

Portfolio Project, Option 1

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Current Economic Condition in China

Economic Growth

China's economy has grown significantly in the past 50 years. Since 1978, the country has grown at an average of nine percent GDP per capita (Pham, 2018a). This growth was due to China's Total Factor Productivity (TFP), its great amount of physical capital, and an expansive labor force (Pham, 2018a). The world's second biggest economy is reaching a slowdown point, but growth has been stable (Jamrisko, 2018). President Xi Jinping has been tasked with transitioning the economy from a low-wage export driven model to greater domestic spending (Jamrusco, 2018). The economy is shifting towards its expanding services and tech sectors to ensure its future growth (Pham, 2018).

China's state-owned enterprises (SOEs) receive preferential treatment when it comes to winning contracts. This can damage the private sector and discourages growth, however, it does allow for a strong infrastructure. China has set multiple infrastructure records including a high-speed railway system and multiple new airports (The Economist, 2012). In 2009, the China State Construction Engineering Corporation took on 5,000 infrastructure projects, earning it \$22.4 billion in revenue (The Economist, 2012).

China's SOEs are effective in advancing the country's technological infrastructure (The Economist, 2012). It boasts the largest mobile phone network in the world and the most reliable, as well as the world's largest number of internet users (The Economist, 2012). The country also plans on having an exceptional "Internet of things" in the future (The Economist, 2012). So far, the SOEs have gained their knowledge for innovation through acquiring international companies,

but President Hu Jintao announced in 2007 that the National Congress of the Communist Party (NCCP) were planning to improve independent innovations (The Economist, 2012). This meant that western companies were invited to China to build research facilities and the NCCP would invest capital into science and technology (The Economist, 2012).

These efforts to fuel innovation do not always succeed, as evidence has shown that SOEs are less productive than private competitors (The Economist, 2012). In fact, the more a country moves away from private companies towards SOEs, the more productivity goes down (The Economist, 2012). China has seen its fair share of successes with its SOEs, but it seems to be at the price of private companies. The odds are stacked against private companies, such as higher interest rates on loans, and less forgiveness for debt repayment. The SOEs also demand greater amounts of talent, leaving less talented workers for private companies.

Economic Data

GDP. China's Gross Domestic Product, or GDP, is expected to reach \$13.2 trillion in 2018 (Jamrisko, 2018).

Investment. China is investing heavily in its human capital, and college education rates are rising (Pham, 2018a). Over 25 million people enrolled in college in 2016 (Pham, 2016a). As education rates rise, productivity of skilled workers will rise, wages will rise, and as a result, profits will increase (Pham, 2018a). China has also accepted nearly \$170 million in Foreign Direct Investments (FDIs), which was primarily used towards manufacturing and the services sector (Pham, 2018a).

Debt. China has allowed its debt to pile up in order to invest it in commercial companies (Pham, 2018a). This method drives growth and profits alike (Pham, 2018a).

Inflation. Consumer inflation (CPI) has risen significantly in 2018. January's inflation was at 1.5 percent, but by February, that number rose to 2.9 percent (Focus Economics, 2018). This was the result of higher food prices around Lunar New Year (CNBC, 2018). This was the highest it has been since November 2013 (CNBC, 2018). Annual average inflation rose from 1.5 percent to 1.6 percent (Focus Economics, 2018).

Exchange rate. The Chinese Yuan is equal to .16 US Dollar. It has gained approximately nine percent against the US Dollar in the past year (Wu, 2018).

Trade and Export

China's economy has been primarily focused on manufacturing exports since it has an expansive human capital pool (Pham, 2018a). This trend is beginning to wane since the economy is shifting towards services and tech opportunities.

Economic Practices and Political Institutions

China's Economic History

In the mid-1970's, following Mao Zedong's death, China's economy was impoverished (BBC, 2006). Mao's intention was to create an economic superpower by consolidating rural farms and creating a state-controlled industry (BBC, 2006). His vision was to move out of poverty into a prosperous nation (BCC, 2006). Mao believed that the only way this was possible was to create a communist society that worked towards this goal as a collective (Reimer, Simon & Romance, 2014). At the time, China's economy was primarily agricultural, so he influenced rural workers instead of city-dwelling industrial workers to further his agenda (Reimer, Simon &

Romance, 2014). Once he mobilized them, he used guerrilla warfare tactics to defeat the Nationalist regime (Reimer, Simon & Romance, 2014). Once Mao's position was secured, his government gradually secured more control over the economy (Reimer, Simon & Romance, 2014).

