to maintain a relatively high price for land and buildings within their respective jurisdictions in order to acquire increased revenue from urban and township land use tax, house property tax, deed tax, stamp tax for property transactions[6] and from various registration fees that are at least partly dependent on property values. Some analysts suggest that this is a major reason for the slow reaction to attempts by the central government to alleviate asset bubbles in the housing market, and it would almost certainly help to explain inter-city differences in property values.

As Eve Cary pointed out,[7] overheating in China generally arises from supply imbalances, rather than from changes in consumer demand. It is nevertheless important to review the demand for housing in China since home ownership is much higher there than in other countries with a similar level of per capita income. More specifically, although China ranks

[6] Wikipedia has a comprehensive enumeration and brief description of the various forms of tax in the People's Republic of China at: http://en.wikipedia.org/wiki/Taxation_in_the_People%27s_Republic_of_China

[7] Eve Oleta Cary, op cit. (in footnote 3), p. 542.

91st among the 180 countries in the International Monetary Fund's income database,[8] it is ranked near the top in terms of home ownership with 94 per cent of China's urbanites owning their own homes or some form of accommodation.[9] In comparison, the home ownership rate in Australia was 68 per cent in 2007-2008, 67 per cent in the USA in 2007 and 68 per cent in Canada in 2006.[10]

Why is home ownership so important in China? There are two main reasons, the first of which is cultural. The word "home" for most Chinese means more than a place in which to live. It also represents a precondition for marriage and an outward sign of the personal competence of the family.[11] Additionally, according to ancient Chinese traditions, the current family home is the principal connection with family ancestors, provided of course that it is worthy of that status. The ontological implications of this have weakened over the years, but residual beliefs continue to influence behavioural attitudes.[12] As a result of these factors, a large portion of the savings held by the extended family is used to assist family

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[8] The database was mention in footnote 2. The specific location of data pertaining to income per capita based upon purchasing power parity is: http://www.imf.org/external/pubs/ft/weo/2011/02/weodata/weorept.aspx?pr.x=73&pr.y=13&sy=2011&ey=2011&scsm=1&ssd=1&sort=country&ds=.&br=1&c=512%2C941%2C914%2C446%2C612%2C.

[9] Reported by *People's Daily*, 9 August 2002. Available at: http://english.peopledaily.com.cn/200208/09/eng20020809_101182.shtml. A figure of 80 per cent was reported for the proportion of urbanites owning their own home. The difference between "home" and "accommodation" is not defined in the article. The Gallop Organisation reported that 93 per cent of respondents (both rural and urban) said they owned their own home in 2004. Ownership was higher among rural respondents (97 per cent compared to 85 per cent for rural dwellers). This article is available at: http://www.gallup.com/poll/15082/homeownership-soars-china.aspx/.

[10] Australian Bureau of Statistics at http://www.abs.gov.au/ausstats/abs@.nsf/Lookup/by%20Subject/1370.0~2010~Chapter~International%20comparisons%20(5.4.6)

[11] Refer to Cathy, "Home Ownership Almost a Prerequisite for Marriage", *China Decoded*, 11 September 2010. Available at: http://www.chinadecoded.com/2010/09/11/homeownership-almost-a-prerequisite-for-marriage/.

[12] A good example can be found in Xiao Mei, "The 'Significant Strangers': Chinese New Year in My Grandpa's Home Village", The Intergenerational Foundation, undated. Available at: http://www.if.org.uk/archives/1582/the-significant-strangers-chinese-new-year-in-my-grandpas-home-village. It should be noted that this characteristic of high rates of home ownership for Chinese applies also to migrant Chinese living in California. A study of home ownership trends from 1980 to 2000 in the Los Angeles Consolidated Metropolitan Statistical Area found that Chinese home ownership rates adjusted by socioeconomic and housing market characteristics are on average 18 percentage points higher than those of native white American households. Refer to Gary Painter, Lihong Yang and Zhou Yu, "Why Are Chinese Homeownership Rates So High?", Working Paper, Lusk Centre for Real Estate, University of Southern California. Available at: http://www.usc.edu/schools/price/lusk/research/pdf/wp_2003_1001.pdf.

members in making a substantial deposit on a new home.[13] China's gross national savings rate in 2011 was 54.8 per cent of GDP, compared to 25.7 per cent for Australia and 12.8 per cent for the USA in the same year.[14]

The second motivation is the capital gain from rapidly rising prices and relatively low interest rates for mortgages. There is little doubt that both residential property prices and sales activity increased substantially in China since 2007, but the extent of both increases is debatable. A national market for residential housing does not exist, and each of China's more than 600 cities will display major differences in market conditions. The chart in the right-hand centre position of Figure 1 in the IMF "China Economic Outlook" (see note 5 for a link to the document) indicates that the amount of floor space sold increased by more than 80 per cent, year-on-year and seasonally adjusted, during 2009 but price rises exceeded 30 per cent only in the third quarter of 2007 and the fourth quarter of 2009. Perhaps more informatively, the authors of an IMF working paper[15] concluded that house prices are not significantly overvalued in China in relation to market conditions during the first half of 2010. However, the mass-market segment of a few large cities such as Shanghai and Shenzhen, and the luxury segment of the market in Beijing and Nanjing, appeared to be "increasingly disconnected from fundamentals".[16]

