

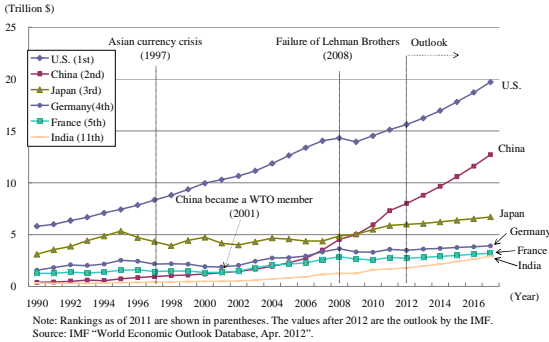
Section 4 Chinese economy: High growth but at a slower pace

1. Overview

(1) Increased Chinese presence

China is increasing its presence in the world economy. China decided to pursue economic reform and an open-door policy and it became a WTO member at the end of 2001 in order to continue a high growth rate of 10% per year in the 2000s (see Figure 1-4-1-1). China continued to expand its economy even under the circumstance where the growth of the European and the U.S. economies remained low after the failure of Lehman Brothers, and developed into the world’s second-largest economy behind the U.S. in 2010, exceeding the Japanese economy. In addition to comparison with advanced economies, China largely surpasses other emerging economies with a high growth rate, such as India in the same Asian region, in terms of economic size.

Figure 1-4-1-1
GDP of major countries (dollar basis)

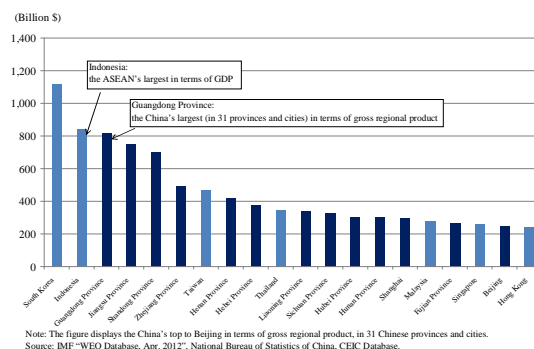


China is composed of 31 direct-controlled municipalities, provinces and autonomous regions, and one province solely has the economic size equivalent to those of neighboring nations. For example, Guangdong Province, which is the China’s largest in terms of gross regional product, has an economic size equivalent to Indonesia, which is the ASEAN’s largest in terms of GDP (see Figure 1-4-1-2).

Furthermore, in terms of trade, China became first in the world for export and the second in the world for import. China had the world’s largest amount of foreign currency reserves of about 3,180 billion dollars at the end of 2011 as well as the world’s largest amount (about 1,150 billion dollars) of government holdings of U.S. bonds (Japan had the second largest amount of about 1,060 billion dollars), and so China is increasing its influence in international society.

Figure 1-4-1-2

Total production of China' provinces and cities and Asian major countries/regions (2011)



(2) Overview of the Chinese economy

In 2011, inflation control was a top priority issue of economic policies and therefore a tight monetary policy was adopted. Meanwhile, exports bound for Europe began to slow down since the middle of the year due to the European debt crisis, and economic growth decelerated mainly in the coastal area that heavily relied on exports.

(GDP)

Real GDP growth rate has been slightly slowing despite solid growth of 9.2% throughout 2011 (see Figure 1-4-1-3). Quarterly transition shows five consecutive quarters of decline in real GDP growth rate until the first quarter of 2012.

By category of demand, in the whole of 2011, the contribution of external demand fell into the negative from the previous year (from 1.0% in 2010 to -0.5% in 2011), while internal demand remained strong. Investment maintained the large contribution despite its slight slowdown (similarly from 5.6% to 5.0%), and consumption also increased (similarly from 3.8% to 4.8%). Below, we examine the indicators related to each category of demand.

(Consumption)

In 2011, the total amount of retail sales of social consumer goods remained strong. By item, the consumption of automobiles and home electronics appliances has been sluggish after ending of provision of purchase subsidies, while the consumption of food and clothing remained brisk but has been recently declining (see Figure 1-4-1-4).

Figure 1-4-1-3

China's real GDP growth rate (ratio to the same period of the previous year)

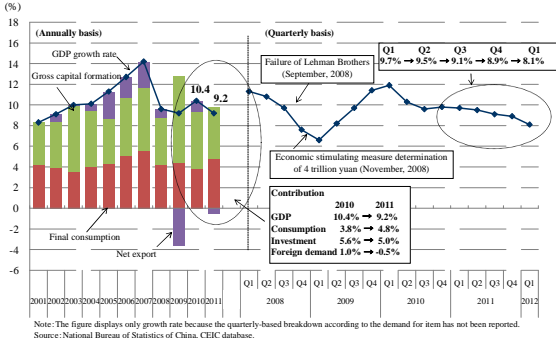
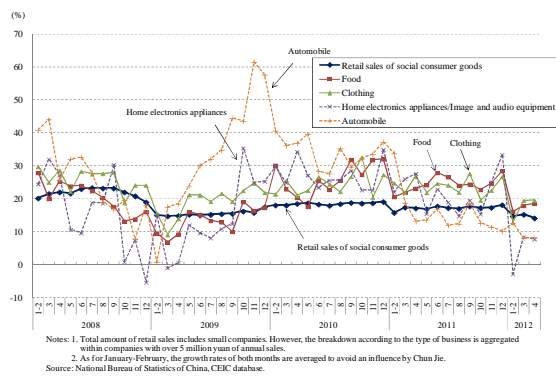


Figure 1-4-1-4

Growth rate of retail sales of social consumer goods (ratio to the same month of the previous year)



According to the trends in income which supports consumption, per-capita income has been rising in both urban and rural areas, and especially the income growth rate in rural areas has risen each year, exceeding that in urban areas after 2010 (see Figure 1-4-1-5). Looking at the sources of income, in rural areas, income from wages and salaries (cash income including money transferred due to working away from home), which accounts for more than about 40% of the composition of income, has increased substantially to record the growth exceeding the real GDP (9.2%): per-capita net income in rural areas is 17.9% on a nominal basis and 11.4% on a real basis (see Table 1-4-1-6). On the other hand, in urban areas, income from wages and salaries accounts for two-thirds of the composition of income, and per-capita disposal income has increased by 14.1% on a nominal basis and 8.4% on a real basis (see Table 1-4-1-7).

Figure 1-4-1-5
Income growth rate in urban/rural areas

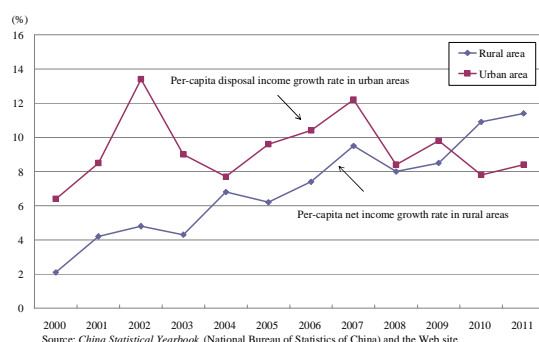


Table 1-4-1-6
Per-capita net income in rural areas

	(Unit: Yuan, %)			
	2010	2011	Growth rate	Composition ratio
Income from wages and salaries	2,431	2,963	21.9	42.5
Net business income	2,833	3,222	13.7	46.2
Primary industry	2,231	2,520	12.9	36.1
Secondary/Tertiary industry	602	702	16.7	10.1
Income from properties	202	229	13.0	3.3
Income from transfers	453	563	24.4	8.1
Net income	5,919	6,977	17.9*	100.0

Notes: 1. The price-adjusted real growth rate is 11.4%.
2. Income from wages and salaries includes cash income including money transferred by migrant workers.

Source: China Statistical Yearbook (National Bureau of Statistics of China) and the Web site.

