

Times MBA Podcasts Week 7 - Fan Gang: Understanding the Chinese economy

My name is Fan Gang. Actually, the family name is Fan. I'm a Professor at Peking University and the Chinese Academy of Social Sciences and I'm a director of China's National Economic Research Institute. We conduct research into macroeconomics, development policy and reform policies.

I'm going to talk about the issues around China's development and reforms. First of all, we should keep in our mind that China, on the one side, is a low-income developing country. Its per capita income was still under \$2,000 by the end of last year, 2006. There is still 40% of the labour force working in agriculture. At the same time, China is an economy in transition which shares similar problems with the former Republics of the Soviet Union, the Eastern European countries - problems like the State-owned enterprises, the legacy of the planning system, the control of the government, the political system, corruption. So that means normally other countries have one side of the problem, either a developing country or an economy in transition, but China has two sides. We have the normal problem of a poor country - the rural society, unemployment, income disparity, all those kind of things - and at the same time you have the problem of planning a formal planning system. All those problems are interrelated to each other, twisted to each other to create more problems.

At the same time, China is a large territory country with a large population. So that also makes it quite different from other countries. Not only are the territories large but also it is a large continental country, which only has a small section of the coastline and a very far-reaching hinterland. That means we have problems with regional disparity, which are very difficult to deal with, unlike Japan or Vietnam, where the whole country is coastline. The geographic conditions in different places are so different. Then, there is the large population. In 20 years of development you can reach full employment but China has a 1.3 billion population with a 700 million labour force and at the beginning of a reform we have 80% of the labour force in the agricultural sector. Even if you create 10 million jobs a year, you still need -- well, so far we have relocated 250 million farmers from the countryside to the industrial sectors but we still need more than 200 million jobs. Even if you create 10 million new jobs a year, you still need another 20-30 years.

So that's the background we should keep in mind. So for such an economy, it's normal to see a lot of problems. You will see the difficulties for development and for reforms because there are so many interested groups in the economy and it's difficult to move things forward. Fortunately, our reform in opening up has been successful in the past 27, 28 years. That means China is now the fastest growing economy in the world. The statistics just came out showing that in 2006 China registered another record high growth, at a 10.7% GDP growth level. Inflation is low, 1.5%. Everybody now knows that China, growing very fast, now has already become the third largest trading partner in the global economy.

But then people always ask the question: how can this growth continue and how can those problems all work out during this process? And if people see these problems, people of course see the risks. Of course, from this point of view, all the developing countries are also called emerging markets because if they have the problems they have the risks and there is a possibility that tomorrow or next year something could go wrong, something could just stop or interrupt the

growth. But this kind of risk is something associated with opportunities. We cannot only have opportunities without the risk.

In many areas, we have to see if there are no problems, maybe there are no opportunities. Not only for the Chinese themselves, but also for the foreign investors. For example, people recognise China has a so-called comparative advantage of a low-cost labour force so a lot of the investment is coming to China for that purpose. But then, a lot of people complain about the small consumption market, about the low level of consumption and the small market size. But these two things are actually the same, because people's incomes are still low and that's a low labour cost but you have to be patient with the growth of the consumption and with the growth in market. At this stage of development, it is normal. The saving rate could be high and the consumption could be low. Even people consume because a majority of the population are still on low incomes so what they could afford to buy are very limited items and a lot of things are actually locally made. So China's imports increase very rapidly, particularly in terms of the consumer goods.

Another example is the capital market development. People now complain about the underdevelopment of the capital market, complaining about the still closed capital account, the capital control and the fact that international capital flows cannot move freely to make money in the Chinese market.

But look at it the other way. If the capital market is fully developed, the Chinese investors also are very strong, very competitive. Also you will have a lot of the risks in the market because of the weakness of the system. This year is the ten-year anniversary of the Asian financial crisis. That crisis just shows that if you have too much liberalisation of the financial market when your system is still weak, you may have very high risks. You have exposed the market to very high risks and you may not make very much money. On the other hand, if you have smooth transformation, if you have gradual liberalisation of the capital market and the financial system, all the investors in this system may make better money and may grow more smoothly in this whole process.

So we need to think about the risks and the opportunities together rather than only look for the opportunities but not the risks associated with it.

Another issue people think about are the problems affecting China's growth. People often ask why the problems cannot be fixed to enable better growth, but actually a lot of the problems can only be solved through the growth and through the process of development rather than fixing it before the development. That's a normal case also for developing countries. For example, we see the income disparity problems. In the long run, this could be of particular risk for the Chinese economy and for the whole society because we see the examples from other countries in history that the social disparity could interrupt the growth or make the country stagnate in the development.

But this problem can only be solved through growth, through job creation, through the long-term development of all kind of industries and service sectors. A lot of people think maybe we should have a social security system to deal with that. Establish first a social security system and you will speed up your development. That is never a good strategy. The social security system is very costly. That is something that has to be based on very solid development and very solid income growth.

If a developing country spends too much money on too many social welfare programmes, that will damage the whole process of the growth and it will stop the creation of jobs, and that will mean low-income people cannot get the opportunity to improve their income level. That will make the situation worse and create a permanent problem in the long run.

So, this problem can only be solved through the process of growth. Also the social security system itself is a process of development.

With other issues such as the legal framework, corruption, the financial sector supervision, you cannot just transplant other countries' system into your system and fix all the problems before your development, because the problems themselves evolve and the institutional development is actually based on that. Without the stage-by-stage development of those institutions, you don't even know how the legal framework should be established and to deal with all kind of problems.

A lot of people think a developing country should just follow the examples of other developed countries. Well, in some sense, in the long-run it's true. At different stages you need different institutions, different policies. Institution building is something that cannot be finished one day and it has to be a historical process associated with economic development. So, from that point of view, in some sense, it's normal for a country like China to have high growth and to have a lot of the other problems. Why I say this is because a lot of people think that the growth of China is not a normal situation. Some people think something must be strange or something must be wrong; if not wrong today, it could run into a crisis or run into the explosion of the problem tomorrow.

There are risks ahead. We have to say that. But if we see development as a risky process with the full range of the problems you may think this is a normal process and it may run into some kind of crisis or cycles. But the cycles and the crisis themselves are also the process of development itself. Also I talk of this because sometimes people just feel unable to explain why China can have this growth. A lot of people, based on their knowledge of modern economics and other theories believe only a perfect institution, a perfect system, a perfect market system, can generate this kind of growth; otherwise it would be abnormal. But I would say if you understand the history, not only the history of developing countries but the history of developed countries, you will see that in their different stages of development they also experience different kinds of problems. The current institutions of the system have been the result of development, and a result of the economy and society evolving. It is not something to take for granted. It is not something given at the beginning. Even the capital market in the United States still experiences the scandals, the corruption. They still need to have reforms of their institutions. That is the way to think about the development, particularly for developing countries. They are in a very difficult situation, in the sense that they are facing very, very serious and strong competition from the multinationals from developed countries, so they need to be more careful to deal with all kinds of risks in the process of development.

So from that point of view I will say you will continue to see problems in emerging markets like China or emerging markets in general, but they may continue to grow in the long run, not this year but in another 10 years, maybe another 20 years, and will continue to be developing. The future of the world will be in this emerging market because opportunities are in this market.

And for the young people, for the MBA students, I think we need to think more about the opportunities in those emerging markets and to work in those emerging markets.