Recent developments have tended to support the view that China's housing bubble is not a source of major concern at the present time. The chart referred to above in the IMF "China Economic Outlook" indicates that both prices and sales of residential property in China fell gradually during the third quarter of 2011 and price changes at the end of that year were relatively modest. The IMF concluded that :

> The government's efforts to cool the property sector have been effective. The market is beginning to deflate, with price growth slowing and transaction volumes down. Encouragingly, underlying investment remains healthy, in part due to the government's efforts to expand the supply of social housing. At present, there seems little reason to backpedal on the measures put in place to deflate the market. Indeed, a modest decline

[13] There is a scarcity of reliable data on this, but it is a reasonable supposition since the average housing price per square metre was reported to be slightly less than US$7,000 in China, compared to US$3,300 in Thailand and US$1,781 in Indonesia. Refer to Global Property Guide at: http://www.globalpropertyguide.com/Asia/China/square-meter-prices. Taking these values as a ratio of per capita GDP in 2011 from the IMF database, for China the average price per square meter is 1.35 times GDP per capita for that year; for Thailand it is 0.62 times; and for Indonesia it is 0.51 times per capita GDP.

[14] From the national accounts portion of the IMF database at: http://www.imf.org/external/pubs/ft/weo/2011/02/weodata/weoselser.aspx?c=193%2c111&t=2.

[15] Ashvin Ahuja, Lillian Cheung, Gaofeng Han, Nathan Porter and Wenlang Zhang, "Are House Prices Rising Too Fast in China?", *IMF Working Paper*, December 2010. Available at: http://www.imf.org/external/pubs/ft/wp/2010/wp10274.pdf.

[16] *Ibid*, p. 27.

> in property prices should be regarded as a welcome development, giving household income an opportunity to catch up with housing costs. Nevertheless, the reliance on administrative measures – to contain leverage and curtail purchases – carries its own risks and could become less effective over time. A more durable remedy to China's propensity for property bubbles has to be firmly rooted in policies that raise the cost of capital, provide a broader range of alternative investment vehicles for savers, and institute a broad-based property tax.

A hard landing sometime in 2012, or perhaps in 2013, is still possible, depending upon external demand for Chinese manufactured goods and, as well, on the ability of the Chinese authorities to restructure the economy so that it can rely less on export demand and more on domestic consumption. This is examined more fully in the next section. In concluding the consideration of hard versus soft landing, the projections of China's economic growth, and its main components for the 2012 and 2013, are as follows:

Table 2. IMF Projections of Main Economic Indicators for China

	2011	2012	2013
Real GDP	9.2	8.2	8.8
Domestic demand (% change)	10.3	9.5	9.3
Consumption (% change)	10.0	9.6	9.6
Investment (% change)	10.6	9.4	8.9
Net Exports (contribution to growth)	-0.5	-0.9	-0.2
Inflation (average)	5.4	3.3	3.0
Current account (% of GDP)	3.3	3.2	3.8
General government balance (% of GDP)	-2.0	-2.0	-1.4

The projections are based upon the presumption that China's net exports will decline in 2012 and 2013 as a result a weaker global environment, especially in the Euro area. Additionally, small government deficits as a per cent of GDP are expected to occur as the Chinese government makes an effort to cushion the adverse effects on employment and incomes. This projected result is consistent with a soft landing in 2013.

2. Restructuring the economy away from reliance on exports for economic growth

For most of the past decade, the major inter-governmental organisations (such as the World Bank, the International Monetary Fund and the Asian Development Bank) recognised that China's services sector was underdeveloped and the ratio of domestic consumption to GDP was less than that for similarly situated nations. A major reason for both of these was China's persistent effort to "catch up" with the four Asian economies that experienced rapid industrialisation in the 1960s and 1970s, namely the Republic of Korea, Taiwan China, Hong Kong SAR and Singapore. China followed a similar strategy of export-led industrialisation with a government commitment to ensure that household income grew, but, at least for a time, at a slower rate than growth in investment and net exports.

The ratio of household consumption to GDP in China reached 55 per cent in 1981 and thereafter fell to 37 percent in 2008.[17] This ratio is the lowest in the Asian region. Since household income is equal to household consumption plus household saving, it follows that the savings rate increased over that period. The current rate places China at the lowest rank within the Asian region as well as among emerging markets. This is summarised in a working paper issued in June 2010 by the Bank for International Settlements (BIS):[18]

> The saving rate of China is high from many perspectives – historical experience, international standards and the predictions of economic models. Furthermore, the average saving rate has been rising over time, with much of the increase taking place in the 2000s, so that the aggregate marginal propensity to save exceeds 50 per cent. What really sets China apart from the rest of the world is that the rising aggregate saving has reflected high savings rates in all three sectors – corporate, household and government. Moreover, adjusting for inflation alters interpretations of the time path of the propensity to save in the three sectors. Our evidence casts doubt on the proposition that distortions and subsidies account for China's rising corporate profits and high saving rate. Instead, we argue that tough corporate restructuring (including pension and home ownership reforms), a marked Lewis-model transformation process (where the average wage exceeds the marginal product of labour in the subsistence sector) and rapid ageing process have all played more important roles. While such structural factors suggest that the Chinese saving rate will peak in the medium term, policies for job creation and a stronger social safety net would assist the transition to more balanced domestic demand.

