

# Market Insight

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## China's Challenges

Nearly 100 years ago, English philosopher and mathematician Bertrand Russell, one of the first Western philosophers to visit and live in China, observed: "Chinese problems, even if they affected no one outside China, would be of vast importance, since the Chinese are estimated to be about a quarter of the human race. In fact, however, all the world will be vitally affected by the development of Chinese affairs, which may well prove to be a decisive factor, for good or evil, during the next two centuries. This makes it important, to Europe and America almost as much as it to Asia, that there should be an intelligent understanding of the questions raised by China, even if, as yet, definite answers are difficult to give."<sup>1</sup>

Even in 2012 definitive answers about China's economic trajectory and political and social evolution still may not be possible! But Russell's prescient observations about China's vital role in the global economy not only still hold true, but are more pertinent today than they were at the time of writing. While the China of 90 years ago was only "slightly industrialized but the industrial possibilities of the country are very great", it has evolved into a manufacturing and export powerhouse. Russell noted that "[t]he Chinese have it in them to give to the world a new contribution to civilization as valuable as that which they gave in the past." To do so, however,

Chinese policy makers must address formidable near- and long-term economic, political and social challenges in the coming decades, as we discuss in this paper.

### Recent Data Point to Slowdown

Recent months have seen the Chinese economy taper off from the breakneck pace of the past three years. In fact, the Communist Party of China recently lowered its target for the nation's 2012 growth rate to just 7.5%, down from its previous 8.0% target and markedly less than the annual growth rates of 9.0–10.5% experienced in 2009–11. China's growth rate came in just shy of 9.0% in fourth quarter 2011, lower than the previous quarter but still above expectations. Unlike the major advanced countries, China was not affected much by the global financial crisis — its growth trajectory remained intact, mainly due to fiscal stimulus, proactive policies and large-scale public investment projects. So far this year, however, economic data have been mixed, on balance suggesting that the Chinese economy is cooling somewhat after years of heady expansion.

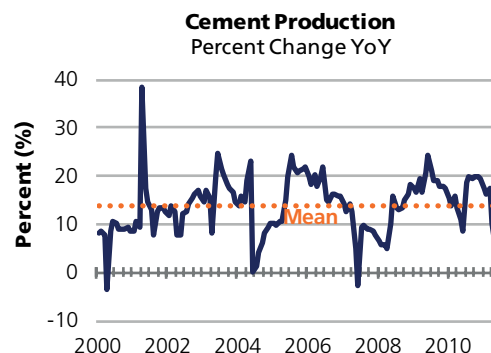
Purchasing managers' surveys in manufacturing and non-manufacturing sectors show that the Chinese economy is expanding less rapidly than last year. Both industrial production (see Figure 1) and electricity

**Figure 1: Industrial Production Has Continued to Expand**



Source: Reuters EcoWin

**Figure 2: Cement Production Has Slowed...**



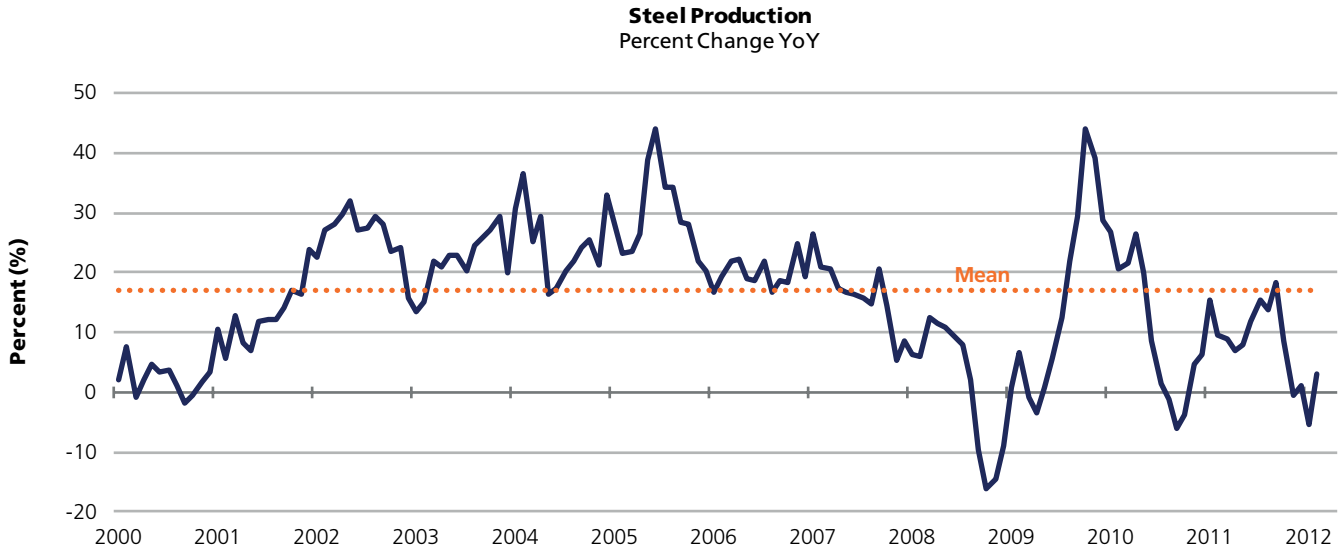
Source: Reuters EcoWin

<sup>1</sup> Russell, Bertrand (1922). *The Problem of China*, p.3, <http://www.archive.org/details/problemofchina00russ>