Table 1-4-1-7
Per-capita disposal income in urban areas

	(Unit: Yuan, %)			
	2010	2011	Growth rate	Composition ratio
Income from wages and salaries	13,708	15,412	12.4	64.3
Net business income	1,714	2,210	29.0	9.2
Income from properties	520	649	24.7	2.7
Income from transfers	5,092	5,709	12.1	23.8
Total income	21,033	23,979	14.0	100.0
Disposal income	19,109	21,810	14.1*	-

Note: The price-adjusted disposal income real growth rate is 8.4%.

Source: China Statistical Yearbook (National Bureau of Statistics of China) and the Web site.

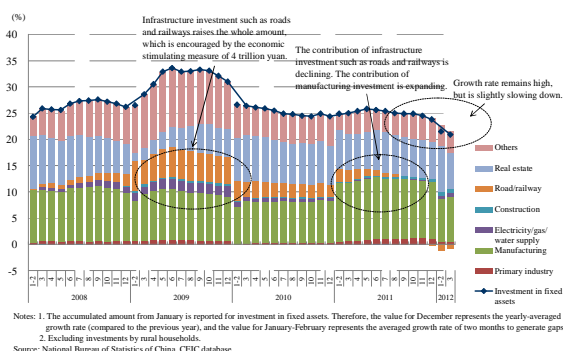
(Investment)

The growth rate of China's investment in fixed assets remains high, but has been slightly slowing down.

By industry, the contribution of infrastructure investment such as roads and railways, which was encouraged by the economic stimulus measure of 4 trillion yuan taken in 2009, has declined, and, in particular, railway investment has rapidly declined following the high-speed railway accident that occurred in Zhejiang Province in July 2011 (see Figure 1-4-1-8). In contrast, the contribution of manufacturing investment has expanded, and strong real estate investment caused souring housing prices, a so-called "housing bubble," to create a social issue.

Figure 1-4-1-8

The growth rate of China's investment in fixed assets (accumulated amount from the beginning of the year, ratio to the same quarter of the previous year)



However, the overall growth rate has been slightly slowing down since the latter half of 2011. In particular, at the beginning of 2012, infrastructure investment such as roads and railways decreased from the previous year.

(External demand)

In 2011, both exports and imports expanded and the trade balance remained in surplus (see Figure 1-4-1-9). However, the monthly export growth rate shows that exports mainly bound for the EU have been slowing down since the middle of 2011 due to the European debt crisis (see Figure 1-4-1-10(a)). In response to a slowdown in exports, imports have been similarly slowing down since the middle of 2011 (see Figure 1-4-1-10(b)). Imports from Japan have been sluggish since March 2011. This may reflect a decline in imports from Japan of intermediary goods and mechanical equipment due to a slowdown in exports in China in addition to the impact of the Great East Japan Earthquake.

Figure 1-4-1-9

China's trade amount

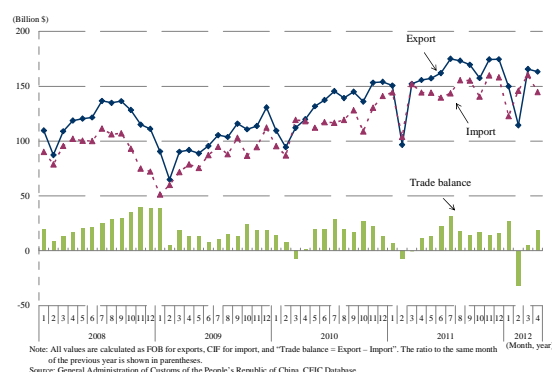


Figure 1-4-1-10(a)

China's export growth rate (ratio to the same month of the previous year)

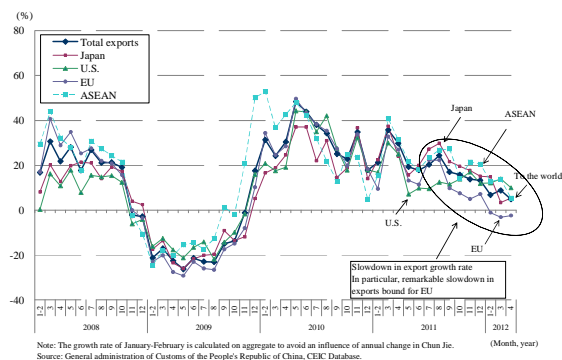
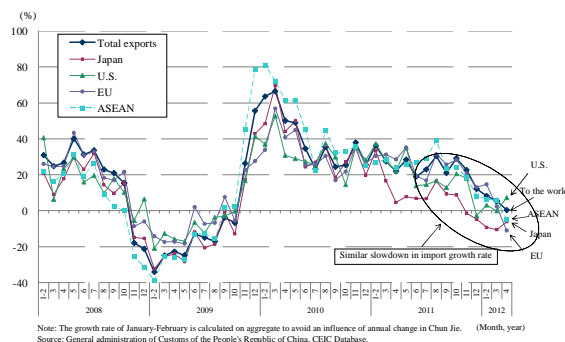


Figure 1-4-1-10(b)

China's import growth rate (ratio to the same month of the previous year)



(Balance of payments)

China ran a current account surplus, and its high growth rate attracted foreign investment to maintain an excess inflow in the capital balance. Not only such factors, but also intervention in the foreign exchange market to suppress the rise in the Chinese yuan resulted in the previous increase in foreign currency reserves. However, in 2011, the current account surplus declined, and the capital balance showed a decrease in net inflows from the previous quarter in the third quarter and showed an excess outflow in the fourth quarter. Such factors resulted in a decrease in foreign currency reserves (see Figure 1-4-1-11).

(Consumer price and monetary policy)

The consumer price index, which fell in 2009 compared to the same quarter of the previous year, rose throughout 2010 exceeding the deposit rate, and rose to the level exceeding an inflation target of 4% in early 2011 (see Figure 1-4-1-12). In particular, food prices, which have a great impact on people's lives, rose remarkably. The Chinese government implemented a tight monetary policy by citing price controls as a top priority issue of 2011. The policy interest rate was raised for five consecutive months from the end of 2010 (a total of 125bp) and the deposit reserve ratio was raised for consecutive nine months (a total of 450bp) (see Figure 1-4-1-13 and Figure 1-4-1-14).

Figure 1-4-1-11
China's balance of payments

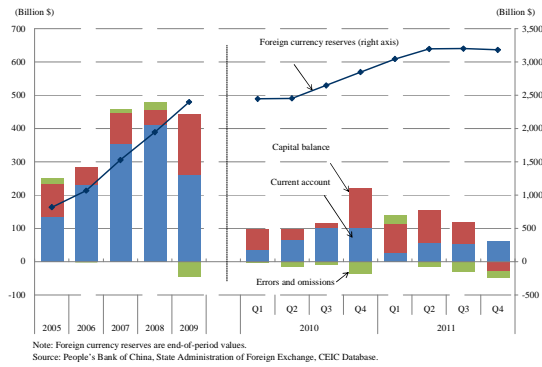


Figure 1-4-1-12
Growth rate of China's consumer price (ratio to the same month of the previous year)