Corporate savings consist of depreciation and retained earnings. In China, the former rose substantially during the past decade as a result of the sharp increase in the capital stock per worker with rapid rates of industrialisation. Retained earnings also rose, giving rise to comments from various analysts that China's large state-owned enterprises should remit dividends to the government.[19] However, the BIS paper indicates that the no-dividend

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[17] Emanuele Baldacci, Giovanni Callegari, David Coady, Ding Ding, Manmohan Kumar, Pietro Tommasino, and Jaejoon Woo, "Public Expenditures on Social Programs and Household Consumption in China", *IMF Working Paper*, WP/10/69, March 2010, p. 3. Available at: http://www.imf.org/external/pubs/ft/wp/2010/wp1069.pdf.

[18] Guonan Ma and Wang Yi "China's High Saving Rate: Myth and Reality", BIS Working Papers No. 312, June 2010, p. 1. Available at: http://www.bis.org/publ/work312.pdf. It was also published in *International Economics*, Vol. 122 (2010), pp. 5-40 and can be obtained at: http://www.cepii.fr/anglaisgraph/publications/economieinter/rev122/guonan.pdf. The former is preferable since it provides a better reproduction of the excellent graphs that accompanied the article. This is referred to hereafter as the Ma and Yi paper.

[19] For example, Emanuele Baldacci, and others, work cited in footnote 17 above. A somewhat different set of recommendations came from Mark Bake and David Orsmond, "Household Consumption Trends in China", *Bulletin*, Reserve Bank of Australia, March Quarter 2010, including policies to encourage the growth of small

policy was introduced by the Chinese government in 1994 with a view to containing the large financial losses that were being incurred by large state-owned enter-prises at that time, and with another view to encouraging these enterprises to provide displaced workers with social welfare support until a "functioning social safety net is in place".[20] Some corporate deleveraging is continuing, and additional social welfare functions by the state are needed, but already the no-divided policy is beginning to be unwound.

According to the BIS paper, government has been the smallest saver in China but a major contributor to the rise in national saving from 1992 to 2008, with an increase during the period from less than 5 per cent of GDP to 11 per cent of GDP.[21] This rise is attributed mainly to increased government income and relatively stable government expenditure. The savings were invested in anticipation of an ageing population that would require partial prefunding for a broadly-based, future pension benefits scheme, as well as greater healthcare facilities. This and other investments[22] by government will probably continue for the next several years, but the BIS paper suggests that these saving-investment activities during the past decade were instrumental in setting the stage for future provisions that are almost certain to be needed.

Household saving is the most controversial of the three components of national savings and also the most difficult to unravel. The main point that emerges from the analysis by Ma and Yi in the BIS paper is the existence of two competing influences – a 10 percentage point decline in income share by Chinese households and a 10 percentage point rise in the average propensity to save from disposable income. The fall in income share can be attributed to the relative gains by the corporate sector, the government sector and perhaps the rural sector. The last of these was the source of the large influx of migrant labour that most probably helped to contain rises in urban wage rates to less than increases in GDP. The jump in the average propensity to save is less easily explained, but household uncertainties during the large-scale restructuring of state-owned enterprises between 1995 and 2005 and similar uncertainties associated with the global financial crisis several years

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and medium-sized entities, increase social spending and reduce the focus on investment-led growth. Available at: http://www.rba.gov.au/publications/bulletin/2010/mar/index.html.

[20] Ibid, p. 12, note 7.

[21] Ibid, p. 20.

[22] A point raised by Ma and Yi that is often neglected in other studies is that China's administrative system rewards provincial and municipal officials on the basis of short-term performance indicators relating specifically to the economic growth of their respective jurisdictions. They therefore have a build-in tendency to invest heavily in infrastructure projects that are sometimes at the expense of the delivery of public services. However, as the stock of infrastructure capital builds up the contribution to growth from that source will begin to decline and thus encourage an increase in expenditure items such as healthcare, education and aid to those who are in need. *Ibid*, p. 23.

later, undoubtedly provided precautionary motives for increased household saving. A drop in all three of the following – (1) household debt as a percentage of GDP, (2) household disposable income and (3) household net worth – from the beginning of 2004 to the beginning of 2007 (slightly longer with household net worth) indicates that at least a portion of the increased saving went into debt reduction.[23] This is likely to contribute to increased household consumption in the near future.

The assessment in the BIS paper is more optimistic than either the IMF assessments mentioned previously or the recently released World Bank Report.[24] Part of this difference is associated with different institutional viewpoints. The Bank for International Settlements has central banks as constituents and the research staff tend to seek out sources of long-term instability in global monetary and financial transfer systems. The IMF's constituents are Treasury people and their concerns are principally to encourage those member countries to correct short-term macroeconomic imbalances in a timely manner, reduce inflation and undertake important trade, exchange and other market reforms that are needed to improve and support sustained longer-term economic growth. The World Bank is oriented toward aid to low-income nations with a view to reducing and ultimately eliminating poverty. These slightly different viewpoints will not necessarily create conflicts in the analysis and interpretation of existing situations, but it is likely that noticeable differences in interpretation will persist.

