CHINA'S ECONOMY AT THE CROSSROADS

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Contents

Preface and Acknowledgements

Like many economists in China and around the world, I have been fascinated by China's reform and opening-up since the late 1970s, and impressed by the results so far. I have been trying to understand the country's transformation since the early 1990s, first as head of the World Bank's office in Beijing (1993-1997) and then, after my retirement from the Bank in 1998, as a teacher at Johns Hopkins' School of Advanced International Studies (SAIS) in Washington DC, my hometown.

As China's economy is growing in size and complexity, it is becoming increasingly difficult to follow and assess the meaning of events. The gap between bullish and bearish perspectives is widening. Influenced by my experience as a temporary resident of and frequent visitor to China, interacting with leaders, officials and ordinary citizens around the country, I am generally optimistic about the country's economic prospects. Much as I, like many other observers, felt sometimes overwhelmed by the magnitude of challenges facing China, time and again I found the leadership willing and able to deal effectively with problems, usually coming out ahead. But I recognize that there is room for less optimistic perspectives and that the country is, once again, facing major challenges in many areas.

This is a collection of essays on different topics, written during the period 2007-2013. They are reproduced here as organized in three parts:

(1) The need for changing China's growth model;

(2) China's responses to and recovery from the international financial crisis;

(3) Selected topics.

The essays provide a window on the evolution of my understanding of economic developments and challenges; except for some of the 13 short essays included in Part 2, they are unedited. Some common themes are pulled together in the "Introduction".

I would like to thank Foreign Languages Press for inviting me to put together a collection of essays for a book in this series. I also thank Gail Fosler, former president and chief economist of The Conference Board and co-author of "Can China's Growth Trajectory Be Sustained?", as well as the following publishers and agencies for permitting me to reproduce essays previously published by them:

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Introduction

China's economy has been "at the crossroads" almost continuously since the start of the reform and opening-up under the leadership of Deng Xiaoping in the late 1970s. The historical decisions of December 1978 set in motion a unique reform process that is still ongoing. The reform came in waves, usually following a crisis. The challenges facing China today are as daunting as they were in 1978, 1989–1993, 1997–1998 and 2008. In steering the reform process, China's leaders were guided by pragmatic considerations, not by ideology. During the period 1978–2012 GDP and average per capita income (at constant prices) increased by a factor of 24 and 17 respectively, a growth record unmatched anywhere, anytime. Hundreds of millions were lifted out of deep poverty; trade and investment links with the outside world were built while domestic markets gradually became integrated. Naturally, there was and is much disagreement on precisely where to go and how fast to move. As the economy became larger and more complex, it became increasingly difficult to reconcile conflicting views on priorities and sequencing. Strong leadership was often needed to break political logjams. The key decisions that were made at critical turns ensured consistency and continuity of the reform path; otherwise China's economy wouldn't be where it is today. Although the experience of other countries provided useful guidance, there was no model to follow. China made effective use of international development agencies such as the World

Bank, but its reforms were homegrown and *sui generis*.

A feature that distinguishes China from most other countries was and is the government's ability to set and successfully pursue long-term development goals. China was careful not to push the pace of reform beyond what society could absorb and institutions could handle; there was no incentive to take undue risks, because the political system remained intact. From the start the process relied as much on "bottom-up" initiatives as on "top-down" mandates. Generally, there were no detailed blueprints or timetables for reform.

In the late 1970s and early 1980s, the main challenge was to improve food security and increase farmer incomes. The main policy question was whether and how to decollectivize agriculture. Most initial reforms were based on local initiatives, with some leaders at the center more ready to accept a return to family farming than others. It took the Communist Party of China (CPC) several years to officially sanction decollectivization, rural markets and private entrepreneurship. *Dual-track pricing* and mandatory quotas smoothed a deliberately gradual transition from plan to market. At first, Western economists didn't think much of China's approach to reform, because it created market distortions.

From the mid-1980s, when rural reforms continued to yield excellent results and a rapidly growing non-state economy had emerged, the attention of policy makers shifted to reforming state-owned enterprises, liberalizing prices and creating markets and other institutions needed to run a marketing economy. Improving infrastructure was a key development objective from the start.

In the early 1990s, after Deng's famous tour of the south in early 1992, investment promotion and the creation of macroeconomic management tools (including a partial recentralization of financial and fiscal controls), capital market development and social security reform became high priorities. The decision of the CPC 14th National Congress (October 1992) to create a *socialist market economy*, followed by the decision of the Third Plenary Session of the 14th CPC Central Committee (November 1993) to create a *modern enterprise economy* provided a framework for further reforms. Those decisions eventually led to China joining the World Trade Organization in 2001 and becoming the world's second largest economy in 2010.

