

China's Economic Rise & New Regional Growth Paradigm*

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It is my pleasure to be here and to have this opportunity to discuss China's economic rise and its new regional growth paradigm. Napoleon is quoted as saying, "Let China sleep." Let's see first whether or not the sleeping lion has woken up.

Understanding China's economic rise

I am sure you are all familiar with the figures. There has really been a big change for China. It saw two decades of high growth in gross domestic product (GDP) from 1979 to 2003. The average annual growth rate in GDP was more than 9%. Also, especially after the financial crisis in 1997, China continued to have a high growth rate, though there was a very short slowdown immediately after the financial crisis. This was still higher than the other economies in the region. GDP has been growing in yuan, as well as in dollars.

China's exports have also been growing annually at more than 20%. Inflows of foreign direct investment (FDI) have been more than US\$ 500 billion. FDI flows are moving generally upward. Last year China became the largest recipient of FDI, exceeding even the US.

All these figures seem to show that the sleeping lion has really woken up. Now we talk about China as a "power" and as a "big power". However, China has two faces. It's big in total size, but everything is small in *per capita* averages. GDP *per capita* is only about US\$ 1'000, ranking somewhere below 100th in the world. But as total sum, it's the sixth largest, and in foreign trade it is the fifth largest. In foreign exchange reserves, it is the second largest. China is the largest producer of an increasing number of goods. We are starting to talk about China as being the "world factory" for, not all, but for many, many goods.

All this suddenly happened in a very short time. Why have people paid so much attention to it? The main reason is that this growth has been very fast. Secondly, it has brought about structural changes in the region and to some extent in the world economy as well. Thirdly, everyone expects big potential from the Chinese economy.

* A transcription of a speech given at Distinguished Lecture forum on Tuesday, July 13, 2004.

Figure 1. China's GDP growth trend (in RMB 100 million)

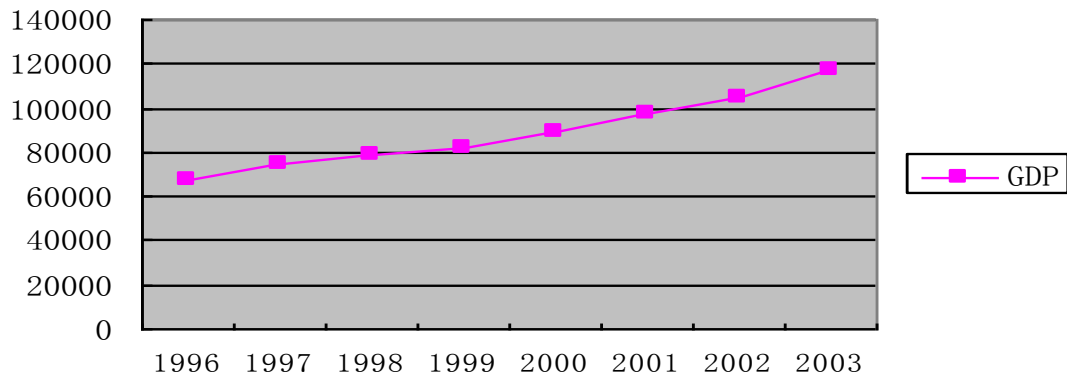


Figure 2. Growth trend in exports

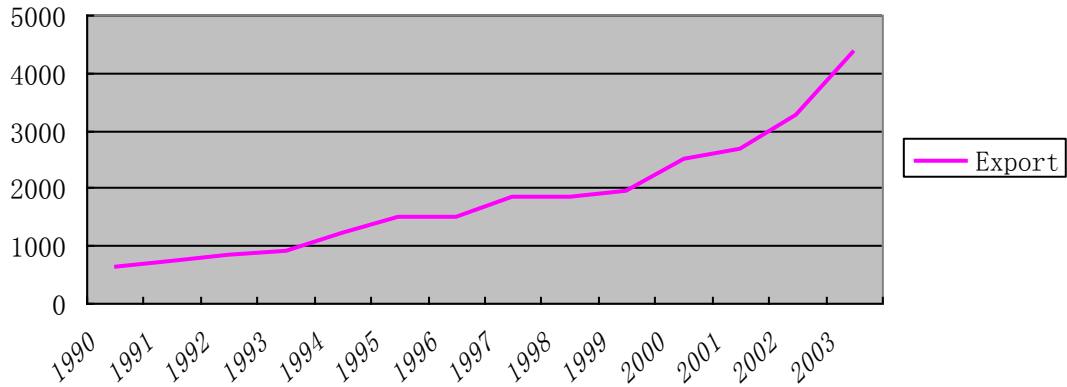
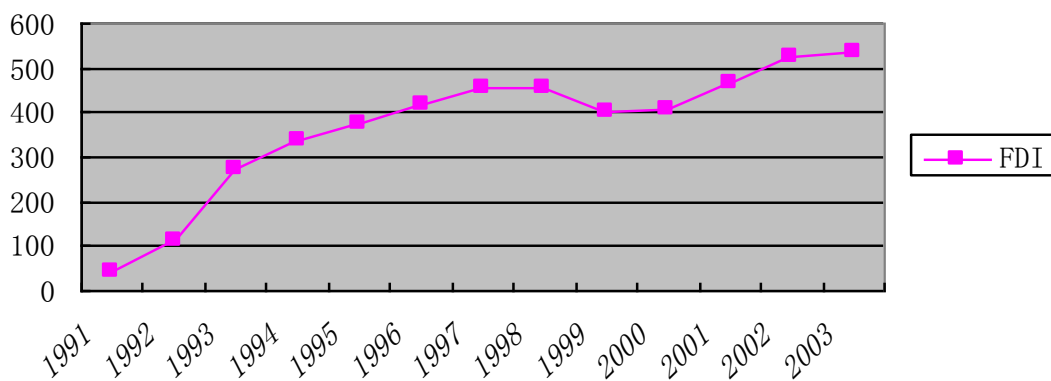


Figure 3. FDI flow to China (in USD 100 million)



The question is whether or not this trend can continue. The majority of Chinese economists are confident that this rising trend will continue for another two decades at the least. This is for several reasons. Potential is still there, even though the economy is undergoing a process of urbanization and structural changes. Japan, South Korea or the

four dragons experienced two decades of high growth. Considering China's larger size, the period of rapid economic growth can theoretically continue for at least double the time of those smaller countries. So at least another two decades of high trends is possible.