The answer to the question *Did China make progress in restructuring the economy away from its reliance on exports during 2011?* depends partly upon which of these viewpoints is particularly relevant. Perhaps more objectively, little was visible during 2011 to suggest that any change in restructuring occurred. But apart from a major collapse of the Euro area, if change does occur it is more likely to be toward a stronger consumption sector for China than a weaker one. Emphasis placed on the perceived need for such a change from internal sources in China, as well as from inter-governmental organisations, has certainly increased during 2011, and that may be sufficient to give it a high priority for the next several years.

3. Rising wage rates and the effect on China's reputation as a low wage nation

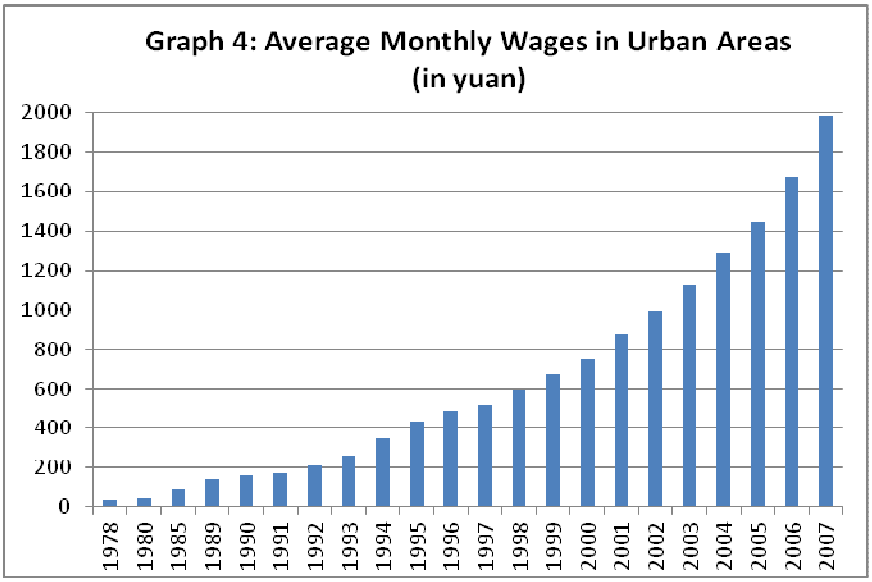
Average monthly wages of workers and staff increased continuously since 1978 and at an accelerated rate from 2000 to 2007 (Graph 4, on the next page). The source for the chart is *China Labour Bulletin.*[25] The original data came from the National Bureau of Statistics of

[23] See especially Graph 13 in Ma and Yi, *op. cit*., p. 20.

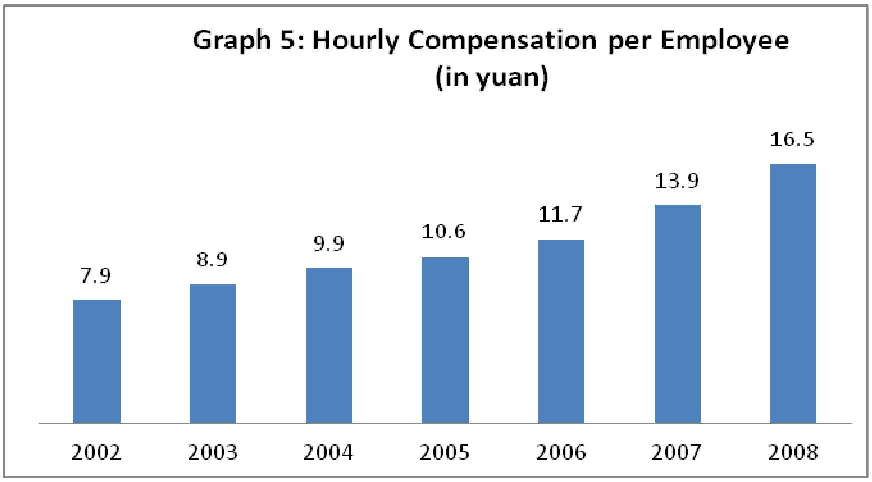
[24] The World Bank, *China 2030: Building a Modern, Harmonious, and Creative High-Income Society,* 2012. Available at: http://www.worldbank.org/content/dam/Worldbank/document/China-2030-complete.pdf.

[25] *China Labour Bulletin* is produced by a non-government organisation in Hong Kong with the same name. The document on wages in China is available at: http://www.clb.org.hk/en/node/100206.

China and probably consist of wages only (that is, with non-wage benefits excluded). A different data series from 1998 to 2008 is based upon estimates of total compensation for China's manufacturing employees including employer payments for workers' compensation, unemployment insurance, medical insurance and old-age pension (Graph 5).[26] Both series increase through their respective periods, but at different rates.



Source: See footnote 25.