production have continued to expand. Per-capita consumption of cement has reached astonishing levels, reflecting the large — and unsustainable — investment in residential and non-residential structures, though growth in cement production has slowed

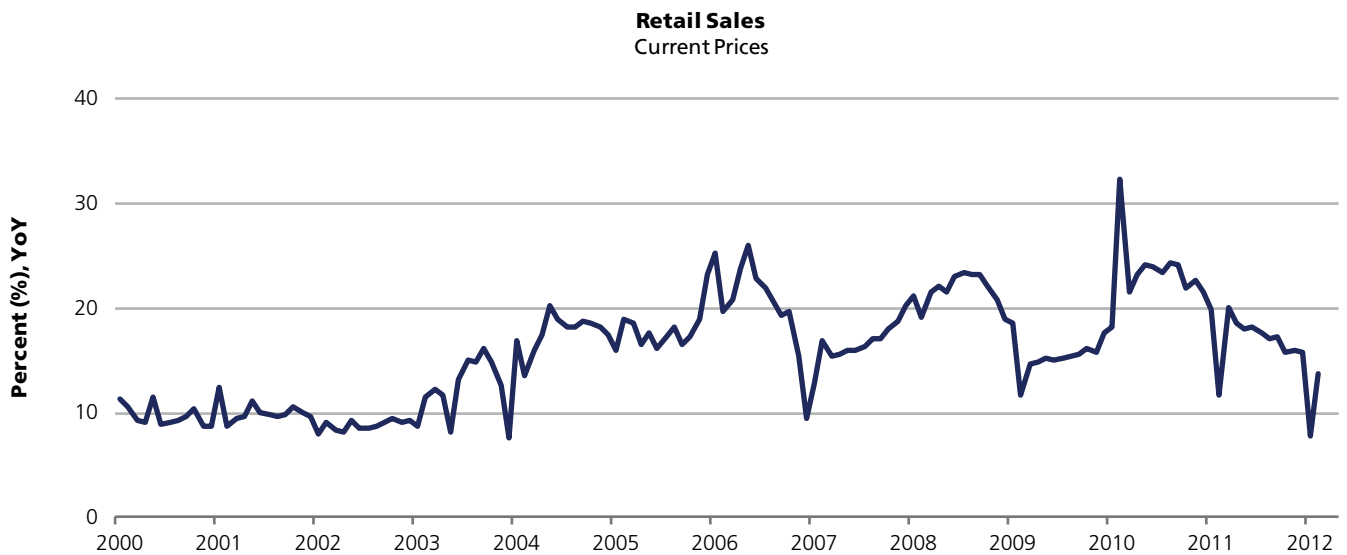
(Figure 2) as has steel production (Figure 3). Retail sales have been decent and continue to rise moderately, though they are less sturdy than they have been in the recent past (Figure 4); auto sales have exhibited a similar weakening trajectory after surpassing the U.S.

