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CHINA AND INDIA -- THE CHALLENGE/Online Extra

What's Next for China's Miracle?

Economist Hai Wen on the challenges ahead in maintaining the current momentum in coming years, from exports to health care

An economics-degree holder from the University of California, Davis, Hai Wen is a leading authority on China's reform and development trends. He serves as senior deputy director of the China Center for Economic Research, a Beijing think tank, and is a professor of economics at Beijing University.

He recently discussed China's economy with *BusinessWeek* Senior Writer **Pete Engardio** at the center's offices, based in a beautifully restored complex of red-lacquered Qing Dynasty-era buildings with sloping tiled roofs at the Beijing University campus. Edited excerpts of their conversation follow:

Q: What should China do about its currency?

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A: The government has a choice. It can choose high inflation, or it can adjust the yuan. I think sometimes the government is too cautious. The current government will make a choice between a slowdown and inflation. They don't want either.

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Q: Will China's current account continue to soar?
A: I don't think this trend will continue at the same speed. In recent years, especially last year, the capital inflows increased very fast. This will not continue. Also I believe the trade surplus will gradually reduce as China's demand for foreign goods goes up and trade barriers drop.

Another source of foreign reserves is foreign direct investment [FDI]. I believe FDI will continue but also will slow down. The reason FDI is so high is that China has opened some fields that weren't open before, like finance, telecom, and other services. This will continue for 5 to 10 years, but the [pace of growth] will slow down.

Reserves also are high because we have to prepare for the free exchange of the yuan. Once you open up the foreign currency market, there will be an initial shock -- and it won't be completely rational.

Q: Where is China's next export push?
A: I think China will start to export cars very soon, because the market now is in overcapacity. Twenty-seven provinces produce cars, and almost all of the foreign manufacturers are here. Demand will begin to slow, but supply is growing fast. Where will those cars go? To the international market.

Right now prices are high, because prices are set by the state, and there are high taxes.

I spoke with the head of Volkswagen a while back. He said if you reduce taxes, our cars already are competitive with international prices. If the government gives a tax rebate, it will be very easy to export.

Exporting is not an explicitly stated goal, but this is the reality. Just like what happened when color TVs were in oversupply. When China becomes very competitive, it will be in economy cars. So the U.S. and Japan will have to upgrade to more luxury cars. What were mid-priced cars 10 or 15 years ago are now becoming economy cars. A car will be more like a bicycle in 15 years.

Q: What is China's long-term growth potential?
A: China's labor cost advantage will stay for a long time, if you look at how far it has to go to catch up in terms of per-capita GDP with the West. This is why China can have another 20 years of high-speed economic growth.

Another reason high growth can last for decades is the large size of the country and the imbalances that remain. Japan and Korea had small populations, so very quickly their standard of living went up. It was easier to make everyone rich. But on the other hand, they lost competitiveness in wages in just two decades.

Q: Why is China less capital-efficient than India?
A: One reason is that we still have a planned economy. Much investment is still not really rational. Second, India is at a different stage. India is maybe like China 10 or 15 years ago. In the early stages of opening up, efficiency is higher because capital goes to the most efficient, most productive sectors. But later, the returns gradually slow down. The first dollar is usually the most productive, and the second is less productive.

Q: Can Chinese companies compete globally?
A: The problem with competing globally is that our companies are too small and too diversified. They are small because of our underdeveloped financial markets. So it is very hard for them to grow up. They could grow very fast by issuing stock or bonds, not just on the domestic market.

On the other hand, they overdiversify. Why? From the company point of view, they still believe in the idea of shared risk. They think in terms of the early Japanese or Korean model, although less than they did before the Asian financial crisis. Also, Chinese companies want self-sufficiency. They want real estate and financial businesses.

These companies should merge. But many are run by first-generation businessmen. Everyone wants to be the head of big companies.

Q: How would you characterize China's privatization strategy?
A: We are first going to the stock market. State companies start with the government owning 100%. At the beginning stage, this goes down to maybe 60%, then maybe 40%. Then, the idea is for government to sell all the shares. The state is reducing its shareholding.

Then, the state can use this money to put into pension funds. We need a lot of social security for retired people. Some of this can come from stocks. It is a good idea, but the problem is that when you sell, the stock market collapses. Now the stock market is terrible. This also hurts state-owned enterprises, because their share holdings are dropping more sharply. So it hurts the company.

Q: What problems does China's aging population present?
A: Housing isn't a problem, because we're different from the U.S. Older people have a place to live. Also their income is enough to buy food. They have at least enough for the cost of living.

But the most worrisome problem is health care. If people are not covered, they can't afford health care. So the solution is either to provide less medical care or expand coverage. I believe coverage will be limited.

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