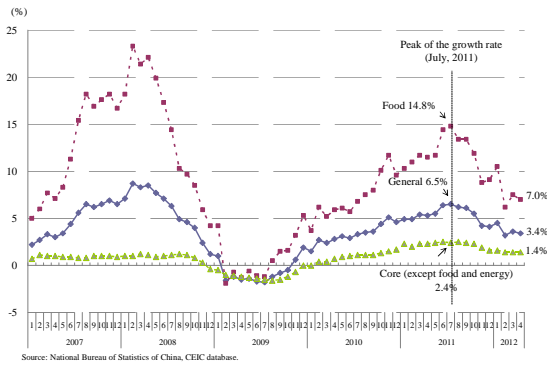


Figure 1-4-1-13
China's policy interest rate

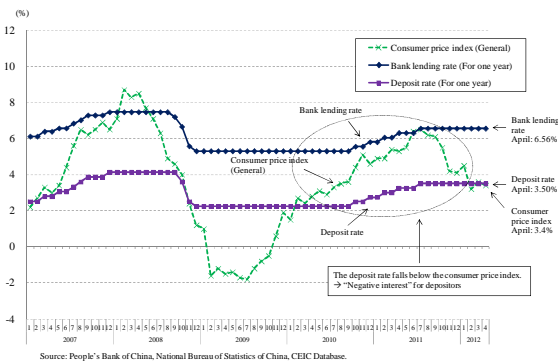
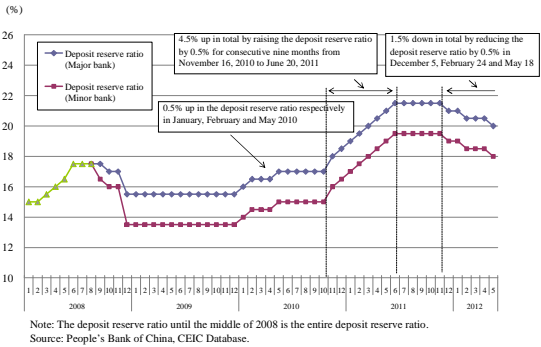


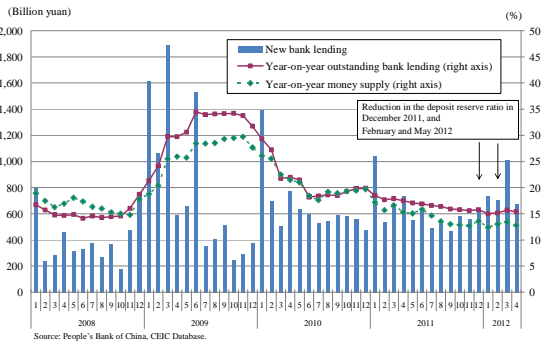
Figure 1-4-1-14
China's deposit reserve ratio



As a result of these measures, the growth rate of consumer prices has been declining after peaking in July 2011. In contrast, there has been increased demand for monetary easing arising from a concern over the deceleration in economic growth due to a slowdown in exports stemming from the European debt crisis. Under such circumstances, the People's Bank of China launched reduction of the deposit reserve ratio in December 2011 and implemented such reduction also in February and May in 2012.

The transition of China's money supply shows that the growth rate of money supply declined from the end of 2010 following the tight monetary policy and, in response to this, the growth rate of outstanding bank lending also declined gradually (see Figure 1-4-1-15). The growth rate of money supply showed signs of a rebound in December 2011 when reduction of the deposit reserve ratio was launched, and money supply and the growth rate of outstanding bank lending as well as new bank lending have been increasing in 2012.

Figure 1-4-1-15
China's money supply and bank lending

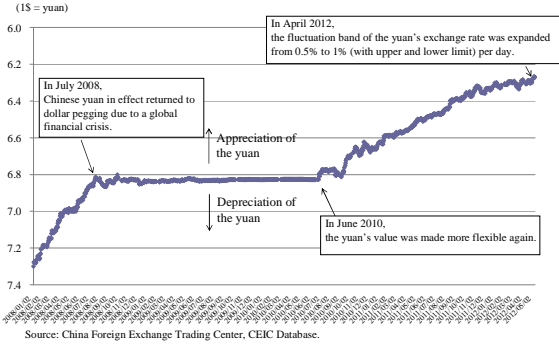


(Chinese yuan)

Though the Chinese yuan in effect returned to dollar pegging after the failure of Lehman brothers, the yuan's value was made more flexible in June 2010 and afterwards has been rising moderately showing slight fluctuations against the U.S. dollar (see Figure 1-4-1-16). Recently, however, it sometimes happens that the yuan's exchange rate continues to fall along with a slowdown in the Chinese economy to reduce the strong anticipation of a high exchange rate. Under such circumstances,

in April 2012, the People’s Bank of China expanded the fluctuation band of the yuan’s exchange rate from 0.5% to 1% (with upper and lower limit) per day. Furthermore, it was decided to allow nationwide companies qualified for trade to implement trade settlement in yuan which had been introduced on a trial basis in April 2009 (August 2011).

Figure 1-4-1-16
Chinese yuan to dollar exchange rate



(Foreign direct investment)

Foreign direct investments in China increased in 2010 and 2011 following a decrease in 2009 (see Figure 1-4-1-17). In addition to an increase in the money amount, there have been a wide variety of industries and areas of investments by degrees. With respect to industries invested in, investment in manufacturing industries has remained high, but recently investment in non-manufacturing industries including real estate, wholesale and retail trade, and business service has been expanding. With respect to areas of investments, the share of the coastal area (such as Jiangsu and Guangdong Provinces), the central area (such as Henan Province), the western area (such as Sichuan Province and Chongqing) and the northeastern area (such as Liaoning Province) has been increasing (see Figure 1-4-1-18). With respect to investing countries, Hong Kong has been a major investor, and Japan and Singapore increased their investments in 2011 (see Figure 1-4-1-19).

Figure 1-4-1-17
Foreign direct investments in China

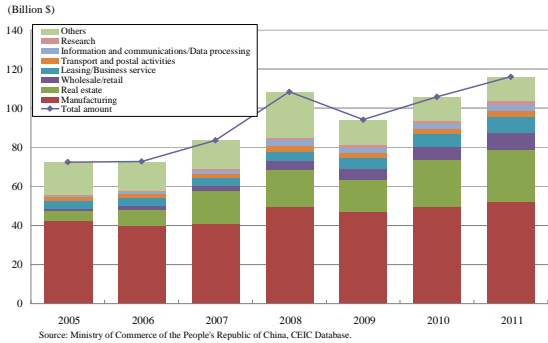


Figure 1-4-1-18

Areas of investments for foreign direct investments in China

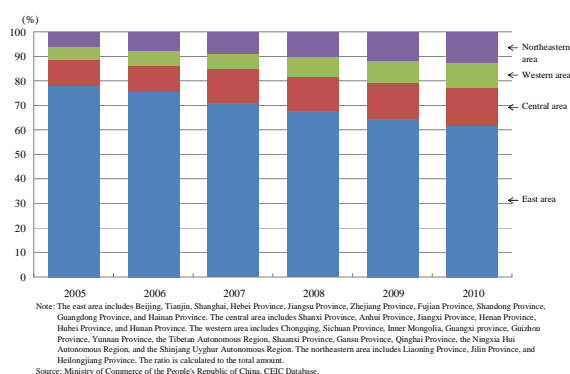


Figure 1-4-1-19

Investing countries/regions for foreign direct investments in China

(Unit: 100 million \$)

	2008	2009	2010	2011
Hong Kong	410	461	606	705
Virgin Islands	160	113	104	97
Japan	37	41	41	63
Singapore	44	36	54	61
South Korea	31	27	27	26
U.S.	29	26	30	24
Cayman Islands	31	26	25	22
Taiwan	19	19	25	22
Western Samoa	25	20	18	21
Germany	9	12	9	11
France	6	7	12	8
Netherlands	9	7	9	8
Total of the world	1,083	941	1,057	1,160

Source: Ministry of Commerce of the People's Republic of China, CEIC Database.

(Outward foreign direct investment)

The Chinese government has advocated Chinese enterprises' aggressive overseas expansion ("Go Global") since the early 2000s, and under this policy, outward foreign direct investments have shown rapid expansion with support of the government (see Figure 1-4-1-20). With respect to industries of investments, the major portion of investments is in the leasing and business service sectors, followed by the finance and by wholesale and retail trade sectors. With respect to investee economies, large investments have been made through Hong Kong, the Virgin Islands and the Cayman Islands (see Figure 1-4-1-21). The purposes of direct investments may be the sale of Chinese products, acquisition of technology, and others. Some sources point out that recently large investments for the purpose of resource development have been made.