**Figure 3: ...as Has Steel Production**



Source: Reuters EcoWin

**Figure 4: Retail Spending Growth Is Less Sturdy Than in the Recent Past**

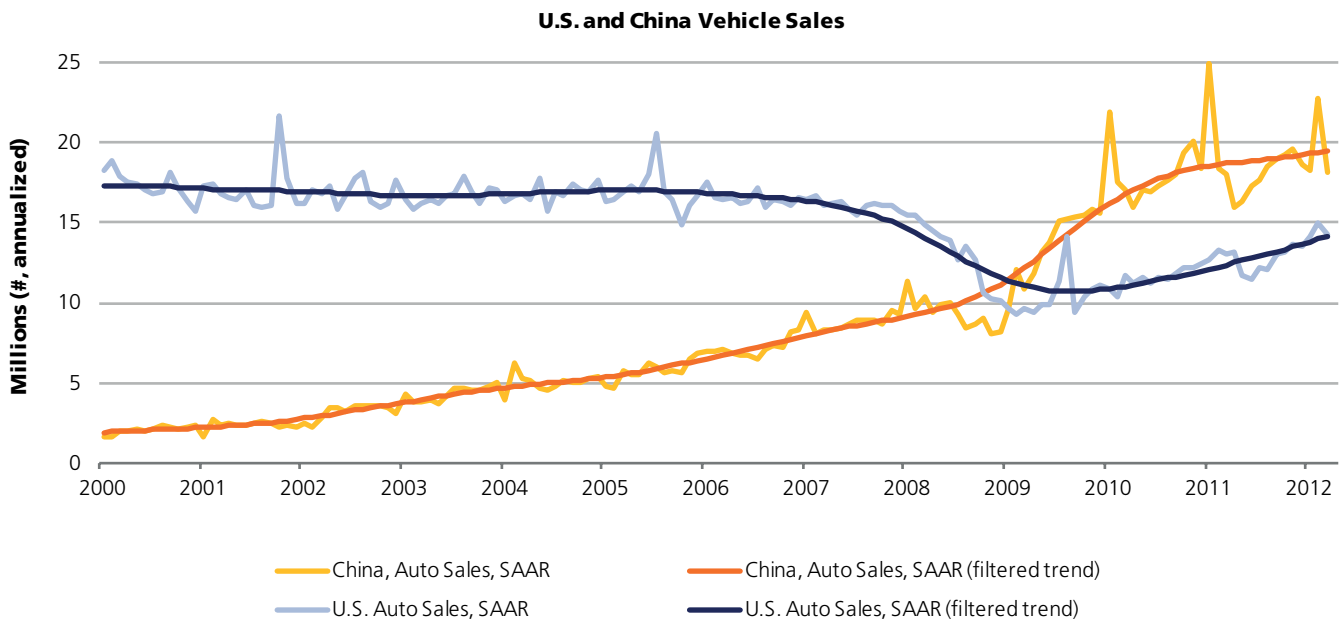


Source: Reuters EcoWin

in mid-2009 (Figure 5). Gasoline sales have continued to increase. House prices are adjusting (Figure 6), as signs of froth in the housing market — particularly in the high-end segment — prompted authorities to undertake measures to restrain speculative excess. House price appreciation has been slowing for the past year, and the push for low-cost social housing will not offset the slowing of private residential and commercial construction activity.

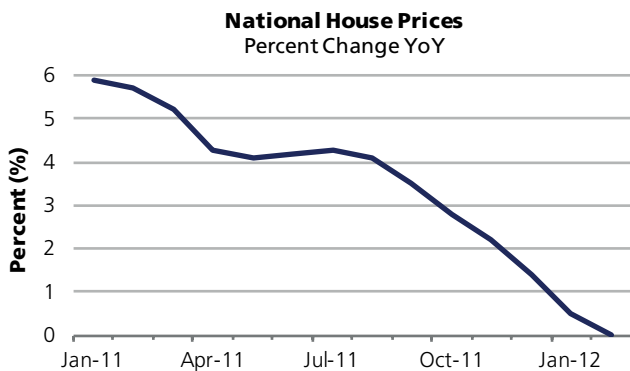
Monetary aggregates continued to grow in late 2011, but at a rate notably slower than in the previous two years. Meanwhile, credit expansion slowed late last year from its heady post-crisis pace, when the authorities boosted and directed credit to Chinese business and state-owned enterprises in order to counter global slowdown (Figure 7). In response to the tightening of monetary policy, short-term rates in the Chinese interbank markets have risen

Figure 5: Auto Sales in China Exceed Those in the U.S., Though They Appear to Be Plateauing