At this point, the aforementioned collectivism of agriculture occurred. Farms were amalgamated and turned into giant communes, and natural resources were pumped into industry (BBC, 2006). Mao established the Chinese People's Republic and launched the Great Leap Forward which was meant to be a speedy economic and cultural reform (Dikotter, 2010). The reform ended up causing one of the world's worst famines - ultimately killing 45 million people (Dikotter, 2010). Much of the cause for the famine was Mao's insistence on mining resources to be used in heavy industry (Smil, 1999). The farmers were forced to mine instead of producing food, thus creating a massive shortage (Smil, 1999). Supply and demand for grain were nearly equal in 1958 (Smil, 1999). The food that was produced was shipped preferentially to the cities and to the ruling elite (Smil, 1999). Mao was prepared to make the sacrifice, as he felt that if more people died, there were fewer people to feed, so the surviving people had just enough (Dikotter, 2010). These reforms were cripplingly unsuccessful and caused more poverty than before.

Once Mao was no longer leading China, Deng Xiaoping introduced new economic reforms that were more sustainable than Mao's (Hirst, 2015). Farmers were once again allowed to sell their crops in marketplaces, and collective farms were restored to private ownership plots (Hirst, 2015). By 1984, food rationing was lifted in China, and the average per capita food supply increased (Smil, 1999). The Law on Chinese Foreign Equity Joint Ventures was

introduced which allowed foreign capital to enter China; allowing the economy to grow (Hirst, 2015). Once companies were allowed to keep their profits and dictate their own pricing, the GDP grew annually by 9.4 percent (Hirst, 2015). Finally, in 1990, the Shanghai Stock Exchange was re-opened and the country became a member of the World Trade Organization (WTO).

Throughout the 2000's, China experienced double-digit growth and enjoyed a booming economy (Minxin, 2012). China had relied on fixed asset investment and export, leaving little for household consumption (Minxin, 2012). The state led growth model has and still is causing favoritism towards state projects (Minxin, 2012). These projects are funded by taxpayer dollars, leaving less consumable income for households (Minxin, 2012). Experts advise Chinese leaders to pull back state control to stimulate a free economy at home. The overproduction and trade surpluses affect the global economy as well.

China is an excellent example of catch-up theory. Before Chairman Mao was in power, the country was poor and economically stagnant. Once Mao was in power and began shifting priorities and resources through The Great Leap Forward, the country experienced a short burst of economic growth. It quickly declined again, but sharply grew again once the Cultural Revolution was introduced. Following the disastrous famine, the economy once again took a nose dive. Once Mao was no longer in power and sustainable economic practices were instilled, China's economy enjoyed three decades of rapid growth. Once a threshold of rapid growth was attained, the economy showed signs of slowing growth, as it became a large, prosperous nation.

China's Political Structure - People's Republic of China

Political party. The People's Republic of China is a Communist Regime. It has 73 million members, making it the biggest political party in the world (BBC, 2018).

Politburo. The political bureau is made up of 24 men, with nine of them in the standing committee, who operate in secret (BBC, 2018). The Politburo influences the National People's Congress (BBC, 2018).

The National People's Congress (NPC). The NPC is made up of 3,000 delegates elected by China's provinces (BBC, 2018). 70 percent of the delegates are Party members, and their decisions are based on the best interests of the Party first, and the NPC second (BBC, 2018).

The Supreme People's Court and Supreme People's Procuratorate. The Supreme Court protects the law, but its duty is to the Party first (BBC, 2018). Individual rights are not observed (BBC, 2017).

President. President Xi Jinping has no limit on the term of his rule (Jamrisko, 2018).

The Discipline Commission. This commission influences the Politburo and the NPC (BBC, 2018). They ensure that there is no corruption or abuse within these two branches (BBC, 2018).

Party Elders. The Party Elders are also influencers of the Politburo and the NPC (BBC, 2018). This position is an example of China's patron-protege method of politics (BBC, 2018). They receive special housing, private bodyguards, secretaries, and drivers for their service as an Elder (BBC, 2018).