Just yesterday, the *People's Daily* published an editorial that, personally, I thought was some kind of memo made by one of the top leaders. It said, "We should be determined to have high growth for another two decades." So that's what the top leaders think. The people, especially the leaders, are confident about future growth possibilities.

As for foreign trade, any current figures you see have already left reality behind. Everything is developing so fast that yesterday's figures are today obsolete. Originally, foreign trade was expected to exceed US\$ 1 trillion next year. But I think it will actually hit that figure sometime this year. The first half of this year already saw trade worth US\$ 523 billion in exports and imports. So it will surely exceed US\$ 1 trillion this year. We will then have become the second largest trader in the world, after the US.

According to current GDP projections we will become the second largest economy in the world in sixteen years, by the year 2020. But, as I said, the average figure *per capita* will still be low in the ranks. That is China.

Those are the general figures of the Chinese economy, explaining why China has received so much attention from the world.

Is a "soft landing" possible?

The second large concern people have about China concerns the current situation and whether a "soft landing" is possible. There is still debate in China whether the economy is over-heating. Some economists argue that there is no over-heating at all, such as the famous economist Professor Li at Beijing University. Others argue there is over-heating.

In 2003, GDP growth reached 9.1% despite the severe acute respiratory syndrome (SARS). In the first half of the year, few people expected there to be such a high growth rate. The government was worried, people were worried, and starting in June a lot of measures were taken to stimulate the economy starting. That brought about the higher-than-expected growth rate.

This sudden high growth had two major effects on the economy. First, there was a shortage of supply. Second, future expectations rose. Because of the high growth and high profits, companies invested more for future profits. Fixed capital investments in 2002 were up 16.1%. Last year, growth reached 26.7%. During the first quarter of this year, it was 47.8%. This trend will continue to be much higher than people expect.

Concerning the money supply, in 2002, M2 grew by 16.8% and last year by 19.6%. In the first quarter this year it was higher than the 2003 figure.

In 2002 bank credit grew by 15.4%, and last year more than 20%. The numbers from the first quarter this year say growth will be close to last year's figure.

In the first quarter this year, GDP grew by 9.7%. In the first half this year, it is expected to reach 10%, even higher than last year.

The economy seems to be going up and up. That has created a shortage of electricity. Prices of raw materials and basic supplies, like steel, cement and aluminum, have all increased very sharply.

The high growth rate is good, but it is too high. The main problem is imbalanced growth. Too high growth depends on too high investments. There is a declining ratio of GDP to investment output. These days, the investment to GDP ratio is more than 40%. Secondly, there is only low growth in the rural, or "third", sector. Most of this investment comes from state-owned enterprises (SOEs), as they are subject to more relaxed lending rules.

There is some confusion about this. According to bank lending figures, credit lent to SOEs last year accounted for about one third of the total. But in terms of long-term investments, the SOEs have a much higher percentage. These figures are controversial. Because of figures from last year, some economists argue that it is actually the private sector that stimulated this sudden high growth of investment.

Personally, I think the main reason is that local governments started too many big projects. If you recall past experiences in the Chinese economy, since 1992 there has always been high growth rates immediately following the inauguration of a new government. There was an exception, though, in 1997 because of the financial crisis. At this time last year, we just had a new governments put in place at both the local and central levels. All these new bureaucrats tried to create high growth rates to show their ability and achievements. There were a lot of projects initiated by local governments.

After the financial crisis in 1997, local governments adopted what was called a "positive budget" policy. Local governments issued a lot of bonds to support their expenditures. But this was done without any strict credit controls. This worked until 2001. But then in 2002 the central government introduced a more relaxed monetary supply policy. At the same time, people were forced into mortgage loans and they were encouraged to consume, to buy cars and houses. Because of this, bank loans and especially consumption loans increased very sharply. Results from last year show that housing sales increased more than 30% and automobile sales close to 70%.

How to solve this problem? In about October last year, economists began debating whether or not the economy was, in fact, over-heating. In spring this year, when the National Congress was being held, the debates started again with renewed vigor. It is too dangerous to come to the general conclusion that the economy is generally over-heating. Some sectors are still seeing low growth. So the general conclusion for the policy makers is that over-heating is happening, but it's only partial. Only some sectors are over-heating, not the whole economy. This requires a more complex policy, one that can identify the different elements in the economy.

The remedies to these problems are mostly administrative, but which policies to use is still debated among economists. The central government mostly uses such administrative measures to stop local government-initiated projects. It wants to stop this kind of speculation in large investments where the local government, or the local administrators themselves, are hoping for big future profits. The central government, therefore, has re-evaluated many projects that had been previously approved.

In particular, the central administration tries to control land use. Many of these local speculative projects use a lot of land. So the central administrators start from that side. Another administrative tool is control of credit. There is a lot of bank credit—loans—involved in these big projects. In both of these ways, administrative rules can be used to stop local speculators through the re-evaluation of these projects. Several big projects have been re-evaluated and stopped. The local government officials and bankers involved were punished. The central administration can also use monetary policy. It can raise the reserve rate, for example.