Reform momentum intensified in the mid-1990s under Premier Zhu Rongji and President Jiang Zemin. To illustrate: from 1995 (peak year for public sector employment) to 2003 employment in state-owned units (many of which were closed, merged or privatized) contracted by almost 45 million, while non-state employment (outside agriculture) increased by 82 million! From 1998 most urban housing was privatized, mortgage markets developed and most state banks were recapitalized while preparing for stock exchange listing.

These aggressive reforms were followed by a quieter period under Premier Wen Jiabao and President Hu Jintao (2003-2012). Attention was focused, at least initially, on continuing earlier reforms and on strengthening social services, including health, education and social security nets for both rural and urban areas. A key objective of China's 11th Five-Year Plan (2006-2010) was to "rebalance" the country's growth model (away from dependence on external demand and domestic capital formation to domestic consumption growth), but that goal was thwarted by the international financial crisis following the collapse of Lehman Brothers in the U.S. in 2008 to which China responded with a stimulus program that relied heavily on state-sponsored investment.

Nonetheless, progress was made, as export dependency declined substantially—"net-exports" is no longer an important contributor to GDP growth. But no progress was made in reducing China's dependency for growth on capital formation. On the contrary, although household consumption growth during the past decade has been very strong, GDP growth in recent years was even more investment-driven than before 2008, when the global financial crisis started. Similarly, the so-called "harmonious society" Hu and Wen hoped to establish turned out less harmonious, though on average much richer, than before. The lack of progress in promoting social harmony is believed to be mainly due to sharply increased income and wealth disparities, corruption, environmental pollution and complaints about inadequate compensation for land needed for non-agricultural purposes.

The new leadership team that took over in March 2013, led by President Xi Jinping and Premier Li Keqiang, will have its hands more than full dealing with the many domestic economic and social challenges facing the country today, not to mention external challenges. It has pledged to resume efforts aimed at domestic economic "rebalancing", but this will probably not involve a sharp decline in China's investment/GDP ratio any time soon. Rapid urbanization, one important way in which the new team hopes to promote domestic economic rebalancing, is going to require huge amounts of investment for many years to come. Other areas that will require the new team's full attention include *hukou* (permanent residence permit) reform, tax policy reform (including fiscal relations between the central and local governments), the creation of rural land markets, further financial sector liberalization and development, industrial restructuring, energy policy and pollution control, the promotion service sector development, a shift from government-sponsored to corporate-sponsored research and development (R&D), and generally: reducing the role of the state in the economy.

Perhaps the most difficult challenges are controlling corruption, reducing inequality, and promoting traditional values in society. Although political *practices* have gradually become much more open, some political system reforms may now be needed to achieve key objectives other than GDP growth, including strengthening the judiciary and the accountability of officials, managing scarce resources responsibly, and promoting greater fairness and trust in society. China's continued support for multilateral and regional efforts to protect the environment, promote fair trade and investment practices and strengthen global governance is generally essential. RMB internationalization combined with continued gradual opening of China's capital account can serve both Chinese and international economic interests, including international financial system stability.

"China 2030", a joint economic report by the World Bank and the State Council's Development Research Center published in 2013 sums up the challenges facing China's economy as "the need to avoid the *middle-income trap*." This is an important concept and a useful organizing principle for guiding economic policy making in the years ahead. Few developing countries escaped this trap when the "easy" or "catch-up" phase of economic development (based on cheap labor and on copying foreign technologies) was over. Japan, South Korea, and the city-economies of Hong Kong and Singapore are important exceptions. In technical economic terms the challenge facing China is to increase the contribution of *efficiency* improvement (total factor productivity growth) to GDP growth. This will indeed require, as China recognized years ago, greater emphasis on the development of human resources, the provision of "public goods" (including, of course, political and social stability), and more reliance on domestic innovation. It is only when total factor productivity (TFP) growth is strong that China can hope to maintain high GDP growth with a lower investment/GDP ratio and slower export growth. However, as explained in some of the essays in this volume, rapid TFP growth is a necessity, but not a sufficient condition for sustained rapid development.

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Economic Developments after the Financial Crisis of 2008 and the Need for a New Growth Model

Can China's Growth Trajectory Be Sustained?

China's Economy in 2020: the Challenge of a Second Transition

PART I

THE NEED FOR CHANGING CHINA'S GROWTH MODEL

Economic Developments after the Financial Crisis of 2008 and the Need for a New Growth Model

Pervasive pessimism about China's economy in recent years and fears of a "hard landing" seems to have been replaced by cautious optimism in the second half of 2013 when the economy stabilized and growth prospects improved. Thanks to astute economic management China has overcome the international financial crisis of 2008-2009 sooner than any other large economy. In spite of a serious slowdown in export growth, potentially dangerous property bubbles in major cities and political upheavals, such as the Bo Xilai affair, the government appears to have regained its capacity to set and achieve development goals.