Influence of Macroeconomic Schools of Thought and Policies

Banking. The world's top four banks in assets are in China (Pham, 2018b). Profits in the private sector rose to 1.65 trillion Yuan, or \$240 billion US Dollars, in 2016, which was an increase of 3.54 percent (Pham, 2018b). They have outstanding Return on Investments (ROIs),

but do not have enough capital to cover risks (Pham, 2018b). The banks also suffer from bad debt because they loan to State Owned Enterprises (SOEs) who do not always pay back what they borrowed (Pham, 2018b). Those Non-Performing Loans (NPLs) are hidden to make the balance sheets look good (Pham, 2018b). The Asset Management Companies (AMCs) absorb the NPLs by purchasing them for full price (Pham, 2018b). The funding for these bail-outs came from selling ten year bonds that were issued to the state-owned banks (Pham, 2018b). The AMCs can borrow at cheap rates, and then lend out at high rates in order to revive the NPLs (Pham, 2018b).

Unemployment. Unemployment in China had dropped to 3.97 percent in 2017, despite fears that the number would rise with slower growth rates (Reuters, 2017). The country hopes to keep this number below 4.5 even as the government closes outdate industrial capacities (Reuters, 2017).

Income. China is still considered a developing country because its income per capita is still very low (World Bank, n.d.). There are 55 million citizens living in poverty in rural areas (World Bank, n.d.).

Population and Demographics

From 1990 to 2005, China's average annual growth rate was at 0.9 percent (Dowling & Valenzuela, 2010). Then, from 2005 to 2015, it was projected to grow 0.5 percent (Dowling & Valenzuela, 2010). The birth rate in 2005 was at 12 percent, while the death rate was six percent (Dowling & Valenzuela, 2010). The largest age group in 2005 was the 15 to 59 segment at 67.4 percent, and in 2050, it is projected that the age groups will be more spread out, however the largest group will again be the 15 to 59 segment at 53.6 percent (Dowling & Valenzuela, 2010).

As China has become a developed nation, the people have a higher life expectancy, which means slower growth (Dowling & Valenzuela, 2010). Women of China will produce fewer offspring because they are less available, as they are employed because they are educated (Dowling & Valenzuela, 2010).

Population policy experiment. Historically, Chinese culture believed that having a large family ensured prosperity and national strength (Jing, 2013). China's population was growing rapidly in the 1950's, which was a cause for much concern and anxiety for the government (Jing, 2013). They had realized that there was a threshold for population growth due to the finite amount of resources available (Jing, 2013). In response, economist Yinchu Ma developed a proposal for controlling the population's staggering growth rate (Jing, 2013). Ma submitted his Malthusian-based *New Population Theory* to China's First National People's Republic in 1957, however the idea of controlling the population's fertility was dismissed (Jing, 2013).

By 1979, the population had grown by 57 percent since 1949, so the *New Population Theory* was revisited (Jing, 2013). The Family Planning Leading Team was established, and began encouraging the population to have just two children per couple (Jing, 2013). The legal minimum age to marry was increased to 22 for males and 20 for females to further discourage multiple births (Jing, 2013). By 1980, the "one couple, one child" policy was put into effect (Jing, 2013). The population began to reject these strict regulations, so the government leveraged their position by threatening fines for non-compliance (Jing, 2013).

There were some allowances left for a second child in certain circumstances, such as the first child being a female in a poor family, both parents are single children, the first child has a disability, or one parent has a dangerous occupation (Jing, 2013). Following its implementation,

the Total Fertility Rate (TFR) decreased from 5.8 to 2.4, and by 2010 dropped to 1.18 (Jing, 2010). The population is projected to peak in 2026 at 1.395 billion people, and then slowly decrease after that (Jing, 2013).

Economic impact of the population policy experiment. With such a surplus of people due to the swift growth rate, the economy has relied on cheap, readily available labor (Jing, 2013). The workforce is aging however, so the country is potentially going to see a void in their manufacturing employment because of it (Jing, 2013). The economy is beginning to shift towards skilled labor and technology so that the void of unskilled laborers is less impactful (Jing, 2013). Education levels have increased with parents focusing their energy on a single child, which compliments the need for skilled workers (Jing, 2013).

While this part of the economy has begun to adjust itself, the economy as a whole has benefitted from the Population Policy Experiment (Hongbin & Junsen, 2007). There is a defined correlation between lower birth rate and slower economic growth (Hongbin & Junsen, 2007). The same could be said for a country that chose not to limit fertility though, because the birth rate will naturally fall as a country progresses. Once women are given the option to have an education and a career, the birth rate decreases.