There is debate nowadays about the possible results of these administration-oriented reform measures. Many people argue that it may create a vicious circle. After the first wave of administrative policy reforms, the trend might begin anew, with new projects being started at the local level. This will only lead to even more policies, and another wave of government crack downs.

They argue that the central government should use conventional methods to increase the interest rate. But it seems that, until now, policy makers are very nervous about raising interest rates. That could add to the banks' burden and exaggerate the situation of their bad loans.

Since this over-heating is only partial, some positive measures and policies are needed to continue to support particular sectors of the economy, for example, the rural sector, the western development projects, and the northeast renovation projects. Those will not stop. The central government will re-allocate a lot of funds to these projects which they think are still too weak.

So generally now, up until June this year, the figures seem positive. As investments continue to decline, and industrial output growth starts to decline, prices for major raw materials, like cement and steel, have all come down. This forces down the industrial sector. In April, growth was 19%. In May, it was 17%. In June, 16%. For five consecutive months, the industrial sector has declined. Last year, in June 2003, the industrial sector growth rate was 16%. Now this June it was 16% as well, close to the level last year.

This shows that up until now, confidence in the whole economy is still strong. These macroeconomic policies will not lower the general confidence level. Confidence still seems strong. Exports continue to grow very fast, at about 36% during the first half this year, and FDI flows seem to be even higher than they were last year when they were at US\$ 50 billion. The private sector also continues to rise.

The GDP growth rate this year was originally expected to be between 8.5% and 9.0%. But now most people think it may be 9.0% or 9.5% because during the first half of the year it was already 10%. That is higher than last year. But the overall economic structure is more balanced than it was in 2003. There are many good signs pointing toward a “soft landing”. Most people now think a “soft landing” is possible.

What is a “soft landing”? It is an economic slow-down without major pain. As long as your growth rate is still very high, it’s not necessary that you hurt yourself when you slow. Growth rates will still be very high in major sectors, but there are some worrisome signs for the future.

The most worrisome feature is the banks. Even though many projects have as yet only been half-financed, some banks have recorded the project as having been already completely completed. In their accounts, they show that they have gotten back all their money. So the number of bad loans may yet increase.

A second worrisome feature concerns small and medium enterprises. I just saw a report about Jiangsu Province. The provincial government gathered together entrepreneurs and other managers from small companies. The government wanted to hear their thoughts and to listen to their ideas. All the entrepreneurs complained. They said they could not get any sort of new credit from the banks, as the banks had said no to them. In their defence, the banks claimed that they had instructions from the central government to not provide any new loans to smaller companies.

This sort of thing happens because the central government uses harsh administrative measures to try to stop anything bad from happening. That is an old story in China; it is always the government that controls. When you have a tight policy from the top, during the immediately following period of time many things—bad and good—may be stopped by the government.

There are already some signs that the central government is considering this type of problem. Generally it will not stop its current tight policy, but it will make some different arrangements and consider individual cases, if possible, later in the year if things worsen.

If you follow these current trends, the Chinese economy will continue to rise. How can we understand China’s rise? It’s a big issue. As we have already seen, China’s rise is generally considered to be a positive factor. It is a positive contribution to the world and to the regional economies. We have all those figures which I just mentioned. But on the other hand, China’s rise is also a challenge. China becomes a strong competitor, not just at the low-end of the manufacturing spectrum, but increasingly at the high-end with value-added goods.

China’s rise provides a big market. China is a rapidly developing market with big potential. But people are still not certain about the long-term future. That is why we think this big potential comes with many uncertainties.

Because of the challenges and because China has been growing for two decades, the figures over the past three years suddenly became much bigger than before. We realize China's growth is too fast and too sizeable. China itself, the region and the world is not prepared for this new, emerging, giant consumer of raw materials and many other things. Some articles, for example, say that the major factor causing higher oil prices is China's demand. Suddenly, everything seems different because of this rise.

So everybody expects high growth rates. High growth rates are good. But suddenly we realized this high growth is not necessarily all good. There are so many new problems. However, let's start with China's rise as an opportunity.

China has become a big incremental factor that makes large contributions to the world economy. We have figures. One-fourth of the world's new growth is coming from China's growth. In particular, China has become a big importer. In 2003 alone, China's imports increased by US\$ 12.6 billion. That's more than half of the rise seen in neighboring East Asian economies. That is why all these economies feel China's strength. The size of this import bill is based, firstly, on exports. These are imports for exports. A lot of these imports are for exports of parts assembled in China. Only secondarily are these imports for domestic consumption.

As a competitor, the largest force we feel is the flow of FDI. The FDI is flowing into China rather than to other regions, especially Southeast Asia. Also, China has become the largest producer for an increasing number of goods. There are a number of goods where China accounts for the largest share of manufacturing in the world, especially in the US market and in competition with other developing economies. As I said before, China enjoys a special advantage in cheap and abundant labor. Not just that, but high-technology capacity is also on the rise.

This abundant labor will continue for some time into the future. Even Guangdong Province now feels pressure to bring in new flows of labor. Because of the abundant supply in the past, they did not raise wages. Other regions can now provide better wage levels. So workers move to other areas. This shows that Guangdong Province is highly reliant on low labor costs for its competitive advantage. Also, with its surging demand, China is a competitor for energy and raw materials. We still do not know the future effects if this trend continues.

As for challenges, there are challenges not just for others but for China itself. The largest challenge for China is its export led growth and resource-intensive production. We are realizing that this is not sustainable. The world cannot secure such high, continuous increases in such demand. Many people argue that Chinese GDP only accounts for 4% of world GDP, but consumes something like 20% or 40% of raw materials, or even 70% in some areas. These figures have suddenly gotten very huge. China itself has realized this is not sustainable. We have to change our ways. The leaders have called for some scientific development concepts to fix this.