Figure 1-4-1-20

China's outward foreign direct investments

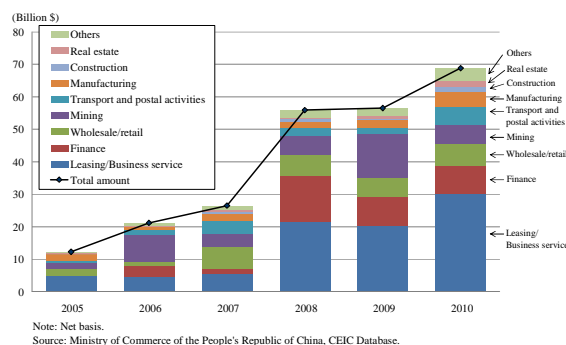
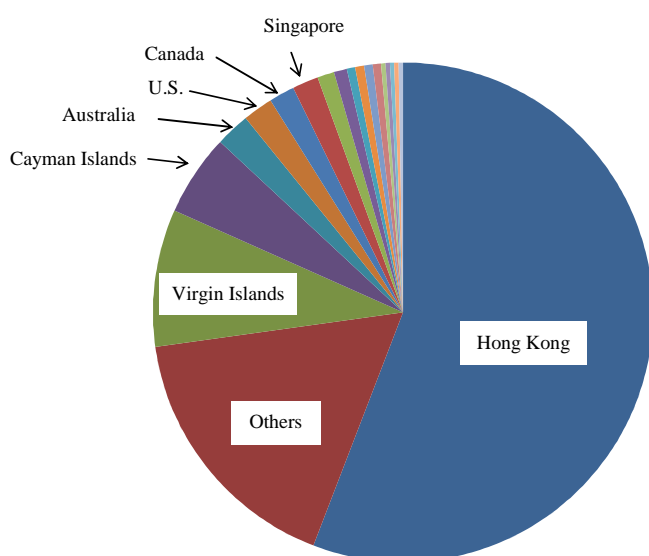


Figure 1-4-1-21

Investee economies of China's outward foreign direct investments (2010)



Note: Net basis.
Source: China Statistical Yearbook (National Bureau of Statistics of China).

	Investing countries	Direct investment (100 million \$)	Composition ratio (%)
1	Hong Kong	385	56.0
2	Virgin Islands	61	8.9
3	Cayman Islands	35	5.1
4	Australia	17	2.5
5	U.S.	13	1.9
6	Canada	11	1.7
7	Singapore	11	1.6
8	Thailand	7	1.0
9	Russia	6	0.8
10	Germany	4	0.6
11	South Africa	4	0.6
12	Japan	3	0.5
13	UK	3	0.5
14	Vietnam	3	0.4
15	India	2	0.3
16	Algeria	2	0.3
17	Nigeria	2	0.3
18	Macau	1	0.1
20	New Zealand	1	0.1
-	Others	117	17.0
-	Total amount	688	100.0

(3) 2012 management policy of the Chinese economy

In December, 2011, the Central Economic Work Conference, which reviews basic economic policies, was held and decided the policies to handle in a balanced manner the relations between (i) stable and relatively fast economic growth, (ii) economic restructuring, and (iii) managing inflation expectations. This marks a shift from “inflation control” to “stable growth.” In response to that, in March 2012, the management policy of 2012 was announced at the National People’s Congress (corresponding to the Diet in Japan; hereinafter abbreviated as “NPC”).

In observing the key points, the government’s major duties included “more speedy development with economic stability” cited as a top priority to emphasize the domestic demand, especially the

expansion of demand for consumption (see Table 1-4-1-22). A stable price level was also cited as a priority issue to propose the policies regarding the enhancement of cost reduction by activating distribution as well as the increase in the production, in particular, of food.

According to 2012 major economic targets announced concurrently, GDP growth rate was reduced from 8% (target in 2011) to 7.5% (see Table 1-4-1-23). It is explained that this is because the transformation of China’s economic development pattern and the enhancement of quality and performance of economic growth lead to long-lasting development. Consumer price remains around 4%. As for financial and fiscal policies, “proactive fiscal policy” and “moderate financial policy” were cited to maintain a fiscal deficit and the amount of government bonds to a moderate level, and the money supply (M2) growth rate was set at 14% (13.6%: result in 2011) to suggest the intention to support stable growth. Concurrently, the policy to make micro adjustments properly and on a timely basis according to the changes in circumstances was also proposed. As for the Chinese yuan, the policy to enhance the flexibility of a managed float system was proposed to suggest the expansion of the fluctuation band with upper and lower limit which would be implemented later.

Table 1-4-1-22

FY2012 major duties ---- from the 11th National People's Congress 5th conference (reports on government activities)

- | |
|---|
| <ol style="list-style-type: none"> 1. Promote more speedy development with economic stability 2. Keep overall price levels basically stable 3. Encourage stable development of agriculture and sustained increase in income of farmers 4. Accelerate transformation of the economic development pattern 5. Implement human resource development as well as science and education 6. Ensure and improve the people’s wellbeing 7. Vigorously enhance cultural development 8. Deepen reforms in key areas 9. Further improve the quality and level of opening to the outside world 10. Strengthen efforts to promote clean government and combat corruption |
|---|

Source: Prepared by the Ministry of Economy, Trade and Industry.

Table 1-4-1-23

2012 major economic targets

	2011		2012
	Target	Actual result	Target
GDP growth rate	Around 8%	9.20%	7.50%
Newly employed worker in urban areas	9 million people	12.21 million people	More than 9 million people
Registered unemployment rate in urban areas	Less than 4%	4.0%	Less than 4.6%
Consumer price	Around 4%	5.4%	Around 4%
Money supply (M2)	About 16%	13.6%	14%
Total amount of foreign trade	Around 10%	22.5%	Around 10%
Fiscal deficit	900 billion yuan	850 billion yuan	800 billion yuan

Source: Prepared by the Ministry of Economy, Trade and Industry based on various materials.

2. Risk factors

(1) Immediate attention points

With respect to the Chinese economy, there are points that require immediate attention.

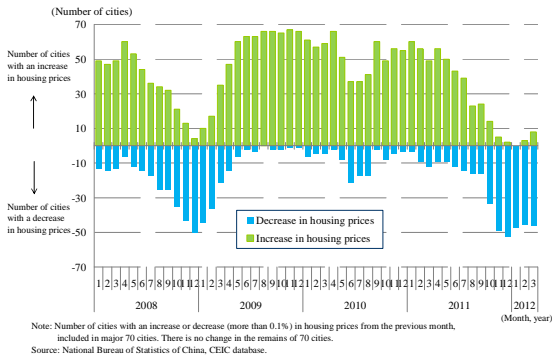
(Housing prices)

As examined in Section 1 of this chapter, housing prices also risen also in China amid global monetary easing after the failure of Lehman Brothers, and there is a concern that a sharp decline in soaring housing prices could lead to a hard landing for the Chinese economy. Up to the present date, a tight monetary policy and measures to control housing prices have kept the housing market from overheating, and the number of cities where housing prices are falling has increased since the latter half of 2011 (see Figure 1-4-2-1). However, the government has not lowered its guard against the housing market because it is believed that, despite some real estate companies’ difficult position, housing demand remains strong along with the advancement of urbanization.