Source: As per footnote 26.

[26] Judith Banister and George Cook, "China's Employment and Compensation Costs in Manufacturing Through 2008", *Monthly Labour Review*, (US Bureau of Labour Statistics), March 2011, pp. 39-52. Available at: http://www.bls.gov/opub/mlr/2011/03/art4full.pdf.

Perhaps of greater significance to China's competitiveness in the production of labour-intensive manufactured goods, is the report by *China Briefing* [27] that China now has the third highest labour costs in emerging Asia. This seems to suggest that China may already have lost its competitiveness. However, the calculations were based upon the average minimum wage per worker plus the average mandatory welfare contributions of employers. While this may have baseline significance as an average cost of labour, it cannot be said to represent overall competitiveness. China has 33 provincial levels of government, consisting of 22 provinces, 4 municipalities, 5 autonomous regions and 2 special administrative regions, each of which has a different minimum wage and may have a number of differences in relation to mandatory contributions. Similarly, India currently has 28 states and 7 union territories. A comparison of competitiveness between China's provinces and India's states would be more meaningful than a comparison with national labour markets that are constructed (rather than observed) by calculating averages.

As a result, different data with different methods of averaging will almost certainly produce differences in the assessment of competitiveness. For example, IHS Global Insight reported that India's manufacturing labour cost were greater than those in China in 2010.[28]

> Total labour costs in India's formal manufacturing sector are expected to average US$2.68 per hour in 2010 compared to China's US$2.51. Basic wages have risen fast in India over the last year, but still lag behind China—India averages US$1.71 per hour, to China's US$1.82.

IHS Global Insight notes that this is a peculiar event since it followed large increases in wages in India. It is expected that India will experience less rapid increases in the near future so that India's wages will be less than China's, but in saying that it is necessary to rely again on trends that are composed of averages.

Theoretical literature adds important information to the analysis of China's continuing status as a low-wage nation. It is generally recognised that wage rates in the rural sector are less than those in the urban sector, but this will have a significant impact on the level of manufacturing wages only if a substantial number of the lower-wage earners are willing and able to obtain higher-paying employment in China's cities. This has of course happened on a large scale with the percentage of Chinese living in cities increasing from approximately 18 per cent in 1978 to 50 per cent in 2011. This change in percentages is not unprecedented in East Asia as the urban population in South Korea grew from 14.5 per cent to 65.4 per cent between 1945 and 1985, and it reached 83 per cent in 2010.[29] The magnitude of China's

[27] Chris Devonshire-Ellis, "China Now Has Third Largest Labour Costs in Emerging Asia", *China Briefing*, 19 January 2012. Available at: http://www.china-briefing.com/news/2011/01/19/china-near-top-of-the-list-for-wage-overheads-in-emerging-asia.html.

[28] "Indian Wage Inflation to Eclipse China in 2010 as GM India Ends Strike on Pay Issues – Report", IHS Global Insight, 11 February 2010. Available at: http://www.ihs.com/products/Global-Insight/industry-economic-report.aspx?ID=106593653.

[29] The figure for 2010 is from the Asian Development Bank, *Key Indicators for Asia and the Pacific*, 2011, Table 1.3. It is available at: http://www.adb.org/Documents/Books/Key_Indicators/2011/pdf/Key-Indicators-

rural-to-urban migration is nevertheless unprecedented in terms of the number of such migrants as a result of China's large population.

It is likely that China's urbanisation rate will continue to grow beyond 50 per cent due to continued rural-to-urban migration. However, there are several reasons to expect future movements of people within China will make a smaller contribution to the maintenance of low wages in China's labour-intensive manufacturing, as compared to the past. All of these reasons revolve around the likely *decline* in the rate of rural-to-urban migration. First, as suggested by two labour economists at the Chinese Academy of Social Sciences, the surplus pool of agricultural workers, which is commonly believed to be about 200 billion, or 40 per cent of the agricultural workforce, could be little more than half of that amount, according to their calculations.[30] Second, more than half of the estimated surplus labour in agriculture is aged 40 years and over, indicating that they are likely to be less prone to migrate to cities, compared to those in the younger age groups.[31] This may be at least partly responsible for the resurgence of township and village enterprises (TVEs) since 2000.[32] These enterprises provide employment for a substantial amount of surplus agricultural labour and are generally located in small towns so they comprise separate labour markets and therefore act as an alternative to rural-to-urban migration. A third factor is the likely decline, in the near future, of China's working age population. This is due to the decline in the birth rate and to longer life expectancy in China.

All of these factors have the effect of maintaining the upward trend in wages and eventually this will eventually affect China's competitiveness with other nations having relatively large populations, such as India (pop. 1,182.1m) Indonesia (pop. 243.2m), Pakistan (pop. 166.2m) and Bangladesh (pop 146.2m).[33] For the next several years the rise in the real wages of migrants is likely to continue to be more rapid than the growth in real GDP, as has happened in the recent past. However, there is no reason to expect the gap in the two rates of growth to increase, and it might even narrow as China focuses slightly more on the quality of economic growth and less on the pace of economic growth.