Ethical considerations. The unintentional effects of the one-child policy will be felt for decades (Zraick, 2015). For instance, China's preference for male heirs has created a gender imbalance (Zraick, 2015). Also, when the population dropped due to the policy, it created a lack of younger people who could care for the larger elderly population (Zraick, 2015). Lifting the restriction will not necessarily lead to more births, either (Zraick, 2015). It has been in place for long enough

that society has adjusted and will still choose to have one child (Zraick, 2015). It is predicted that with a two-child policy, the birth rate will only increase to 1.8 per woman (Zraick, 2015).

The Population Policy Experiment did have a positive effect on the Chinese economy in the short run. However, it was not good for promoting a free society, as citizens were upset that the government would dictate fertility. The policy also caused lasting effects that will be very difficult for the country to overcome in the coming decades, such as gender imbalance and care for the elderly. The economy is inextricably intertwined with birth rate, and so, China can expect the birth rate to remain low because it is a developed nation. The country may experience some difficult times ahead, both socially and economically due to this policy's effects.

The UN projects that a quarter of its residents will be over 60 by 2030 (Jamrisko, 2018).

Trade and Trade Policy

Asia began as a protectionist trade regime, meaning that the percentage of wages, interest, profits, and depreciation are weighed against unrestricted foreign trade competition (Dowling & Valenzuela, 2010). The rate of production percentage is added to the foreign import as a tax (Dowling & Valenzuela, 2010). Most Asian countries protected their industries while they were new, but began to lift them as their production capabilities improved (Dowling & Valenzuela, 2010). Most tariffs however, are very high in most Asian countries (Dowling & Valenzuela, 2010). For some, this means a higher price for domestically produced products (Dowling & Valenzuela, 2010). FDIs can increase the domestic production for export by bringing in technologies that were previously unavailable to the country (Dowling & Valenzuela, 2010). These technologies were welcomed by Asian countries, despite tarriffs on other imports (Dowling & Valenzuela, 2010).

FDIs have increased in Asia from \$160 billion in 1980, to \$2,709.6 billion in 2007 (Dowling & Valenzuela, 2010). Trade regulations were relaxed over this time, which accounts for the increase in FDIs (Dowling & Valenzuela, 2010). It was also a time of rapid growth in Asia, as they were less developed industrially, which attracted FDIs (Dowling & Valenzuela, 2010). China and Singapore were the biggest attractants of FDI (Dowling & Valenzuela, 2010).

Environment

China's attitude toward the environment stems back centuries (Albert & Xu, 2016). Many dynasties would exploit natural resources, leading to famine and natural disasters (Albert & Xu, 2016). This pattern of behavior has been difficult for the country of China to reverse.

Life expectancy in China is lower now, due to the extreme air pollution (Albert & Xu, 2016). To the north of the Huai River, life expectancy is 5.5 years shorter (Albert & Xu, 2016). China is also the largest source of carbon emissions in the world (Albert & Xu, 2016). Coal is largely to blame for this, as China is the largest producer of coal in the world (Albert & Xu, 2016). Although this seems like an un-winnable situation, China's coal consumption and production has dramatically decreased, thanks to a slowing economy (Albert & Xu, 2016).

China's economic growth is being threatened by environmental damage (Albert & Xu, 2016). It is costing the country about three to ten percent of its gross national income (Albert & Xu, 2016). The cost of pollution is at about \$227 billion US Dollars, or 3.5 percent of GDP (Albert & Xu, 2016). It is also raising health care costs, as it contributes to 1.2 million premature deaths a year (Albert & Xu, 2016).

Summation of Findings and Recommendations

China's rapid growth and progress is impressive. It has gone from being a rural, agrarian, famine stricken country to the second largest economy in the world in just 50 years. While the Communist Party maintains its stronghold on the government, it seems that sweeping policy changes will not occur. This is a large disadvantage, as issues like the environment are not being attended to with the urgency they deserve. The environmental damage is a cause for unrest with citizens, which could mean political instability and lack of cohesiveness. The welfare of the people has been largely ignored with the Party's goals for growth being of primary concern. This is going to catch up with them, as environmental damage continues to stunt the country's growth.

The same is true for China's banking system. The practices that maintain positive growth ledgers are not only unethical, but destructive in the long term as well. If the NPLs are consistently swept under the rug, the bail-outs will eventually collapse. The corruption within the banking system must also be examined, because when corruption runs rampant, inefficiency occurs. Increasing transparency would likely help combat corruption within the banks. Citizens are unable to criticize or scrutinize the system, so unethical practices have increased.

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