(Debt problems of local governments)

The amount of local government debt has increased because local governments were put under a certain financial burden by the economic stimulus measure of 4 trillion yuan. The National Audit Office (corresponding to the Board of Audit of Japan) published the report that local government debt had reached 10.7 trillion yuan at the end of 2010: Among the debts, 6.7 trillion yuan is the debt that local governments have an obligation to repay; 2.3 trillion yuan is the debt that they have an obligation to guarantee; and 1.7 trillion yuan is the debt that they have an obligation to give a certain level of financial aid. According to the report, the debt that local governments have an obligation to repay account for 52.3 % of the local government’s revenues, and 70.5% in case of adding the debts that they have an obligation to guarantee.

Figure 1-4-2-1
New home sales prices, nationwide, 70 cities



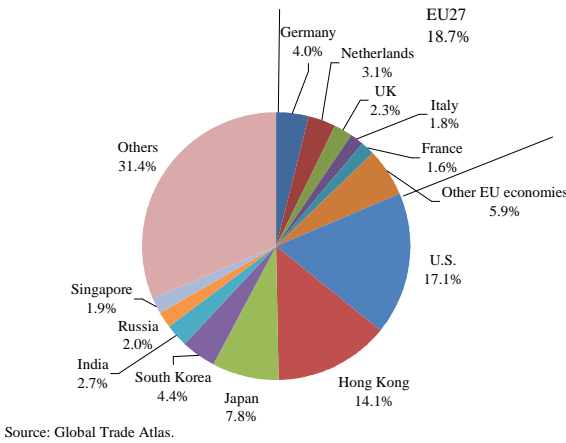
China local governments are, in principle, prohibited from independently financing and establish the investment companies called “local government finance platforms” to raise money required for infrastructure development, etc. from financial institutions. According to the abovementioned report

by the National Audit Office, there are about 7,000 nationwide local government financing platforms, which owe 5 trillion yuan of the total amount of local government debts as borrowers.¹⁶⁵ In contrast, according to the survey conducted by the China Banking Regulatory Commission from the standpoint of a financial institution, about 10,000 nationwide local government financing platforms had piled up debts of 9.1 trillion yuan as of September 2011, and only 65% of the debts are collateralized. There are controversial points about the local government financing platform due to its vague definition as well as its unclear operation and stance. The amount of local government debt has been decreasing because the central government strictly controlled new borrowing. However, the debt repayment deadlines are concentrated in 2012, and so the China Banking Regulatory Commission announced a policy to encourage local governments to consult with banks on a six-month to twelve-month moratorium in case of inability to repay the debt.

(Slowdown in exports stemming from the European debt crisis)

As examined in Section 2 of this chapter, an evident slowdown in the European economy has resulted in a decrease in exports bound for Europe from China from the previous year in early 2012 (see Figure 1-4-1-10(a) above). The EU is the major export counterpart for China. That has a substantial impact on coastal areas with high dependence on exports (see Figure 1-4-2-2). It is necessary to pay full attention to future trends. .

Figure 1-4-2-2
China’s major export counterparts (2011)



(2) Mid- and long-term challenges and measures

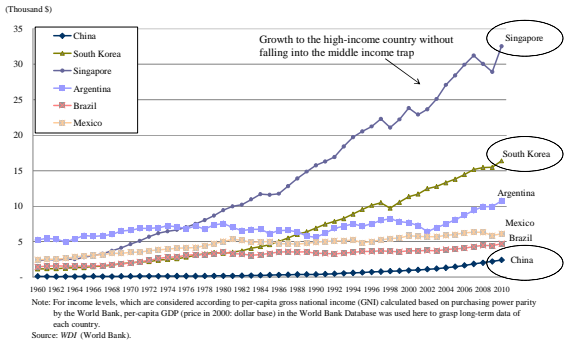
(A) Pitfalls of economic growth

China faces challenges pertaining its mid- and long-term growth as well as risks pertaining to short-term economic trends. China became the second in the world for total amount of GDP, but remains at a low level in terms of per-capita GDP (see Figure 1-4-2-3). In the past, there were many

165 Some sources point out that there include financing platforms of local governments only at provincial, municipal and county levels and do not include those at town and township levels.

developing economies falling into the “Middle Income Trap”¹⁶⁶: a situation where a country which attains a certain income due to its economic growth will get stuck at that level. For example, though Singapore, South Korea, and Central and South American countries were at almost the same level in terms of per-capita GDP from 1960 to 1980, Singapore and South Korea post a continued rise in per-capita GDP, and on the other hand, Central and South American countries remains at the former level for a long time. A great deal of attention is paid to whether China’s growth can last for further high income levels.

Figure 1-4-2-3
Per-capita GDP (price in 2000: dollar base)



It is pointed out that the “Middle Income Trap” arises from exhaustion of the labor surplus in the agriculture sector, rising wage levels and declining cost competitiveness in international markets, and limitations of using existing foreign technology. Below, we review the recent trends in China, keeping in mind such mid- and long-term structural problems.

(Labor market)

In the long term, tight supply and demand and wage increases in the labor market develop. Job offer to job-seeker rates in urban areas rose in the 2000s, exceeded 0.9 in 2004, and reached 0.98 immediately before the failure of Lehman Brothers (see Figure 1-4-2-4). Though temporarily declining after the failure of Lehman Brothers, the rate exceeded 1.0 and continues to rise remaining in the situation where the number of job offers exceeds the number of the number of job seekers. Some sources point out that the background to this is decrease in the labor surplus in rural areas¹⁶⁷ and job

166 The after-mentioned joint report by the World Bank and Development Research Center of the State Council of China points out the following: Developing economies can, in an early phase of development, gain high productivity increase by shifting labor force and capital from the low-productivity sector including agriculture to the high-productivity sector including manufacturing industries. Later, however, exhaustion of the labor surplus in rural areas and end of such shift between industries result in rising wages and declining cost competitiveness in international markets. Furthermore, technological catch-up has been promoted, and so it is necessary to increase productivity by innovation to find a new source of growth. Japan, South Korea and Singapore are cited as a country which became a high-income country without falling into the “Middle Income Trap”.

167 It is believed that, in the course of industrialization, absorption of the labor surplus in the agriculture sector into the industrial sector causes the exhaustion of the labor surplus in an agriculture sector and the tight supply and demand situation in the labor market to result in wage increase. This is called the

creation in local areas encouraged by the economic stimulus measure of 4 trillion yuan. Such labor shortages cause rising wage levels as well as increased workers rights awareness and rising living costs, and recently the wage levels have become high, especially in coastal areas including Beijing, Shanghai and Guangzhou (see Figure 1-4-2-5). In comparison of the annual burden of Japanese affiliated companies (manufacturing industry) between China and neighbor countries, wages in such coastal cities have exceeded those in Jakarta, Manila and New Delhi, and have risen to the almost same level as those in Bangkok and Kuala Lumpur (see Figure 1-4-2-6).

Figure 1-4-2-4
Job offer to job-seeker rate in urban areas in China

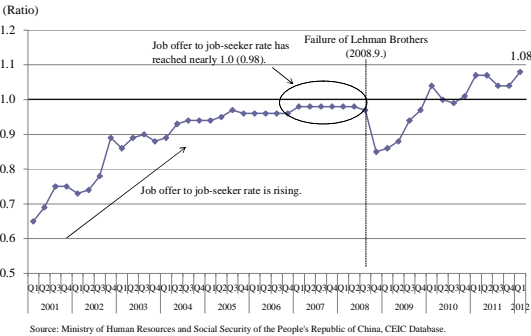
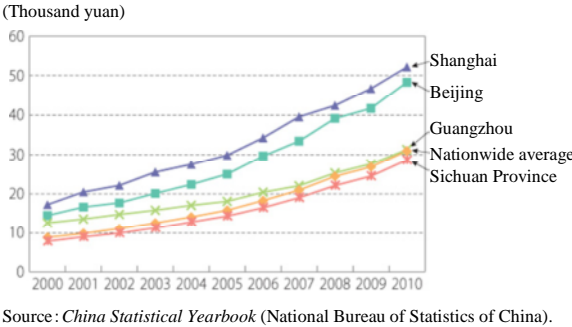


Figure 1-4-2-5
Average wage of China’s manufacturing industry in urban areas



(Demographics)

It is expected that, just like Japan, China will have an increasingly aging population under the one-child policy. According to the population projection by United Nations, China will reach the peak of productive-age population in 2015¹⁶⁸, and the percentage of productive-age population will decrease (from 72.4% to 68.9%) for twenty years from 2010 to 2030 (see Figure 1-4-2-7). In contrast, the

“Lewis turning point” as introduced by Arthur Lewis, English economist. Some sources point out that, in China, the rural labor surplus, which was supplied as a rural migrant (míngōng) to cities in the coastal area, has begun to be exhausted.