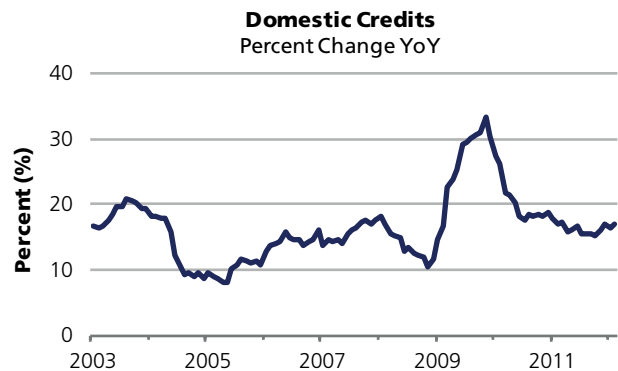
Source: Reuters EcoWin

Figure 6: House Prices Are Correcting



Source: Reuters EcoWin

Figure 7: Credit Growth Has Turned Fairly Tepid



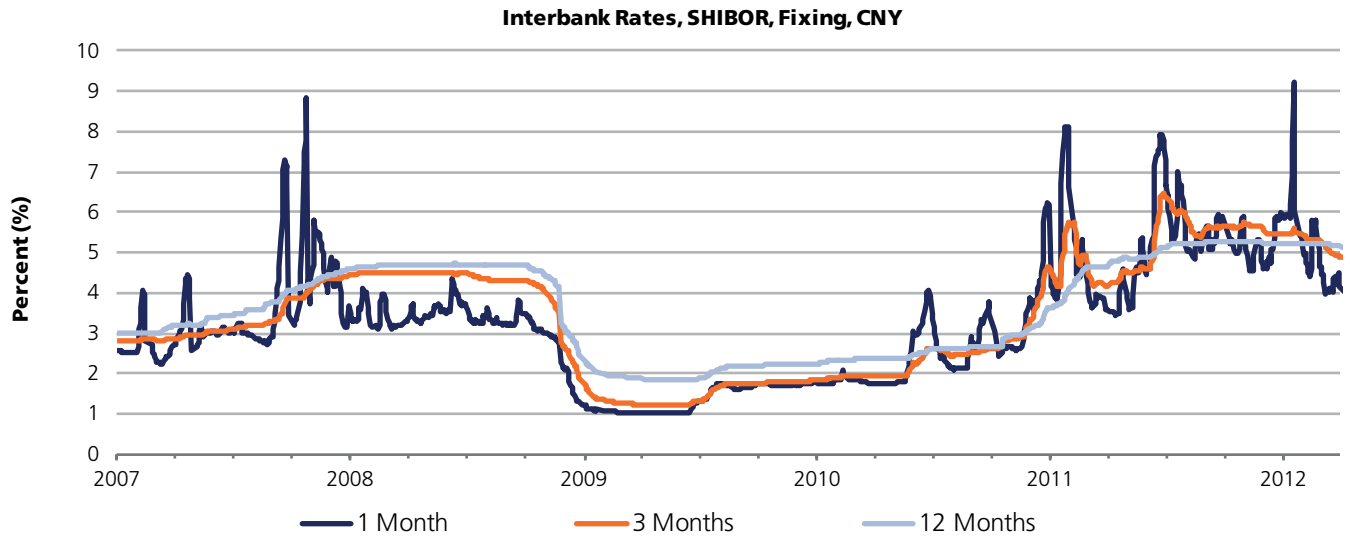
Source: Reuters EcoWin

gradually since late 2010 (Figure 8). The People’s Bank of China had tried to tighten China’s monetary policy beginning in late 2009 by raising the reserve requirements and lending rates; however, the central bank began lowering reserve requirements in late 2011 as credit had become difficult to obtain, particularly for private and small and medium enterprises. Though it is debatable whether the manipulation of the reserve requirement is an effective means for controlling overall credit growth, credit currently appears more restrained than it had been.

After rising sharply for two years, primarily due to the increase in food prices, inflationary pressures are still high and subsiding only slowly (Figure 9). Authorities will be challenged to balance their efforts between restraining inflationary pressures and promoting growth in demand.

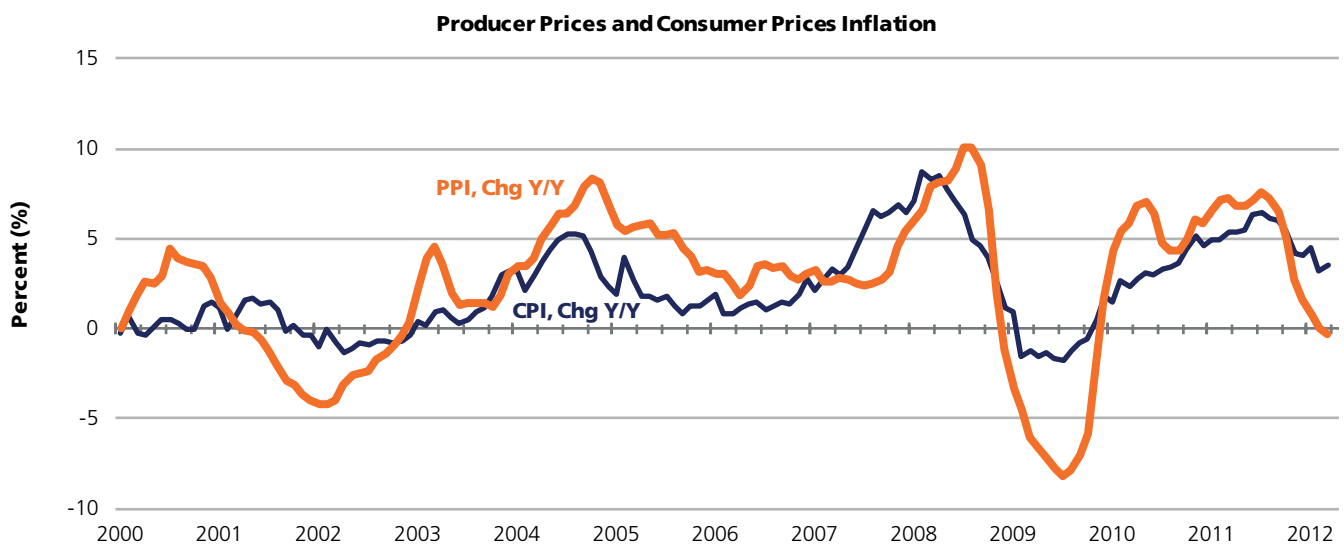
Chinese equity prices have adjusted downward amid concerns about the global outlook and signs of softer domestic demand growth. We believe expansionary trends in China will remain intact this year but moderate in the 7.5–8.5% range.

