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China's Economic and Social Problems

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As skyscrapers spout and railways roar through the vast land, the rapidity of China's economic development becomes impossible to ignore. Thirty years has seen China evolve from a planned economy to a mixed economy, with new buildings shining with the gleam of modernity. What hazards lie under the shiny surface? Is this "rapidity" sustainable?

In *China's Economic and Social Problems*, Chow analyses China's economy and society, and suggests solutions for the problems he finds.

Part One, "Economic Problems," focuses on nine problems facing China: the excessive trade surplus, the tax system, the lack of social responsibility, damaging ways of stimulating aggregate demand, imbalances of demand and supply for health care, low wages, income inequality, environmental degradation, and illegal behavior.

China's excessive trade surplus has increased the money supply and inflation. Chow suggests that, as of mid-2012, China needs to continue to appreciate the RMB, while expanding domestic absorption. By buying more of other countries' goods China will aid the global recovery. Chow, should also have stressed that, more importantly for China, more Chinese imports would diminish China bashing by its trading partners.

To maintain full employment, a decreased Chinese trade surplus needs to be balanced with increased Chinese consumption. However, according to Chow, policies to stimulate consumption through tax cuts won't work, because people worry about their future income and save a lot, although better social security, which I presume includes health insurance, should stimulate consumption. He recommends more government spending, for example, on high-speed rail and encouraging spending on housing through fostering urbanization. As he suggests later in the book, making bank lending more efficient would be useful too. It is not clear, however, why Chow considers the low responsiveness of consumption to taxes to mean that lowering taxes is bad. It just means that taxes need to be cut by more, and the fiscal authority can cut distorting taxes by more without concern for inflationary consequences.

The recent increase in Chinese wages, he writes, is due to improved physical and human capital.

Health care: Chow writes that as China's population increases, its demand for health care increases. The price of health care also rises. The central Government only acknowledges the existence of government-operated (gongban) hospitals and gives money to fund them to local governments, but local governments divert that money to improve their economies, leaving health care needs unsatisfied. According to Chow, the best and easiest solution is to give people-operated (minban) health institutions a green light to establish themselves. Providing health insurance for treatment at either private or government operated hospitals would create competition and good care would drive out bad care. Allowing *minban* and *gongban* hospitals to compete at the same level would create the most capable health institutions.

Chow's training at the University of Chicago has left him with a deep respect for the salutary effects of competition. However, competition is not a miracle solution. It must be supported with anti-trust laws, a fair and well-functioning judicial system, no arbitrary subsidies, hard budget constraints applied to state owned enterprises, effective bankruptcy laws, and no political threats and the book would have gained from more emphasis on these issues.

Part Two, "Economic Studies," tells some tales that describe how to practice economics.

According to Chow, economists can forecast accurately only things that can be explained. For example, they cannot predict accurately short run movements in the stock market, for the stock market is an efficient market in which future expected price movements are already reflected in the current price.

There are two ways to form expectations in econometric models. One is adaptive expectations, proposed by Milton Friedman in his work on the permanent income hypothesis; another is rational expectations. Chow finds that adaptive expectations forecast better than rational expectations do when either economic agents don't understand the complex dynamics of the economy or when the builder of the model of the economy on which rational expectations are based got the model wrong.

When editing the *Handbook of the Chinese Economy*, Chow rejected the proposal of Routledge, the publisher, to provide a list of important topics; instead, he advertised in the *American Economic Review*, asking would-be authors to present their proposals and their qualifications. This generated an authorship from many authors and countries with a range of topics that a single expert would have been ill equipped to select. Once again, his love of competition and free entry reflects his PhD work at the University of Chicago.

Chow predicts that as of 2012 China's real growth of GDP will be 8% or slightly more for the next ten to fifteen years based on three factors: the quality of economic institutions, the quality of human capital, and the degree of economic development. China's economic institutions are not yet fully capable in spite of their progress. For the second factor, China has abundant high quality human capital. The third factor predicts that China's GDP growth will slow down because of its transition into a fully developed economy, hence its lessened ability to exploit the gap between it and economies on the technological, institutional, and legal frontiers.

China's growth of real GDP was 7.7% in 2013, 7.3% in 2014 and the Chinese government predicts 7.0% growth for 2015,[1] so Chow's predictions may be optimistic, especially in light of the factors that precipitated China's stock market shock of 2015. A long-term economic forecast has its drawbacks since it cannot take future eruptions into account.

Part Three, "Economic Policy," evaluates China's present economic policies, foreign policies, urbanization, and the banking system. Chow recommends that private firms be allowed to compete on a level playing field with public firms.

Chow suggests that the urbanization of China should be voluntary. The economy prospers when a city grows if it is located next to a river or ocean that makes it convenient for its residents to travel and trade, such as Shanghai or Nanjing or Guangzhou. But when a city is arbitrarily constructed without a rationale for its location, forcing citizens to move there is costly. If farmers are unwilling to move to a city, because they correctly believe they won't have a nicer life or better opportunity, neither they nor China would benefit from the move. Moreover, investment in such cities creates discontent and hampers the achievement of a harmonious society. Furthermore, the additional city-creating government expenditure may lead to inflation and increased government indebtedness.

Chow advocates reform of China's banking system. The government keeps the deposit interest rate artificially low, so low that the real rate is negative. Similarly, the lending rate is kept artificially low and this leads to bribery by would-be borrowers. The low deposit rate has spawned an underground "shadow banking system." The shadow system pays deposit rates that are higher than the official one. Chow thinks the shadow banking system benefits China's economy by eliminating the shortage of loans supplied in the market. It also allocates loans without bribery. He suggests that the first best policy is to allow the market to determine the interest rate in the official banking system, so the fair interest rate wouldn't occur only in clandestine operations. Bringing all transactions under the supervision of regulators reduces the probability that the shadow banking system would lead to bank failures. He also suggests 100% reserve requirements for the banking system, an idea from Milton Friedman. In order to provide a decent real return to depositors, he must have in mind Friedman's proposal to pay interest on bank reserves, although he doesn't mention it.

Part Four, "Social Problems," compares several social issues in America and China.

[1] Mark Magnier, "China Cuts 2014 Economic Growth Estimate to 7.3% From 7.4%," Wall Street Journal, September 7, 2015, (http://www.wsj.com/articles/china-cuts-2014-economic-growth-to-7-3-from-7-4-1441593730)

"In the US universities, creative scholars encourage their students to think independently. The relationship between teachers and students are [sic.] more equal than in China. Professors and graduate students study together and learn from one another. In China, professors say they 'direct doctoral students' while in the US, professors try to help students to think originally and creatively. In academic discussions, we observe mutual respect among scholars, professors and students alike." (p.149). Chow writes that China's university system has made great progress. Top Chinese universities now pay PhD graduates world market salaries. He expects to see steady growth in the quality of Chinese education. Here is a window to Chow's ideal vision of university education.

The book leaves the reader with an appreciation for Professor Chow. It soundly illustrates the application of economic and econometric tools to explore economic relationships. It presents his conviction of the importance of dialogue between policy makers and economists. It is a good example of how to write for a lay audience. Too few economists today follow in the path of Milton Friedman, John Maynard Keynes, Greg Mankiw, and Paul Samuelson, writing both for the economics profession and them.

Overall, Chow's "China's Economic and Social Problems" lets reader view the landscape of China's present economy and society using comprehensible language. It makes deep subjects understandable to those with a shallow knowledge base. It fits readers who want to learn about China and provides them with some wise suggestions about how to smooth China's path forward.

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