168 The population projection by United Nations reported that China would reach the peak of productive-age population (aged between 15 and 64) in around 2015, but China announced that the productive-age population decreased by 0.1% point in 2011.

percentage of aging population will double (from 8.2% to 16.6%), and it is inevitable that measures be taken to counter the effects of an aging society and to shoulder a heavier social security burden. Furthermore, a decrease in the percentage of young population (from 19.5% to 14.6%) suggests future further aging.

Figure 1-4-2-6
Comparison of the salary level of Japanese manufacturers in China and major Asian countries

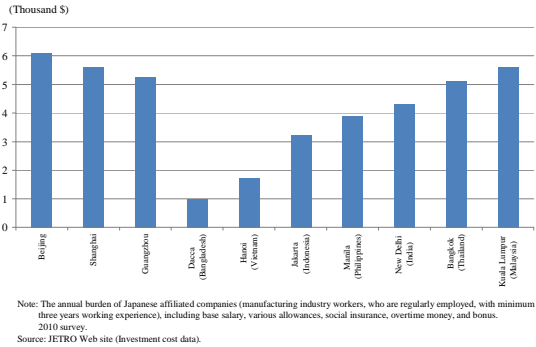
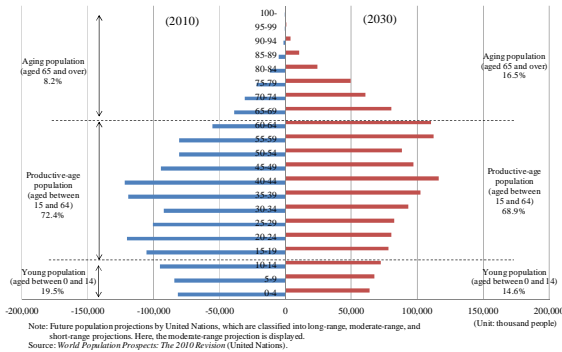


Figure 1-4-2-7
Outlook for China’s population composition



(B) Transformation of the economic development pattern

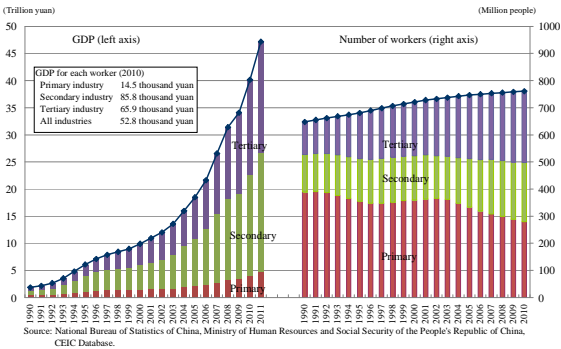
In response to such trends, we review the transformation of the economic development pattern supported by the Chinese government at first. Afterwards, we introduce the joint report released by the World Bank and Development Research Center of the State Council of China in February 2012 to examine the issues reported thereof, including structural reforms to develop a market-based economy and encourage innovation.

(Transformation of the industrial structure)

Major issues for the transformation of the economic development pattern cover the following: (i) transformation of the industrial structure, (ii) transformation of the demand structure, and (iii) balanced regional development. According to the transition of China’s industrial structure, on a GDP basis, the secondary industry has mainly grown while primary industry has been sluggish, and tertiary

industry has grown late (see Figure 1-4-2-8). On the other hand, the number of workers has been shifting from primary industry to secondary and tertiary industries. However, primary industry still has a large number of workers and lags behind the other two industries in terms of per-capita GDP. As for the secondary industry, though the number of workers has increased in the past, and there is a limit on the capacity for employment due to the progress of mechanization. Instead, it is remarkable that the number of workers has been increasing in the tertiary industry.

Figure 1-4-2-8
China’s industrial structure



Under such circumstances, the Chinese government advocates in the 12th Five Year Plan both the modernization of agriculture, which lags behind in productivity, to improve rural residents’ livelihoods and the further development of the service industry which promises the future growth and increased capacity for employment. Furthermore, regarding the manufacturing industry, the policy was proposed to improve sophistication and international competitiveness mainly for seven strategic emerging industries (see Table 1-4-2-9).

(Transformation of the demand structure)

In light of the demand side of China, the proportion of investment increased and the proportion of consumption decreased throughout the 2000s (see Figure 1-4-2-10). The transition of the contribution of China’s real GDP growth rate also shows that investment played a major role and, in addition, exports emerged in the middle of the 2000s as a driving force for economic growth due to the expanding trade surplus (see Figure 1-4-1-3 above). However, economic growth supported by domestic demand, especially the importance of consumption-driven growth, was further recognized amid continuing uncertainty of the world economy. The 12th Five Year Plan advocated a well-balanced economic growth among consumption, investment and trade, and moreover aimed to increase income exceeding the pace of economic growth to boost consumption. For example, action plans included to increase the per-capita real income of rural residents with a low growth rate of no less than 7% (beyond the economic growth target) in the same level as that of urban residents, and to increase the minimum wage standard on a nominal basis by no less than 13% on average each year. The abovementioned rising wage level reflects the Chinese government’s policy to aim at transformation of the demand structure. There are questions concerning whether or not China can shift

to a structure where people can share the fruits of growth.

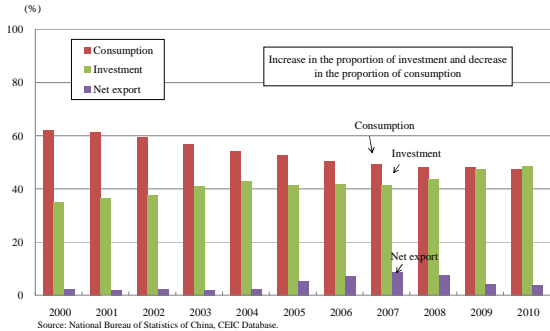
Table 1-4-2-9

Strategic emerging industry

1 Energy saving and environmental protection industry
2 New-generation information technology industry
3 Biotechnology industry
4 High-end machine and equipment industry
5 New energy industry
6 New material industry
7 Clean energy vehicle industry

Figure 1-4-2-10

China's GDP composition ratio

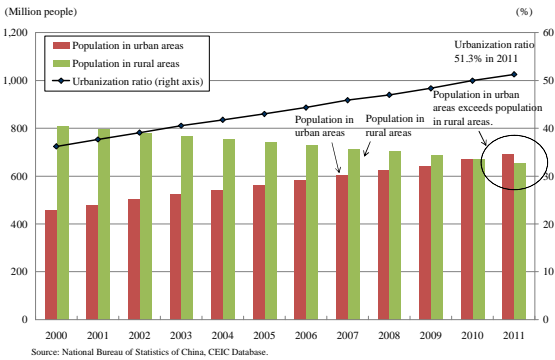


Looking at the result of economic growth in 2011 from such viewpoint, we can see the trend of the first year of the 12th FYP in line with the plan, in which the contribution of consumption increased while the contribution of investment decreased (see Figure 1-4-1-3 above).