2011.pdf. Other figures are commonly found from online sources such as Wikipedia, though differences are noticeable depending upon the primary sources and the definition of "urban" that each nation follows.

[30] Fang Cai and Meiyan Wang, "A Counterfactual Analysis on Unlimited Surplus Labour in Rural China", *China and the World Economy*, Vol. 16, No. 1 (2008), p. 53.

[31] *Ibid*., Table 3 on page 56.

[32] Bingqin Li and Xiangsheng An, "Migration and Small Towns in China: Power Hierarchy and Resource Allocation", Working Paper 16, (Working Paper Series on Rural-Urban Interactions and Livelihood Strategies), International Institute for Environment and Development, July 2009, Figure 9 page 21. The "resurgence" was possible as a result of a *decline* in the number of TVEs during the 1990s due to a realisation of economies of scale by city-based, state-owned enterprises that undertook both organisational and financial reform. These economies of scale continue to exist but the supply of better infrastructure and other incentives initiated by county-level governments helped to reverse the downward trend. This reversal is not likely to continue indefinitely, however.

[33] Asian Development Bank, *Key Indicators for Asia and the Pacific*, 2011, Table 1.1 Midyear Population, p. 134. Available at: http://beta.adb.org/key-indicators/2011/main.

A Brief Overview of Major Economic and Social Changes During 2011

The 7.5 per cent target for GDP growth in 2012.

Like other changes discussed in this section, the drop from a target of 8 per cent growth to 7.5 per cent is more subtle than many analysts realise. For a start it is not a forecast, as some have suggested.[34] Rather it is regarded as a threshold target for the rate of growth, below which the Chinese authorities would have difficulty in maintaining social stability.[35] Perhaps of greater significance is the fact that the new 7.5 per cent rate is *higher* than the the target rate of growth for the five-year planning period beginning in 2011,[36] which was 7 per cent:[37]

> We have set a target of 7 per cent annual increase in the economy over the next five years with significant improvement in the quality and performance of economic growth. Based on 2010 prices, the country's GDP in 2015 should exceed 55 trillion yuan.

The same document cited in footnote 37 gives a different target rate of growth for the current year under the heading "Work for 2011":

> The major targets for this year's national economic and social development are as follows: to increase GDP by around 8 per cent, further optimise the economic structure, keep the CPI increase around 4 per cent, create more than nine million new urban jobs, keep the registered urban unemployment rate at 4.6 per cent or lower, and continue to improve the balance of payments situation. Our main purpose is to create a good environment for transforming the pattern of economic development, and to guide all sectors to focus their work on accelerating economic restructuring and raising the quality and results of development as well as on increasing employment, improving the people's wellbeing and promoting social harmony.

Examining a similar statement in the work plan for 2012 reveals a difference that is of greater importance than the 0.5 percentage points drop in the annual target (Italics are added to the original translation):[38]

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[34] For example, see Matthew Kidman, "Taking Stock is About Picking the Right Theme", *The Sydney Morning Herald*, 12 March, 2012. Available at: http://www.smh.com.au/business/taking-stock-is-about-picking-the-right-theme-20120311-1usiv.html.

[35] This is stated in a similar way in "Year of the Tortoise: China Seeks (Slightly) Slower Growth", *The Economist*, 10 March 2012. Available at: http://www.economist.com/node/21549977?fsrc=nlw%7Cnewe%7C3-8-2012%7Cbusiness_this_week.

[36] At the end of the 10th five-year planning period, the name of the document was changed to "guideline" " (Chinese: 规划; pinyin: *guīhuà*) rather than "plan". See Wikipedia at: http://en.wikipedia.org/wiki/Five-year_plans_of_the_People's_Republic_of_China. However, it continues to be translated as "plan".

[37] Wen Jiabao, "Report on the Work of the Government", speech delivered at the Fourth Session of the Eleventh National People's Congress on 5 March 2011, p. 16. Available at: http://online.wsj.com/public/resources/documents/2011NPCWorkReportEng.pdf.

[38] Wen Jiabao, "Report on the Work of the Government", speech delivered at the Fifth Session of the Eleventh National People's Congress on 5 March 2012, p. 10. Available at: http://online.wsj.com/public/resources/documents/2012NPC_GovtWorkReport_English.pdf. Note that links

> The main targets for this year's economic and social development are as follows: to increase GDP by 7.5 per cent, create more than 9 million new jobs in towns and cities, keep the registered urban unemployment rate at or below 4.6 per cent, hold increases in the CPI to around 4 per cent, increase the volume of total exports and imports by around 10 per cent, and continue to improve our international balance of payments. At the same time, we will make further progress in industrial restructuring, innovation, energy conservation, and emissions reduction, and ensure that both urban and rural residents' real incomes increase in line with economic growth. Here I wish to stress that in setting a slightly lower GDP growth rate, we hope to make it fit with targets in the Twelfth Five-Year Plan, and to guide people in all sectors to focus their work on accelerating the transformation of the pattern of economic development and *making economic development more sustainable and efficient, so as to achieve higher-level, higher-quality development over a longer period of time.*

Apparently, Chinese authorities decided that achieving the objectives denoted with Italics in the above statement may require acceptance of a slightly slower pace of economic growth, which can be justified since it is expected to yield "higher quality over a longer period of time". Details as to how this is likely to be achieved will hopefully emerge during 2012.