Bank bad loans are also a big problem. In the past, the government set up special financial companies to reallocate bad loans. But there are new bad loans that have been created, based on the high expectations for the future which I already mentioned. But now banks can't get their money back. Competition is very, very sharp for the companies.

Another general challenge is transition. There is a transitional problem. Some areas are growing very fast and some areas are not. There are growing gaps. This can be seen in migrant labor. Large numbers of migrant laborers have no legal protection. In the past, the government policy focused too much on liberalization of labor migration. That has already been realized. The second following issue is how to protect them, their rights, their benefits, their welfare, and education for their children. All these kinds of things have happened suddenly. You need a system of support for the people.

Political reform is another challenge. There are many cases of corruption. How can you reform the political system? What model should we follow? The leaders realize that we need reform, but how? When? And what model should we follow? To be honest, there is no model we can follow. China is really quite different from any other country.

There are also challenges as many people are discussing power and whether China intends to revert to the "Middle Kingdom" or become a leader. Is there a possible conflict between China and the US in the future? How do we solve the Taiwan issue? All these kinds of things come to the table when China becomes powerful. How do we handle these issues? I leave the questions on the table and, I'm sorry to say, I don't have any answers to these many questions.

A new regional growth paradigm

Let me now turn to some positive views of my own. Has a new regional growth paradigm emerged? My answer is yes. It is emerging.

China's rise is different from Japan's rise and the rise of the four dragons. Japan did not receive FDI. It imported technology, produced it on its own, and re-exported. As for the four dragons, only the Korean case is the same. The other three are too small for comparison. But in the Chinese case, we have more than US\$ 500 billion in FDI. This FDI creates a horizontal network. All FDI is closely connected with investments in other economies.

Because of China's emergence, China has become a hub that connects all the investments in the region. Also, due to its size and potential, China may become a big market for the region. China could also change its pattern toward domestic demand-led growth. That pattern is possible.

There is an old growth model for the economies of East Asia: the "flying geese" model. In the 1960s it was Japan, in the 1970s the four dragons and in the 1980s the ASEAN four. If China were to follow that trend, in the 1990s it would be China. But that old growth model stopped. There was a capital flow from Japan to the four dragon countries

in about 1985. There was a capital flow from the four dragons to ASEAN in the early 1990s. In the past this created a chain in the region.

But there is one thing missing. East Asian economic growth is highly reliant on the US market. Japan exports to the US. The US is its largest export market, with a surplus. The four dragons export to the US, also with a surplus, and it is their largest market. Finally, ASEAN exports to the US with a surplus and it is their largest export market.

Japan became the second largest economy in the world, but failed to provide a growing market for the region. In terms of ASEAN-Japan trade, ASEAN has a deficit. In terms of the four dragons-Japan trade, the four dragons have a deficit. With the growing size of its economy, Japan has failed to provide a big market for the region. There is no market to support regional growth. So regional growth is highly reliant on an outside market, that of the US. It's not stable.

This is another possible explanation for the financial crisis. The crucial factor was that the market played a very important role. If you recall, before the financial crisis, most economies had a bad balance of trade. The trade deficit increased, which hurt confidence in the market. Also, Japan became a "fallen lead goose". So the chain of growth which I described was broken.

Now we have new hope with China's network of FDI. The FDI flows into China create a new network of production and services. China has become the hub for multinational corporations in the region. A new trade and investment trend has emerged. Intra-regional transactions have increased sharply.

China has seen an import surge. In 2003, China's imports increased by US\$ 12.6 billion and exports by \$ 11.3 billion. Also in 2003, China's imports from East Asia rose to \$250 billion, a rise of \$7.5 billion from 2002's figure.

China's new role, which used to not exist, is to reallocate resources and trade surpluses, especially from the four dragons. It is a hub for production networks, not just for exports but also for sale within China. It is a growing market for the region due to re-exports and increased domestic demand. If these emerging trends continue, it could become a potential investor in the region in the future. For instance, China's FDI outflow last year was US\$ 2 billion, according to statistics. We thought, though, it would be much higher than this.

If you look at Figure 4, you will see that in all cases exports to China from other East Asian countries increased from 1990 to 2002. It increased very sharply. Figure 5 shows the direction of China's trade in ASEAN, in Korea, in Taiwan and elsewhere in the region.

Figure 4. Changing export shares to China

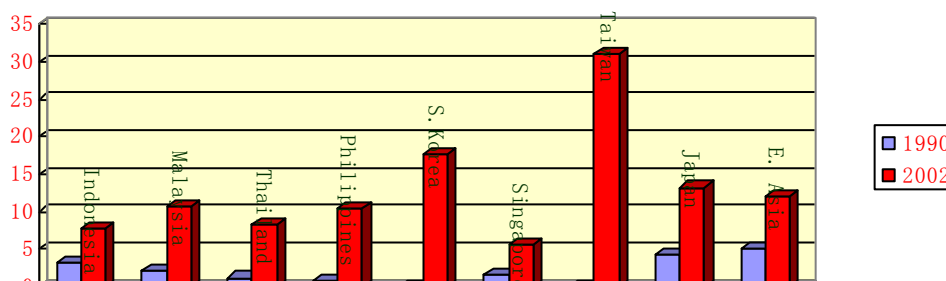
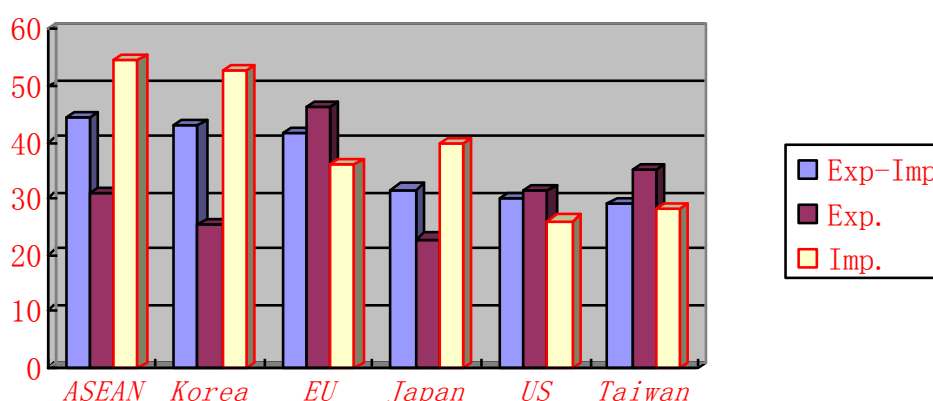