**Figure 8: Interbank Rates Had Been Rising Until Recently**



Source: Reuters EcoWin

**Figure 9: Policymakers Must Encourage Aggregate Demand While Keeping Inflation in Check**



Source: Reuters EcoWin

**China Faces Significant Structural Challenges**

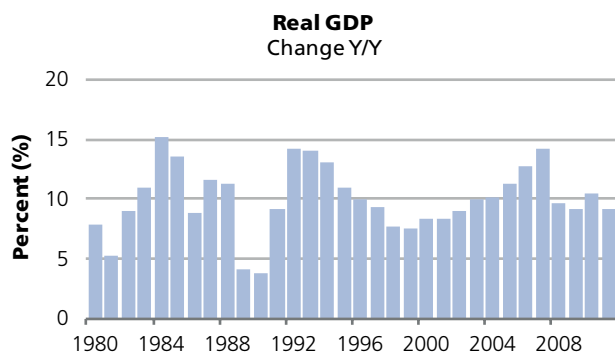
In spite of the economic cooling expected this year, Chinese economic progress since reforms were first introduced in the 1970s has been quite remarkable. The bold changes that post-Mao Chinese leadership instituted have resulted in massive transformation of the economic and social systems and fostered strong growth. However, Chinese policy makers face formidable near- and long-term economic, political and social challenges in the coming decades, as we discuss below.

**Economic growth.** Bold reforms have sustained strong growth in China over the years (Figure 10). From 1980 to 2011, China’s growth rate has averaged slightly above 10% per year, leading to a remarkable rise in annual per-capita income from \$200 in 1980 to nearly \$5,200 in 2011 (Figure 11) and lifting millions out of poverty. In 1990, nearly 80% of the population earned an income below the World Bank’s poverty threshold of \$2.00 per day; as of 2005, this figure stood at less than 40%.

The rise of China in the global economic system has been quite dramatic. China now boasts the world’s second-largest economy (measured using purchasing power parity GDP). Its share of global GDP has risen from 2% in 1980 to nearly 14% in 2011. China’s share of global exports (10%) exceeds Germany’s (8%) as of 2010.

Nevertheless, China’s 2011 annual GDP per capita of \$8,000 (measured in purchasing parity terms) is still low compared both with advanced countries such as the U.S. (\$48,000), Germany (\$38,000) and Japan (\$34,000) as well as with medium-income countries such as Argentina (\$17,000), Mexico (\$15,000) and Brazil (\$12,000). For China to catch up with high-income nations and to follow the success of Asian compatriots like Japan, South Korea and Singapore, it must invest substantially in science and technology, and research and development. China’s progress as an economic power will also require it to develop a national scientific capability and national innovation system.

**Figure 10: Bold Reforms Sustained Strong Growth in China Over the Past Three Decades**



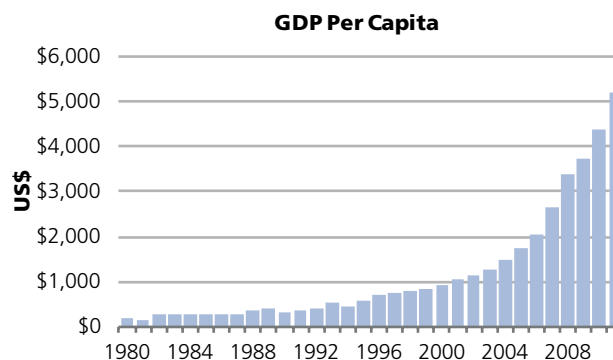
Source: Reuters EcoWin

**International relations.** China’s economic linkages with the rest of the world have increased multifold in recent decades. Chinese exports and imports constituted less than 10% of its GDP in the early 1980s and more than 25% in the late 2000s. Trade with China is vitally important for Asian countries such as Japan and Korea as well as for commodity producers worldwide. Japan exports more to China than it does to either the U.S. or Europe. For Australia, China surpassed Japan two years ago as the most important destination of its exports.