For the first time in history a minority of Chinese now live in rural areas

China's urbanisation rate (urban population as a per cent of the total population) passed the 50 per cent level during 2011.[39] This was discussed in more detail in the previous sub-section. Attention here is mainly on the effect of the change.

There is a concern that as the rural population contracts they will be increasingly "marginalised" and ultimately become part of a social and cultural fringe. During the recent meeting of the National People's Congress some of the deputies urged the government to narrow the cultural gap by encouraging more cultural workers to become engaged in China's countryside and by ensuring that rural residents continue to get access to the same or similar cultural services and products as are enjoyed by city dwellers.[40] For example, the percentage of China's rural residents who had access to the Internet in 2007 was only 5.1 per cent, compared to 31.6 per cent in urban areas.[41] This could change substantially in the future, particularly if the central and provincial governments work together in improving telecommunication services to China's more remote and more sparsely populated areas. Per capita disposable income of urban residents in 2011 increased less rapidly than the equivalent income figure for rural residents, 8.4 per cent compared to 11.4 per cent,

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to these two reports in Chinese and links to other related documents are available on the Chamber's "G20 Monitor" at: http://www.accci.com.au/g20.htm#china.

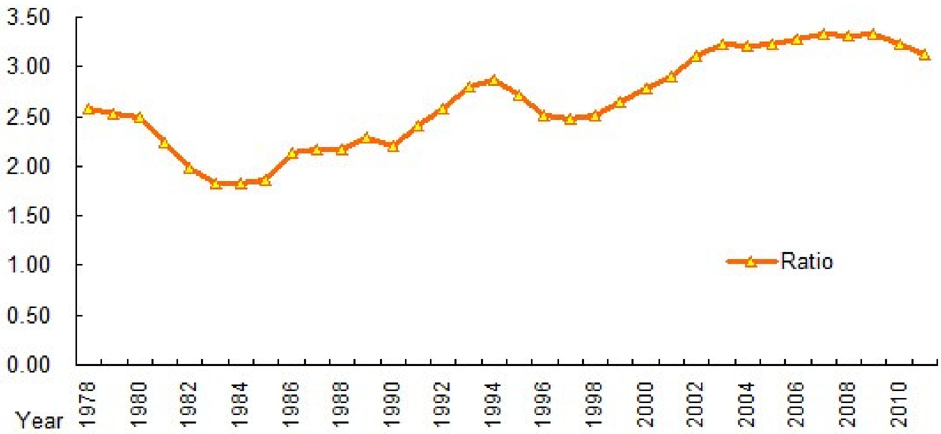
[39] Matt Rosenberg, "China's Urban Population Now Exceeds 50% of Population", Bloomberg News, 17 January 2012. Available at:

[40] Liu Lu, "Deputies: Narrow Urban-Rural Cultural Gap", *China Daily*, 11 March 2012. Available at: http://www2.chinadaily.com.cn/china/2012-03/11/content_14806267.htm.

[41] Internet World Statistics, undated. Available at: http://www.internetworldstats.com/asia/cn.htm.

respectively[42]. Nevertheless, an income gap persists so the distribution of income is likely to remain in favour of urban residents for some time (Chart 6). Continuing improvements in rural-urban inequalities will remain a pressing need for China.

Graph 6: Income Gap Between Urban and Rural Residents



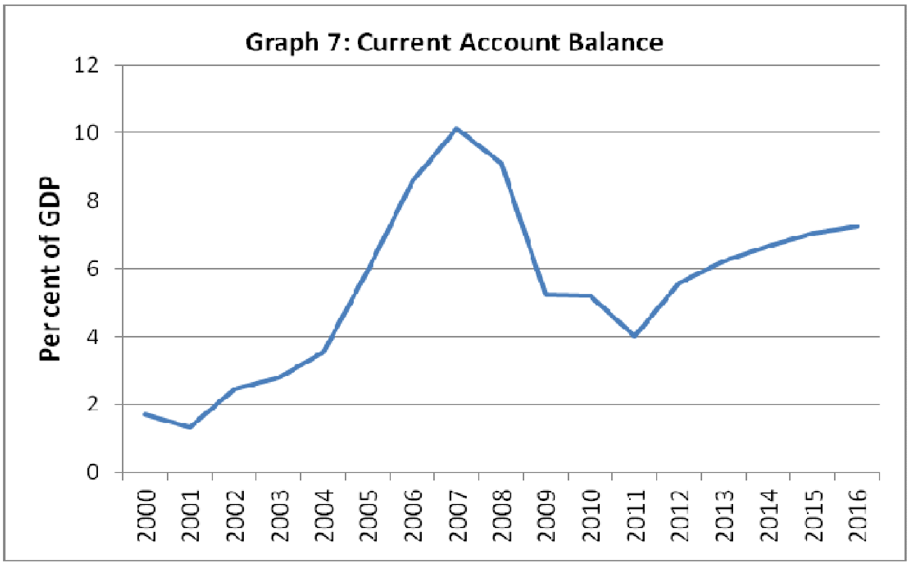
Source: National Bureau of Statistics of China, "Income of Urban and Rural Residents in 2011". 30 January 2012. Note that personal disposable income was used for urban incomes, whereas net income was applied to rural residents and was defined as total rural household income minus household operating expenses, depreciation of fixed assets for production, taxes and fees paid, and gifts to non-rural relatives. Available at:
http://www.stats.gov.cn/english/pressrelease/t20120130_402787464.htm. .