Figure 5. Direction of China's trade (2003, growth rate)



Below, Figure 6 reflects a study done by the Asian Development Bank (ADB). It looks ahead to 2020 and assumes that China will continue to play the role which I described: reallocating the trade surplus of nearby economies. The study assumed that China would continue to gain the surplus from the US, the EU and the rest of the world, and then reallocate this surplus toward East Asia; toward ASEAN, the newly industrialized countries (NICs) and Japan.

Figure 7 shows to some extent the clear positive relationship between China's economic growth and that of the rest of the region. China's figures are actually a little bit higher than this, because this is a prediction based on the 8.5% GDP growth *per annum*. So the lines are a little too low in this chart. As we can see, China's growth pattern is largely similar to that of the region this year.

Does a new pattern or trade emerge? Yes, but we still need more time. It is emerging, it has not yet emerged. The US market is still important, but exports to the US are stagnating and even declining for most economies. The total sum is still big, but the trend is declining. This shows that its role is declining for the region.

Figure 6. China's trade balance: Capital contribution to the region (2020, ADB)

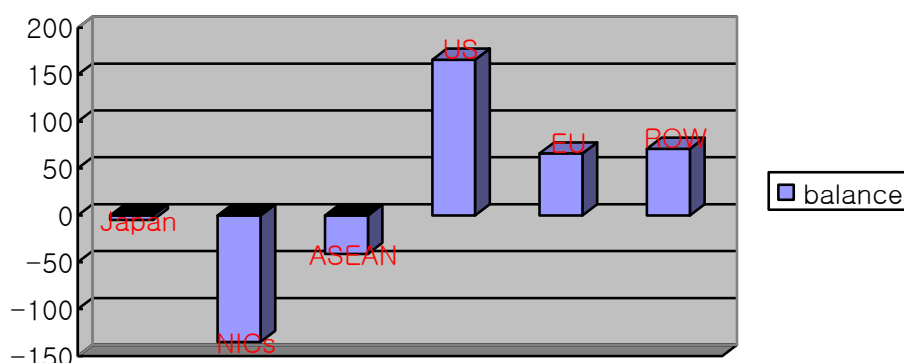
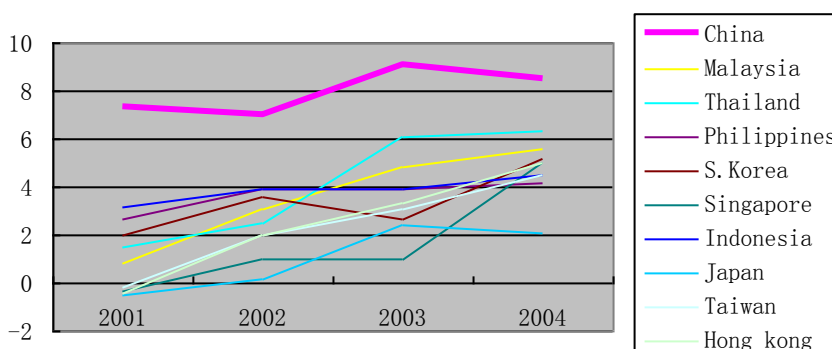


Figure 7. A clear linear line: Growth of China and the region



This new FDI network creates a stable and increasing market for the region. The most highly growing part is intraregional trade. China emerges as a big market for exporters with huge potential for the future. If this current trend continues in China, Asia may establish a new growth paradigm, which we have lacked during the past experience of the so-called East Asian “miracle”. The “miracle” too highly relied on the US market alone. Now, because of China’s economic rise, we are starting to create a major market for the region which may set a stable foundation.

The nature of the new growth pattern is different from the traditional top-down model. Because FDI is horizontal and has a division of labor, it creates multiple processes among the many economies in the region, not just one or two economies. The process of production can happen in many countries. The intraregional process can begin to happen.

Wealth distribution has been decentralized. Its kind of a parallel development. Some economists call it a “bamboo” economy, because you have one kind of production

activity, and then suddenly some more follow, increasing the trend upward and upward. This intraregional trade and investment is continuing to grow. This is different from the top-down “flying geese” model.

Does regionalism help? We are discussing East Asia’s regionalism. This emerging regionalism is based on economic integration and economic cooperation. There are all kinds of different multilayered FTAs now in progress. In the past, this regional economic integration was highly based on the market performance itself. But there was a lack of policy support and there were a lot of obstacles that hurt the efficiency of transactions. What we need now is policy support through government arrangements, through these FTAs.

These multilayered agreements will find a way to coordinate and create an East Asian FTA in the future. We cannot solely, or mainly, rely on the region itself. East Asian FTAs follow this new open regionalism, different from Asia-Pacific Economic Cooperation (APEC). APEC regionalism is based on unilateral liberalization open to all. But here it is through arrangements. This does not prevent East Asian economies from making other arrangements with other regions.