The U.S. runs a persistent trade deficit with China; over the past 12 months, the deficit amounts to nearly \$300 billion. Even though this large trade deficit benefits U.S. consumers and multinational corporations, it has been often a source of conflict, partly due to allegations that China keeps its currency undervalued as a matter of policy in order to give its exporters a competitive advantage. U.S. lawmakers — irrespective of their political affiliations — have complained about China’s de facto currency peg. Although every U.S. administration pays lip service to a policy of “strong dollar,” the current U.S. administration has been asking for yuan appreciation, which would result in a weaker dollar. The U.S. trade deficit with the rest of the world can be reduced through either weak aggregate demand in the U.S., strong demand in the rest of the world, a weak dollar or a combination of all three. Clearly, a weak dollar accompanied by strong international demand would be the preferred way to reduce the trade deficit, as opposed to weak domestic demand. While the U.S. manufacturing sector prefers a weak dollar for competitive purposes, consumers and the financial services sector prefer a strong dollar policy because it keeps import prices and inflationary pressures low and makes foreign assets cheaper to acquire.

Some analysts fear that U.S. pressure on Chinese authorities would tempt the Chinese to dump its holding of U.S. Treasury securities to the detriment of U.S. financial markets and global financial stability. China has indeed piled up huge foreign currency reserves, to the

**Figure 11: Per-Capita Income Has Risen Sharply Since 1980**



Source: Reuters EcoWin

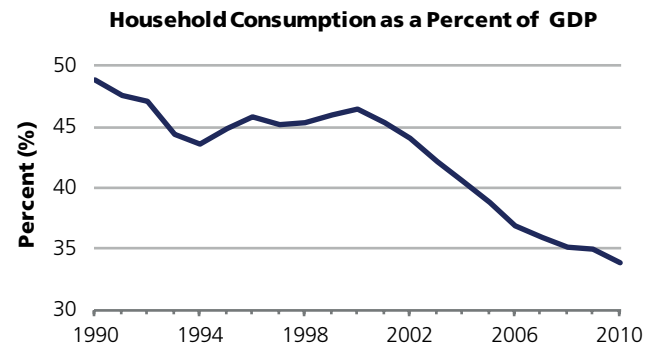
tune of more than \$3.2 trillion as of 2011, \$1.1 trillion of which are U.S. Treasuries. However, concerns that Chinese authorities would dump Treasuries are misplaced, as such action could raise long-term interest rates, which in turn would have an adverse affect on growth. And given that the U.S. is the destination of about 18% of Chinese exports, it is completely antithetical to Chinese interests to undercut U.S. growth. Moreover, the Fed could easily counter any increase in long-term interest rates through additional large-scale asset purchase programs, which would also result in dollar depreciation.

Inward foreign direct investment (FDI) has been a driver of China's industrialization and the modernization of its industry. FDI started to rise noticeably since the early 1990s. While inward FDI as a share of GDP has subsequently declined, China has continued to attract substantial FDI volume. While the main sources of FDI have been Hong Kong, Taiwan, Macau and various tax havens, the U.S., Europe and Japan are also sources, as are other East Asian countries including Korea and members of the Association of Southeast Asian Nations. Nowadays, most incoming FDI in China is in the form of wholly foreign-owned ventures, whereas equity joint ventures, joint development projects and contractual joint ventures dominated this subset of FDI in the past. Foreign multinationals are eager to establish their presence in China because they view it as both an important sales market and a manufacturing hub. They also want to retain control over their intellectual property and processes.

**Domestic demand.** Household expenditures as a share of GDP remain low in China (Figure 12). Indeed, household consumption as a share of GDP has declined from just below 50% as of 1990 to around 35% as of 2010. Even after controlling for its per-capita GDP, the consumption share is lower than in other countries, while its investment share is much higher. China has been making substantial investment in infrastructure projects related to electricity generation and distribution, post and telecommunications, and transportation.

China needs to rebalance its economy and promote domestic demand to improve its citizens' standard of living. Chinese authorities can boost private consumption through a variety of measures: reducing household income tax, raising transfers to vulnerable and low-income groups, enhancing social safety mechanisms and increasing public contributions to health and education. Medium-term reforms in pension, health care and education would improve the quality of life, enhance opportunities and promote equality for Chinese citizens. Liberalization of interest rates would increase deposit rates and boost financial income of households as banks and financial institutions would need to compete to attract household savings. Increasing the dividends paid by state-owned enterprises would benefit shareholders and households. Capital-market development would create a robust bond market, reducing the need for large corporate sector savings and provide an alternative avenue of financing for Chinese corporations.

**Figure 12: Household Expenditures as a Share of GDP Remain Low**



Source: Reuters EcoWin

**Social issues.** Disparity has increased since the beginning of China's evolution, seeding social unrest and potentially delegitimizing the economic transformation. Income inequality, as measured by gini coefficient<sup>2</sup>, has increased, as has the disparity in wealth. Meanwhile, regional inequality between urban and rural dwellers has increased. There are many causes of the rise in inequality in China. Eastern and coastal provinces benefited from transition, whereas Western provinces lagged. Rural areas initially benefited from reforms as agricultural incomes rose, but reform in the industrial sector spurred urban incomes to rise faster. Meanwhile, the rural/urban gap has increased as the state's role in the public provision of education, health care and other services has declined. Public policy has also contributed to increased disparity. While "eating from the same iron bowl" signified the importance of equality in the Maoist era, "it is glorious to be rich" became the slogan of reforms instituted by Deng Xiaoping.