China's Trade Surplus

China continues to experience a sizeable trade surplus, reported to be US$201.1 billion for 2011. The relevant change from the previous year was the fall in China's net exports in 2011 for only the third time since 2000. The statistics are preliminary and are therefore subject to change, but the figure for the 4th quarter 2011 was US$ 59.8 billion, which is down 41.5 per cent from the US$102.2 billion a year earlier. China's international reserve assets increased by US$ 12.4 billion in the 4th quarter, which is much lower than US$91.7 billion during the previous three months.[43] IMF projections for China's current account balance show an upward trend beginning this year, but it is much flatter than in the period for 2004 to 2007 (Graph 7).

[42] Wen Jiabao, op. cit, footnote 37, p. 1.

[43] Xinhua, "China's Current Account Surplus Narrows Sharply in 2011", *People's Daily*, 10 February 2011. Available at: http://english.people.com.cn/90778/7725971.html.



Source: International Monetary Fund, *op. cit*. in footnote 3. Values for China current account balance after 2012 are IMF estimates.

China and the Inter-Governmental Organisations

The current Deputy Managing Director of the International Monetary Fund (IMF) is Min Zhu and he is a native of China. His academic training in economics was concentrated at Johns Hopkins University, after receiving a BA degree from Fudan University and an MPA from the Woodrow Wilson School of Public and International Affairs at Princeton University. He served as special advisor to the Managing Director of the IMF before being appointed to his current position, and was also Deputy Governor of the People's Bank of China.[44]

The World Bank's 468-page report, entitled "China 2030",[45] was co-written by the Development Research Centre (DRC) of the People's Republic of China. *The Economist* suggested that "the DRC is an influential organisation which supplies the government with policy advice. The finance ministry was also involved. A deputy prime minister, Li Keqiang, who is expected to take over as prime minister from Wen Jiabao, is thought to have played an active role in arranging this co-operation between officialdom and the bank".[46] *The Economist* also suggested the following in the same article:

> The World Bank is viewed with suspicion by [Chinese] hardliners, who see it as a meddler in the affairs of developing countries and a purveyor of ideas that could undermine party rule in China. With a semi-official stamp of approval on it

[44] Biographical information from the IMF is available at: http://www.imf.org/external/np/omd/bios/zm.htm.

[45] World Bank, "China 2030: Building a Modern, Harmonious and Creative High-Income Society", 2012. Available at: http://www.worldbank.org/content/dam/Worldbank/document/China-2030-complete.pdf.

[46] J.M. "2030 Vision: China and the World Bank", *The Economist*, 28 February 2012. Available at: http://www.economist.com/blogs/analects/2012/02/china-and-world-bank.

> [through the DRC], the report will be less easy for conservatives to dismiss as part of a Western plot. In turn, it's believed, the DRC used the World Bank as cover in its discussions with foot-dragging bureaucrats ("Don't blame us for these proposals, blame the bank"). At times, behind closed doors, the DRC argued for even bolder reforms than the bank itself was suggesting.

Apart from Chinese hardliners, we suspect that Chinese policy makers are cautions about advice given by Western economists who know little or nothing about Chinese culture and institutions. Neo-classical economic theory, after all, does not include shift variables to account for different cultures and institutions. Markets are expected, in theory, to perform the same in China as in Western countries, but this does not always carry over as expected with businesses and households, where marginal propensities, among other things, may differ markedly. Culture does matter but economic theory has not developed a satisfactory way of making it matter. Thus, some degree of suspicion remains.

What evidently has changed during 2011 is the willingness of China's leaders to work within inter-governmental organisations rather than outside them. Moreover, the swinging door from Chinese universities and Chinese institutions to Western universities and then to inter-governmental organisations is beginning to operate on a steady basis. A similar door is also beginning to swing in the opposite direction. Late last year, the Chinese government began their "Thousand Foreign Experts" program, which is designed to attract up to 1,000 foreign academics and entrepreneurs during the next 10 years to help improve China's capacity for research and innovation.[47] The program is aimed at transferring Western knowledge and culture to the Chinese, with hopefully some of China's culture being acquired by the experts through experiences they gain working in China. The important point is that these two processes were initiated by, and are controlled by, the Chinese. Perhaps for Westerners this is an additional barb on the hook mentioned in the opening of this review – not only do data points sometimes change faster than debating points, but the failure to grasp cultural differences may render ineffective debating points that would otherwise be well-informed.

[47] Liz Gooch, "Chinese Universities Send Big Signals to Foreigners", *The New York Times*, 11 March 2012. Available at: http://www.nytimes.com/2012/03/12/world/asia/12iht-educlede12.html?pagewanted=1&ref=education.