Hope is there if we successfully converge all these multilayered arrangements into one. As of today all these emerging concepts, like East Asia as a region, or the East Asian community, or an East Asian FTA, have been accepted without controversy. But the issue still remains: how to formulate this concept into practice? We need wisdom, efforts, a process and time.

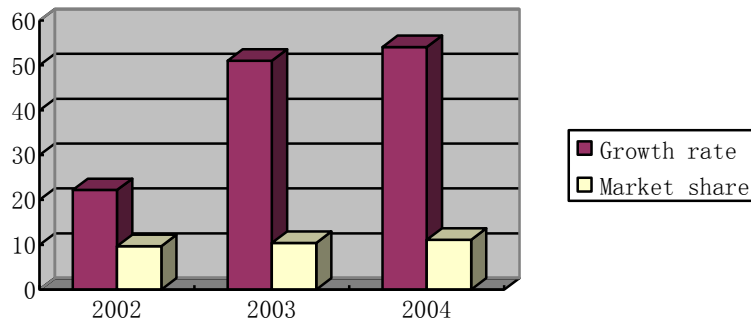
The China-South Korea relationship

Generally, the China-South Korea economic relationship is highly complimentary. This will continue. Korean FDI-led exports by Korean companies and imports by Chinese companies are beneficial to both sides. This trend will continue. A lot of Korean economists are worried whether or not this complimentary nature will change in three or five years. My perspective is that it will continue for a decade or so, or even longer. The Korean economy is so creative. I think it will find a way to operate itself. The gaps will continue to exist, and this complimentary nature will continue.

The gap will be reduced in some areas, but overall the Korean economy will keep its competitiveness in many high technology sectors. Figure 8 shows China’s imports from South Korea. Based on this trend, Korea’s exports to China last year increased 51%. China continues to have a high number of Korean exports, and this year—I just saw the new figures—this trend will continue.

You have to see that China is changing the macroeconomic environment and forcing readjustments. This creates opportunities, as did industrialization. This general trend is similar to that which occurred in South Korea during the 1970s. Korean companies should grasp this opportunity to domestically reallocate their capacities and then upgrade themselves to new factories. Another opportunity is telecommunications. This has great potential.

Figure 8. China's imports from South Korea



But Korean firms must be cautious about the car industry. The car industry in China has too many investors and too much competition. Prices will come down very sharply. So be cautious about investing new money there. Study the market carefully.

Another point is that Korean companies need to consider network building in the region. This means they must allocate their investments not just to China but they should consider the whole regional network.

Questions & Answers

Q We all know that China's "soft landing" is crucial for the world economy. It seems that the Chinese government has decided to cool off its so-called "over-heated" economy by restricting bank loan growth. It seems to me there are more than a couple tools in the hands of the Chinese government to attack this issue of an "over-heated" economy. Will these measures include things like permitting more Chinese investment abroad, or perhaps a currency revaluation, which is a hot topic in US politics today?

In particular, many critics blame the pegged currency as being the major reason for the US-China trade deficit and surplus. It seems that a currency revaluation is a more logical step to redress this "over-heated" economy than, say, restricting bank loan growth, which could perhaps hurt the local economy. Do you have any comments on this?

A The deficit and surplus in trade between China and the US is due mostly to the transformation of the regional economic structure. There has been a reallocation of exports from Japan and the four dragons to China, to use its cheap labor. It is not because of the exchange rate of China's currency. In particular, when we consider regional integration and the network of production processes across the region among different economies and companies, we see that a stable Chinese currency is beneficial to all, not just to China.

If you changed the exchange rate, you would change these networks. It would create an unstable factor, in addition to China's already existing unstable factors of banking and all the other factors. The regional network needs a stable currency. We have a multi-cooperation network in the region that requires a predictable exchange rate.

The deficit and surplus in trade between China and the US is not a Chinese factor alone. It's a regional factor. In addition, it's not coming primarily from the exchange rate between the *renminbi* (yuan) and the US dollar. If we were to change now the *renminbi*-US dollar exchange rate, China would probably not be able to afford it. We still need time before changing the rate. China valued its currency in the early 1990s. We already have such a long time at this rate. Export capacity is not based on the valuation of the currency. It is based on all the development and reallocation of resources that has taken place in the new regional growth paradigm and of export capacity in the region.

I hope that in the future the *renminbi* rate against all currencies will be more flexible. But not right now. There are still too many problems that might occur if you unloosed this particular exchange rate.

China imports to export. A revaluation of the *renminbi* would reduce the cost of imports. So it would make Chinese products even *more* competitive rather than increasing their cost. This is no way to change the deficit and surplus in trade between China and the US. It would just cause problems in the banking sector. According to another study of Chinese exports, the current exchange rate is almost representative of China's export costs. I don't think there's a close linkage between China's current figures and competitiveness.

If you change the exchange rate you can release the pressure on the money supply. The central bank would have a heavier burden to buy back in order to keep stability. The problem is, if you change the exchange rate, you create even bigger instability in the monetary market. This change in policy, if it were to happen, would only occur in the future when the situation were more stable.

Q What are the long-term prospects for the liberalization of China's capital account?

A Over recent weeks, the central bank has adopted several measures that hint at more flexible capital control. This will more easily allow capital to flow out to relieve the pressure of mounting capital accumulation in the Chinese market. That's one way. Another way that is encouraged is to get companies to invest abroad and to transfer the capital if necessary.