Major tasks in 2012 for the Chinese government include a wide range of measures: to increase income of low- and middle-income groups through change in the structure of income distribution (policies such as tax reduction) for enhanced purchasing power; to expand services concerning people's livelihoods such as care for the elderly, health care and insurance, culture, and tourism; and to encourage environment-conscious products.

Urbanization was in progress throughout the 2000s and the population in urban areas exceeded the population in rural areas for the first time in 2011 (see Figure 1-4-2-11). It is considered that urbanization causes increased consumption of durable goods and various services (including entertainment, health care and education) as well as increased investment for improving housing and the urban transportation system.

Figure 1-4-2-11
Urbanization in China



(Balanced regional development)

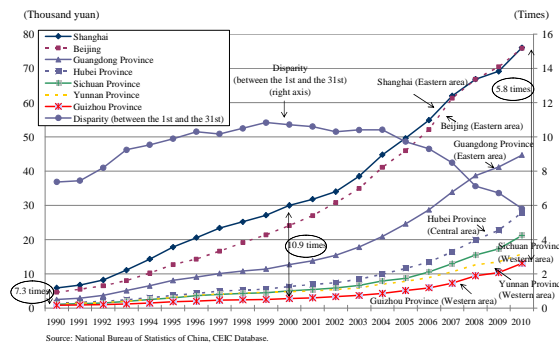
In China, problems concerning disparities among regions, between urban and rural areas, and in urban areas have arisen in the process of remarkable economic development. It is pointed out that generally in developing countries, disparities grow initially in the process of economic growth and shrink as the fruits of growth spread over the whole society. China, at first, gave priority to economic growth under the reform and door-open policy and now is engaged in correction of its growth disparities.

Firstly, as for disparities among regions in China, the transition of per-capita GDP by province shows that the eastern area (coastal area) including Shanghai has achieved high economic growth driven by export due to foreign capital inflows, while the central and western areas (inland areas) have experienced relatively delayed economic growth. For example, in comparison of per-capita GDP between the 1st- and 31st-ranked province, the disparity widened to 10.9 times in 2000 (see Figure 1-4-2-12).

Under such circumstances, large-scale development of the western region was launched in 2000 aiming for growth based on rich resources and large-scale infrastructure development, and northern region development was implemented on a full scale as a national strategy in 2003 aiming for transformation of the industrial structure from a state enterprise-centered economy to a market-based economy, along with the promotion of foreign investment. Furthermore, in 2005, central region development was specified as a national strategy in the 11th Five Year Plan. These efforts have gradually reduced the abovementioned disparities in per-capita GDP. However, it is also true that considerable disparities remained as of 2010.

Figure 1-4-2-12

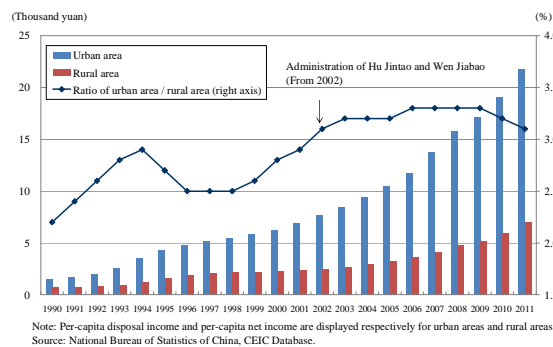
China's per-capita GDP by province/city



Secondly, as for disparities between urban and rural areas, the transition of per-capita income in both areas shows that the disparity has grown since the late 1990s (see Figure 1-4-2-13). Under such a circumstance, the administration of Hu Jintao and Wen Jiabao, which came to power in 2002, has tried to increase incomes mainly in rural areas with the aim of the realization of a “harmonious society.” Afterwards, income disparities between urban and rural areas stopped expanding and instead, there have been signs of a reduction since 2010. However, a factor of three disparity remains, and we need to focus on the future trends.

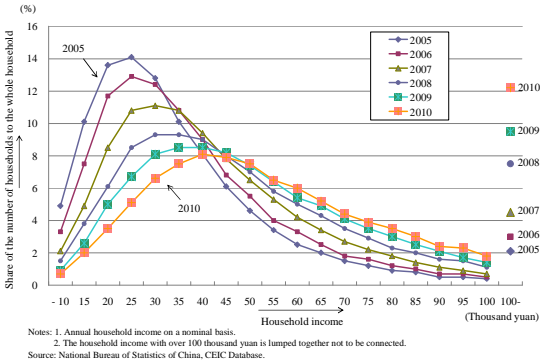
Figure 1-4-2-13

Per-capita income in urban areas and rural areas



Finally, as for income in urban areas, the transition of household distribution by income group shows that the households have shifted to the upper income groups and income levels have increased as a whole. This data does not show the household distribution of high income groups, but the situation, in which many households were concentrated in low income groups, has improved (see Figure 1-4-2-14).

Figure 1-4-2-14
Household distribution by income group in urban areas in China



(C) Measures for modernization of the economy and strengthening of a market-based economy
(Report released by the World Bank and Development Research Center of the State Council of China)

The World Bank and Development Research Center of the State Council of China released the joint report “China in 2030” in February in 2012. According to the report, China has achieved remarkable economic growth for the past 30 years and over 500 million people were lifted out of poverty, and it is expected that China is likely to become a high-income economy and the world’s largest economy before 2030. On the other hand, however, the report throws a question concerning whether or not such growth is sustainable based on the world economy and environmental problems. The report answers to this question that China has the potential to sustain such growth, but achieving this objective will not be easy and China needs to implement a new development strategy. As a result, six strategic directions are proposed to become a high-income economy by 2030 (see Table 1-4-2-15).

Table 1-4-2-15
Proposals contained in “China in 2030”

1. Implement structural reforms to strengthen the foundations for a market-based economy
 2. Accelerate the pace of innovation and create an open innovation system
 3. Seize the opportunity for “green growth”
 4. Expand opportunities and promote social security for all
 5. Strengthen the fiscal system
 6. Seek mutually beneficial relations with the world
- Source: *China 2030* (World Bank, Development Research Center of the State council of China) (Feb, 2012)

The proposals cover a wide range of elements: to implement structural reforms to strengthen the foundations for a market based economy by redefining the roles of the government, reforming and restructuring state enterprises and banks, promoting competition, and deepening reforms in the land, labor, and financial markets; to accelerate the pace of open innovation by participating in global research and development networks as well as improving the quality of domestic human resources and universities; to expand opportunities for employment, public services and social security for all; and to strengthen the financial basis of local governments. Moreover, it is pointed out that the current 12th

Five Year Plan provides an excellent start. We examine the current status of some key elements, taking into consideration of these proposals, the abovementioned reports on government activities announced at NPC, and the 12th Five Year Plan.

(Strengthening of a market based economy)

- Enterprise sector

High growth in China is supported mainly by the vigorous activity of private firms, but many sectors including electricity, petroleum and petrochemicals, telecommunications, coal, and transportation are kept under absolute control by state enterprises. Some sources point out that state enterprises bring pressure on private firms by their efficiency, monopoly on the market, and advantageous access to capital, resources and orders (the state advances, the private sector retreats). The abovementioned report points out that it is important to promote efficiency and the revitalization of the economy through free competition.

- Financial market

In China, state banks have strong influence on the financial market, and the government is prominently involved in interest rates. Some sources point out that interest rates set by the government may be used in inefficient investment to lead to excess investment and that it is difficult for private firms, especially small and medium-sized firms, to get financing because state enterprises are given priority. Further growth of China will require reforms: supply of funds to sound private firms, especially improvement of systems to foster small and medium-sized firms, and financial liberalization including liberalization of interest rates. There is a concern about liberalization of interest rates because competition among banks causes financial crisis for some banks. Therefore, it may be necessary to introduce a financial safety net including depositor protection together.