**Employment.** In spite of strong GDP growth, employment growth in China has been low, and the creation of jobs will be a major challenge. Economic transition and the restructuring of state-owned enterprises have led to employment retrenchment in urban centers. Rural transition has resulted in dismantling of collectivization and efficiency improvement, rendering surplus labor in rural China, which has been only partially mitigated by the emergence of town- and village-based enterprise and the migration to urban areas. China will need to absorb significant surplus labor — about 300–400 million people — in the next 40–50 years.

State-owned enterprises still employ a large chunk of urban workers in China. The share of employment in manufacturing and services has been rising as China's economy has transformed. As suggested by the experience of Japan and Korea, future employment growth in China is likely to come mainly from the service sector as per-capita income rises.

<sup>2</sup> A gini coefficient of 0 means that everyone in the economy has the same income, whereas a gini coefficient of 1 means that only one person has all the economy. Therefore, the higher the gini coefficient, the greater the income inequality.

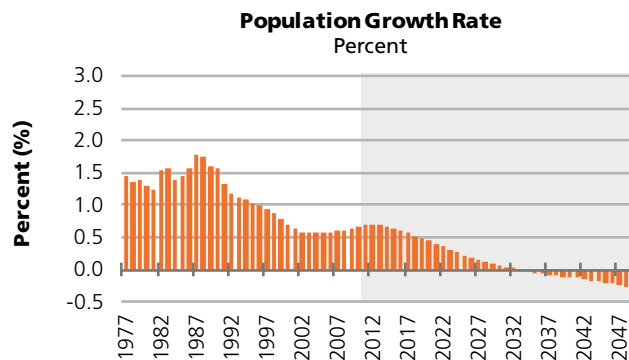
**Business ownership.** Business ownership remains an unsettled issue in China. While there has been growth of private enterprises both inside and outside of China’s special economic zones<sup>3</sup>, state-owned enterprises still play a vital role in the Chinese economy. There are different types of state-owned enterprises: national, provincial, and town and village. There has been partial privatization of state-owned enterprises in China, and many town and village enterprises (TVEs), which originated under local governments or cooperative ownership, were privatized. The share of state-owned enterprises in total industrial output remains fairly stable. There has been a shift from wholly state-owned enterprises to state-controlled enterprises. The issue of state ownership of industrial assets is not settled. State enterprises earn plenty of profits, but either retain the profits or provide it to the government.

**Banking/finance.** China’s financial intermediation system has developed rapidly, ensuring a high saving rate and a high investment rate, and there have been some fundamental banking sector reforms. However, since the major banks are state controlled, the banks provide disproportionate lending to state-owned enterprises. Equity and bond market capitalizations are still low. There is uncertainty about the efficacy of strategic partnership with foreign banks. China should try to avoiding the mistakes of “overfinancialization” and excess leverage.

**Demographics.** There have been remarkable changes in China’s demographics (Figure 13), as the country’s population growth has slowed dramatically due to the government’s one-child policy and rising per-capita income. China is currently benefiting from a low “dependency ratio” and a large working-age population. But this will change going forward, as China’s current working-age population enters retirement in conjunction with a decline in total population. In addition, China’s female/male ratio is markedly low. The imbalance in China’s female/male rate has worsened over time due to marked preferences of couples for male children and selective abortion of female fetuses; sociologists believe that such a marked imbalance in the female/male ratio can have harmful social effects in the long run. The authorities should consider relaxing the one-child policy.

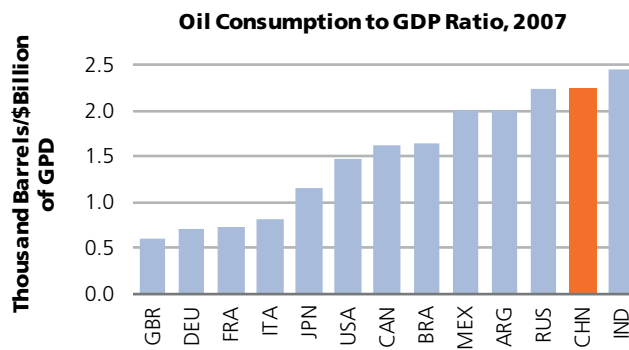
Meanwhile, China’s life-expectancy gains have been less impressive than its gains in income growth and poverty reduction. Reddy (2007) found that China’s life expectancy gains between 1980 and 2000 were achieved much more quickly by almost all other countries considered, and in particular by most lower middle income countries that had similar life-expectancy improvement.<sup>4</sup> Even those Chinese provinces that performed best over the period experienced rates of improvement that were significantly lower than those for comparable countries. It is clear that China needs to invest substantially in public health infrastructure to improve health outcomes as its population ages.