The flexibility of exchange rates will not become policy during the next few years. The trend is there, but not in two or three years. Capital controls will be released gradually to let capital flow out and to relieve pressure at home. In the near future, increased capital contractions within China would make capital transactions more flexible.

Q What is the roadmap for reforming the banking sector and all its problems?

A This process has already started. Step one is to liberalize the banking sector and banking services for foreign companies, as more and more companies come into China. Another is to encourage foreign banks to buy major Chinese banking shares, particularly in the Chinese construction and industrial banks. This would allow them to become multinational. Also, security companies are open for foreign buyers.

Q Can there be a multi-currency floating basket peg system for the *renminbi*? What is the Chinese view on an Asian currency unit?

A Most of those currencies are not yet fully convertible. I do not think there is any possibility in the near future of such a collective floating system in the region. In the near future, what we may do is financial and monetary cooperation and create a more secure regional market to provide the confidence for the market.

If some economists from countries like Korea, Japan or Singapore want to have, as a pioneer, this kind of collective floating system, I think it would be acceptable to China. But China would not join before its currency became convertible.

As for the regional currency, there is an Asia-Europe Meeting (ASEM) special group that is responsible for writing recommendations for the leaders' meeting in October. We are very cautious about our choice of words in this regard. We can only talk about a "possible" one currency for East Asia. I still remember some of the debate among our East Asian group members. We have to talk about "possibilities", as opposed to any "feasibility". It's a good idea, but it still has a long, long future.

One currency needs high-level political support. Without support from the high-level political establishment, you cannot have a regional currency at all. That's a regional high-level political issue that needs to be built up. We still need a long, long time. I guess more than a half century from today, until the Chinese accept a regional political community for the future. I do not know about Korea. In Korea, you have to realize unification first, rather than unification of the region. We will not see this in our lifetimes.

Q The US has enjoyed good growth for a number of years. Economists there say it could grow, while containing inflation, particularly due to the productivity growth of the high technology industry, especially IT, for a number of more years.

But recently, there has also been an argument that the containment of inflation is thanks to the import of cheap Chinese products. These days China consumes a lot of raw materials: oil, coal, aluminum, steel, *et cetera*. Is there any danger or chance that this will trigger worldwide inflation?

A Several months ago, all the questions referred to deflation as being a Chinese factor, not inflation. Now, it is inflation.

Generally, this import of raw materials is only partial. When raw materials become a manufactured product, it can still generally reduce the costs of the final product. Oil,

though, is one factor that is uncertain in this regard. China is not a major factor contributing to the current oil price boom.

We expect future inflation rates to reach between 4% and 5%. But worldwide, when I consider China's share of the total world's GDP production, I do not think the China factor will become a major factor to inflate all the world's prices.

Q Your presentation today provides a base level upon which we can now build discussion. We all share very much your perspective. We already have the experience of a country like Korea where, for 40 years, the *per annum* growth rate has averaged 8%. I have no doubt that China has the potential to achieve what Korea has achieved.

You described China as being in the 1970s relative to Korea's case. But there are huge differences. If Korea were a little ballerina climbing that tightrope of growth, China is inevitably a huge elephant that is trying to accomplish the same thing. There are clearly differences between the cases of Japan and Korea, which were command economies, and that of China. I do not see China pursuing a command economy growth model. It is really a free market economy. Both Korea and Japan excluded foreign players from their markets, particularly in the early days. China has actively included foreign players into its economic development right from the beginning.

Quantitatively, the numbers are impressive. But qualitatively we all know there are huge challenges. For example, whilst China is becoming a larger and larger consumer of raw materials and energy, it is still a very wasteful consumer of those things. At the same time, it is a huge producer of pollution.

To what degree is the Chinese central government going to play a leadership role during the early stages of economic development to try to mitigate both of these problems? How will the central government increase the efficiency of use of raw materials so that China's impact on the world's supply of raw materials is not too extreme? Simple extrapolation from today would have the world consumed by China within a hundred years. Also, how can the Chinese government quickly raise pollution standards before industrial development gets too far ahead?

Secondly, while cheap labor is fun, we all know that cheap labor is not the same as productive labor. Therefore there is a huge qualitative challenge for China, to upgrade the quality of its labor and to provide education. Apparently, very few Chinese people today can go to university. Access is only for about two million people per year, out of a population of one billion. This qualitative upgrade of the workforce is vital. Cheap labor will not last for very long, as people in Shenzhen, Guangzhou and Shanghai will tell you. Industries are even migrating away from those regions.

One final question concerns logistics and infrastructure development. It is very difficult to move goods around China. To what extent does the Chinese central government understand these issues and pursue them aggressively, even whilst maintaining the balance of the elephant?

A You actually raise some very complex issues. I mentioned that the Chinese case is very unique and very new. We have never experienced such a huge country in the process of such industrialization. What does this new industrialization mean?

There is a transfer of the population and a change in the economic structure. We need a clean economy and we need a high growth rate. How do we balance all this? I don't think there is just one answer.

Some areas are more positive. This FDI-led growth pattern will see people move more and more toward the efficient sectors. This will put China in a better position to move toward a better and less-polluted stage of development. During these early stages, China is a great maker of pollution as the transfer of cheap labor production occurs. But later on, we will see the reversal of this process. FDI will help China shorten this period of inefficient growth.

Secondly, efforts made by the Chinese central government have forced the larger cities to abide by EU emission standards for their cars, for example. Many measures were adopted to have more restrictions on such pollution standards.

But on the other hand, as a developing economy, you can see when travelling in China why there is so much consumption of steel, cement, *et cetera*. Those are basic infrastructure developments. You can build with steel and cement for upward of two decades because of China's size, just trying to build basic infrastructure. There will be more and more demand for cheaper prices for the basic infrastructure. This is the other side of the dual economy.