- Land

In China, the state has ownership in land and residents only have the right to use the land. This enables rapid progress in large-scale development, while this causes social problems were weak residents, especially farmers, cannot receive full protection. Moreover, the problems are escalated by the fact that tax revenue concerning sale of the right to use the land which was purchased and real-estate development becomes important fiscal resources of the local governments. For the purpose of solving the problems, it is necessary to protect residents' rights as well as to address the issue of fiscal resources of the local governments as described later.

- Labor force

Manufacturing industries in China are largely attributable to migrant workers from rural areas, who are called as the “rural migrants (míngōng),” and there were 250 million migrant workers in 2011 (see Table 1-4-2-16). Further economic growth demands the free movement of such workers, but such workers are put in a precarious position under the current family register system (hukou system). For example, when working in urban cities, rural migrants without urban hukous are denied access to social security services including health care, education or housing. It is expected that the growth rate of the labor force will slow in the future also in China, and the effective use of a valuable labor force is an important issue. For the purpose of solving the issue, it is necessary to reform the hukou system, to

introduce social security instruments (pensions, health, and unemployment insurance) that are portable nationwide, and to address the issue of fiscal resources of the local governments that support such instruments.

Table 1-4-2-16
Number of migrant workers

(Unit: Million people)

	Migrant workers	Within regions	Outside regions	Breakdown		
				Eastern area	Central area	Western area
2008	225	85	140	43	52	45
2009	230	84	145	46	53	46
2010	242	89	153	49	56	48
2011	253	94	159	50	58	50

Note: "Within regions" and "Outside regions" are classified according to whether or not the workplace is within a township or a town where a family register exists.
Source: National Bureau of Statistics of China, CEIC Database.

(Science technology and innovation)

While it is expected that the growth rate of the labor force will slow in the future, a high degree of expectation is paid to the introduction of mechanizations as well as development and application to science and technology related industries to improve productivity. Looking at the movement of research and development expenses of China as an indicator, we can see that the ratio of research and development expenses to GDP has rapidly increased and reached the equivalent level to those of the United Kingdom in 2010 (1.8% of GDP). Furthermore, the 12th Five Year Plan sets the target to increase the ratio to 2.2% by 2015 (see Figure 1-4-2-17). Looking at the transition of number of patent applications as an indication of such achievement, we can see China's efforts as the number of patent applications in China has rapidly increased since the beginning of the 2000s (see Figure 1-4-2-18).

The abovementioned report emphasizes that science, technology and innovation should proceed through free competition and the creative efforts mainly of private firms, and proposes that roles of the government include the establishment of domestic research and development networks, participation in global joint research, and fostering innovative cities taking advantage of the massing of enterprises research and development centers and world-class advanced universities, in addition to the establishment of standards and support with the tax system and subsidies.

Figure 1-4-2-17
Ratio of research and development expenses to GDP of major countries

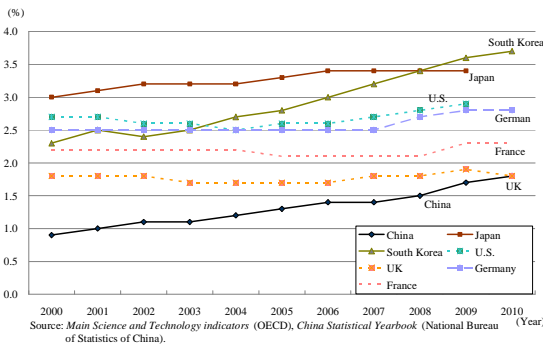
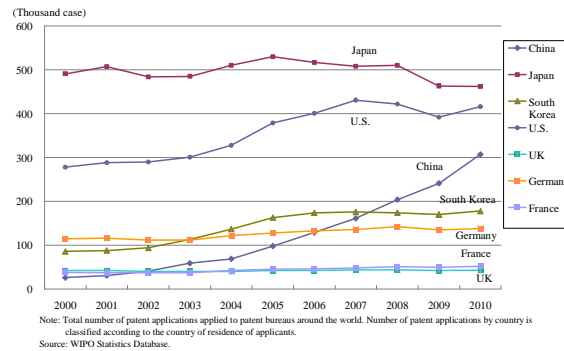


Figure 1-4-2-18

Number of patent applications in major countries



(Environment, resources, and energy)

With the economic growth in China, resources and energy consumption has rapidly increased to create environmental problems. While demand for resources and energy is expected to expand also in the future, the 12th Five year Plan places environment protection and enhancement of resources and energy use as an important issue to set targets for increase in the ratio of non-fossil fuels, energy consumption per GDP, and CO² emission.

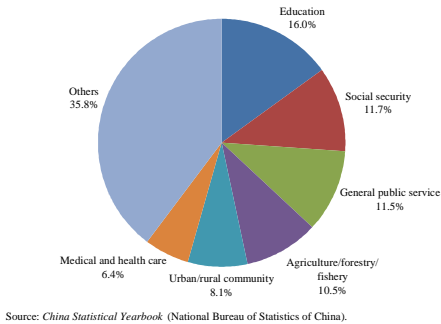
(Social security)

In China, there are differences in social security services (including education, health care, pensions and employment insurance) that people can receive under the hukou system. In addition, it is impossible to receive public services without family registration, as described above concerning the rural migrants.

(Fiscal reform)

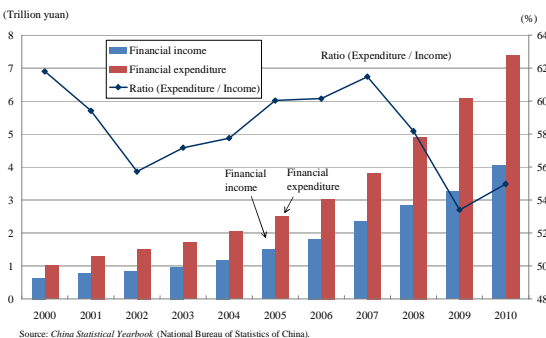
China's local governments provide public services are directly connected to residents, and education, social security and health care account for a large percentage of the fiscal expenditure (see Figure 1-4-2-19). However, the local governments lack fiscal revenues to support necessary fiscal expenditures, and have no choice but to depend on money transferred from the central government or independently-earned income (see Figure 1-4-2-20). In 2009 and 2010, when local governments were put under a certain financial burden by the economic stimulus measure, in particular, a decline in the ratio of tax revenues to the fiscal expenditure caused debt problems of local governments as described in "(1) immediate attention points" in this paragraph.

Figure 1-4-2-19
 Breakdown of the fiscal expenditure of China's local governments (2010)



While it is required to strengthen the fiscal system of local governments, the central government introduced a pilot program in 2009 that allows local governments to issue bonds (which was previously banned) in the manner that the central government issues the bonds as an agent in order to allocate money to economic stimulus measures of 4 trillion yuan. Since then, respectively, in 2010 and 2011, 200 billion yuan of bonds were issued, and, in 2011, the central government allowed, on a trial basis, selected local governments (Shanghai, Zhejiang province, Guangdong Province and Shenzhen) to issue bonds independently. Furthermore, in 2012, the central government issued 250 billion yuan of bonds as an agent, and intends to allow about ten local governments including Beijing to issue bonds independently.

Figure 1-4-2-20
 China's local government finance



As examined above, though China has taken measures in consideration of long-term issues, results are still as yet insufficient and many problems remain. It is desirable to take comprehensive measures to address the mutually related problems beyond fields. It is difficult to solve the problems immediately. Currently, China has been in progress to address the problems. We cannot assume that China will achieve further growth to become a high-income economy. However, China has already developed a large-scale economy following the U.S, and Chinese leaders are to be changed this autumn. China's future moves attract global attention.