Figure 13: A Sharp Demographic Shift Is Approaching



Source: Bureau of Census, International Databasse; Reuters EcoWin

Figure 14: China’s Ratio of Oil Consumption to GDP is Very High



Source: Reuters EcoWin

<sup>3</sup> Special economic zones were created to attract foreign direct investment in China and to promote exports the goods produced in these zones.

**Energy.** China is not self-sufficient in terms of energy and faces the challenge of ensuring adequate access to energy resources. It also needs to improve its energy efficiency; its ratio of oil consumption to GDP is very high (Figure 14). It will need to ensure and safeguard its environment as it industrializes. China's share of world crude oil consumption has increased from below 3% in 1980 to more than 10% in 2011, and its carbon dioxide emissions already exceed that of the U.S. even though its per-capita CO<sub>2</sub> emissions are much lower (Figure 15 and Figure 16).

**“New Hope in the Moment of Greatest Need”**

It is worth recalling Russell’s sagacious observation: “The problem of transforming China into a modern country is a difficult one, and foreigners ought to be willing to have some patience while the Chinese attempt its solution... If they [the Chinese people] are left alone, they will, in the end, find a solution to their character...A solution slowly reached by themselves may be stable, whereas one prematurely imposed by outside powers will be artificial and therefore unstable.” This remains true as China continues its transformation. Foreigners — whether they are Treasury officials seeking rapid appreciation of the Chinese yuan, trade negotiators calling for increased imports of foreign goods to China, or human rights activists demanding better protection of labor standards — ought to have patience. Moreover, unlike in the era of imperialism, Western countries are not in a position to impose conditions on China.

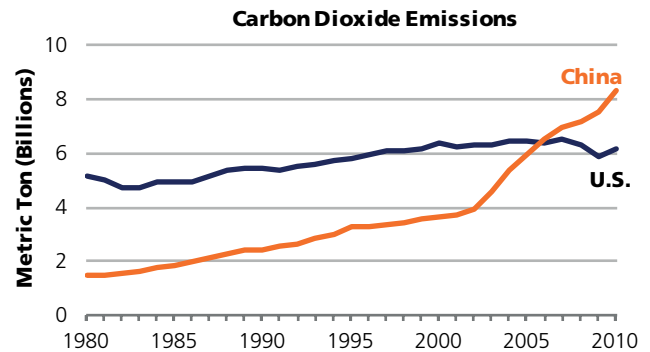
The major challenges facing China today are fundamentally different from those that Russell had discussed in 1922. Today, China’s key challenges are governance and regime stability; industrialization and modernization of the economy; mitigating increased disparity in incomes and wealth; human capital development, education and health care; managing the demographic transition; ensuring access to energy resources and improving energy efficiency; and safeguarding the environment. Russell had identified “the establishment of an orderly government,” “industrial development under Chinese control” and “the spread of education” as three requisites for China’s advancement.

If China’s leaders are able to address the country’s long-term challenges that have been discussed here, China will indeed have “played the part in the world for which she is fitted” and give to humanity “new hope in the moment of greatest need,” as Russell wrote many years ago. ■

**Acknowledgements**

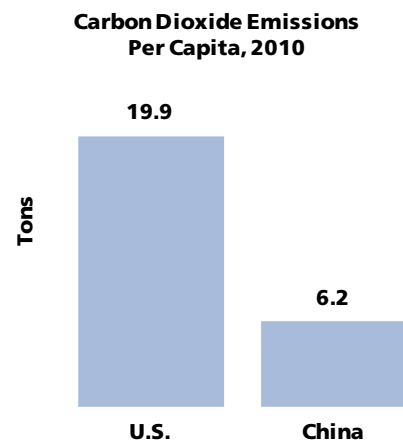
The author wishes to thank Tavis Barr, Xu Cheng, Lirong Li, Maggie Li, Jun Ma, Jayant Ray, Sanjay Reddy, Ernie Tang, Tao Tang, Jeremy Wohlberg, Julia Zhu and Yingli Zhu for discussions about China. He also wishes to thank Dan Donnelly for his editorial support and David White for the graphics.

**Figure 15: China’s CO<sub>2</sub> Emissions Are Higher Than Those of the U.S. ...**



Source: Reuters EcoWin

**Figure 16: ...but Its Per-Capita Emissions Remain Much Lower**



Source: Reuters EcoWin

<sup>4</sup> See Reddy (2007), “Death in China,” *New Left Review* 45, May-June, <http://newleftreview.org/?view=2669>



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