Economists and policy makers suddenly realized that this current model cannot be sustained. This raw material-based growth cannot be sustained in China or in the region. But how do you transform this understanding into a coherent policy? There are a lot of difficulties. We all want to see the ideal modernization of China. But it's a problem for all of us, not just for China.

For instance, we have to stop the transfer of polluted production into China. But it's very difficult. Companies need it. China needs it. I just travelled to Guanxi Province last week. We investigated many local projects. You see, all local projects—like steel or cement—all pollute a lot. But they are very profitable, too. One way or another, you have to use the administration to stop them from polluting. But you have to find a way in which to allow the people to make money, too. They have to do something for a living. What is a clean way for them to do so?

Scholars can argue that rural people should just keep their natural surroundings. But nobody wants to live in such nature for long. This is a problem. This is a challenge, not just for China but for the world. The world has to help China find a way toward a proper modernization path. The challenge is for all human beings. We have never experienced such a sizeable growth so quickly. We have to share our collective wisdom.

The market is one side. It is very strong. Government policy is another side. It is sometimes very strong and sometimes very weak. That's why we have a pollution issue, even across borders. We need cooperation, rather than just asking China to stop this or that. In fact, a lot of the investments that make the pollution come from Korea and Japan.

Q What is the GDP *per capita* in the three major cities of Beijing, Shanghai and Guangzhou?

A Last week, we had a debate between some top Chinese economists. One of them pointed out that Korea experienced a very high growth rate and, hence, moved toward becoming an advanced economy. Why has China failed to yet become an advanced economy after two decades of rapid growth?

Beijing, Shanghai and Guangzhou have reached a level close to that of Korea, at least of Korea during the mid-1990s. But the other parts of the country have not. This dual economy will continue to exist for some time. I hope that after another two decades of growth, at least half of the Chinese economy will be as rich as Korea during the mid-1990s. By the year 2050, all of China should have what we call a comfortable life and have reached the level of Korea in the early 1990s. Still, you continue to find many parts of China that are still at a low stage of development. This sharp comparison will continue. It just reflects the nature of our economic structure. The gap between regions will continue to exist for a long time.

Q What is your strategy to deal with the huge imbalance between the prosperous regions and cities and the rest of China?

A Generally, there are three or four major policies. First, the government has started to adopt this "Great Western Development" strategy to allocate funds toward poorer western regions. Also, there are sister arrangements between well-off and rural cities, like between Shanghai and Yuenlong, or somewhere. They transfer a lot of resources from rich areas to the poor, including human resources. There is a special system where you have to spend several months or a year working in that poor area without any payment from the locals, all paid by Shanghai or by the coastal areas.

Last year the central government adopted the new "Northeast Renovation Project". It focuses on the readjustment of the SOEs and opening them up for foreign investment. They can now be bought by foreign companies and area allowed to participate in joint ventures. This is one way to attract more funds and to give more privileged policy arrangements.

The second way is to adopt a new, more liberal policy. In the past, the "Northeast Renovation Project" would have mostly relied on the central government. But they are trying to create institutional change in that region. They encourage more private sector individual efforts to allocate seed money to support individual firms or businesses. This is to create not government jobs, but individual and firm jobs. This was a very big shift when it happened last year.

Third, the government must change this traditional poor relief policy. They must turn it into a development-oriented policy, to support more entrepreneurship, business and technological transfer to the poor regions. This would develop local economies.

Fourth, encourage foreign investors to come to the region. As I mentioned, though, this regional gap will continue to exist for quite some time. There has also been a mind shift about the way in which to develop these least-developed areas. In the past, the thinking was to simply support economic growth. But now, policy makers realize this is wrong.

When I travel to, for instance, Qinghai Province or Yunnan Province you realize it causes really big problems when you simply provide funds to support the local economy. You damage the locals' environment, both business and ecological. There is some new thinking underway now where you reallocate populations from the mountainous areas and encourage them to flow to other regions. This includes the creation of urban areas to encourage people to move. Some economists also argue that, in the future, the coastal areas alone will probably be able to take at least 80% of the population, leaving the western parts to nature, for instance rivers, mountains and the environment. This will change the overall development picture of China.

So there are some new thoughts on these matters. Generally, they follow concepts about scientific development strategies. They try to create new ideas. Already, the government has begun discussing how to preserve nature and how to encourage farmers to plant trees while growing food. There are a lot of new measures, especially modernization and industrialization measures. What do these traditional concepts mean in the Chinese case? How to implement them? How to use these ideas in China? We have to jointly discuss it to find a way.

Q The Korean central government has been pushing various so-called “business hub” projects. It would like to induce regional cooperation in Northeast Asia. In this context, the Korean government would like to play the role of a catalyst which would trigger multinational cooperative infrastructure investment projects involving China, Russia, North Korea, South Korea and Japan, of course. The focus of these infrastructure investments would also include the northeastern part of China, as well as Siberia. Do you see some feasibility in this idea?

A Just yesterday, a conference started in Dalian. It's titled “Northeast China Industrial Restructuring in the Context of Northeast Asian Cooperation”. There are a lot of Koreans, Japanese and Russians gathered there with government officials and experts, all sitting together. This is a sign of the progress that has taken place. There are many things we have done, including various calls of some sort for a “Northeast Asian Development Bank”.

This kind of government-oriented project seems very difficult. But there are commercial ways to do so. We could launch a bank in Tianjin and call it the “Northeast Asia Commercial Bank”, or perhaps the “Bohai Commercial Bank”. Such cooperation would be based in China, Korea and Japan. For the environment, such as oil projects, Russia

and Korea already have some sort of gas pipeline project. This kind of thing will continue to happen. All of these projects have a good future, but with some difficulties.