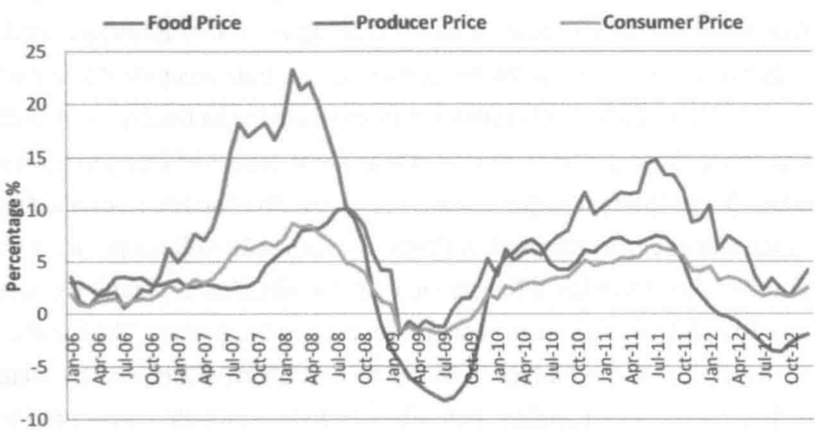
Political succession during the CPC 18th National Congress (November 2012) was smoother than expected. The new top leaders are very capable and experienced in government. They seem to have accepted the inevitability of slower growth (7-7.5%) in the years ahead and appear determined to pursue structural economic reforms. Proactive corruption fighting is also a top priority. But the country faces formidable challenges, including resistance to fundamental change from political conservatives and certain interest groups, rising production costs, and rising public discontent due to many factors, including rising social inequality and environmental problems.

A "second transition" toward a more equitable and sustainable growth pattern is likely, but will take time and require political change. The biggest challenge is to increase the efficiency of investment. The political system needs to evolve in the direction of greater social inclusion, transparency and "downward" accountability of officials. The biggest risks facing China's economy in the next few years are probably more internal than external and more political than economic in nature. Because of slower growth and the need for social reforms, budget problems must be anticipated, pointing to the urgency of fiscal reforms, especially with regard to central-local government fiscal relations. The risk of financial instability due to over-leveraging and shadow banking has risen, but appears manageable. Important financial reforms aimed at mitigating those risks and at further opening the financial system, including RMB internationalization, are being implemented.

Recent Economic Developments (2007-2012)

The last five years have been tumultuous for China's economy, reflecting both domestic and international turmoil. The problems did not start with the global financial crisis (triggered by the collapse of Lehman Brothers in the United States in September 2008), but with the high domestic CPI and house price inflation in 2007 that followed years of double-digit growth and the accumulation of very large external surpluses. China's current account surplus reached a record high of 10.1 percent of GDP in 2007. On top of that there were substantial "hot money" inflows from abroad, attracted by a property boom in major cities and the expectation of RMB appreciation. To slow the

Chart 1. Food, producer, and consumer price inflation (monthly, annualized percentage change, January 2006–December 2012). (Sources: NBS, Bloomberg)



pace of appreciation, the central bank intervened heavily in the foreign exchange market and sterilized excess liquidity in the banking system resulting from external surpluses by raising reserve requirements and/or selling central bank bills. In retrospect the sterilization effort may not have been aggressive enough, as both CPI (especially the food price component) and property price inflation became serious in 2007 (Chart 1).

Beijing responded to the inflation problem of 2007 with relatively aggressive monetary tightening. This action was probably more effective than had been expected; food price inflation declined quickly, while house prices began to fall in the fourth quarter of 2007, triggering a slump in the construction business. Developers began to lay off construction workers, mostly migrants, in large numbers. Many in government began to worry that GDP growth was slowing too fast. At that time a new problem developed: export orders began to fall as a result of the financial crisis that had been brewing in the United States since 2006. Mounting subprime mortgage defaults and related bankruptcies created occasional credit crunches and fears of worse to come. Many Chinese exporters had to scale back production and lay off workers. By July 2008, the government became so concerned about the growing unemployment problem (affecting mostly migrants) that it re-froze the RMB/USD exchange rate to provide at least some protection to exporters. Financial sector problems in the United States intensified especially after the collapse of Bear Stearns in March 2008. While China's exports were still growing, new export orders dropped fast. As is well known, the global financial system went into a stupor following the collapse of Lehman Brothers (14 September 2008), causing a sharp contraction of global trade, including exports from China, which by the end of 2008 had laid off an estimated 20 million workers in export industries. Total migrant unemployment at that time was probably some 30–40 million. Quarter-on-quarter GDP growth fell to near zero in the final quarter of 2008.

It was under those dire circumstances that China launched an aggressive stimulus program. It was the first major economy to do so after the international financial system froze and exports collapsed. A RMB4 trillion ($586 billion) program was announced in Beijing on Sunday, 9 November, only 8 weeks after Lehman's collapse! The bulk of the stimulus money was to come in the form of bank loans. The fiscal component—mostly in the form of budget subsidies for consumption and various social programs such as "affordable housing" and job re-training—probably accounted for less