# “The New Season of Chinese Economic Miracle” and its Challenges

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**Abstract**

*The investment and export-driven economic model followed by Chinese governments after 1978 served very well their catching-up vision, but China's unprecedented race to the top had its flaws and drawbacks, leading to negative externalities and multiple structural imbalances. The global economic crisis and the interventionist package implemented to countervail its impact triggered a host of unwanted, negative outcomes which further aggravated the imbalances of the Chinese economy and created some new ones. It therefore became more obvious than ever that the old economic model had reached its limits and it needed to be changed. This task rests with the new cabinet led by premier Li Keqiang who launched a blueprint of bold reforms, but their implementation will presumably meet the strong opposition of powerful vested interests. The paper looks at the structural imbalances of the Chinese economy, highlighting the needed rebalancing processes. It also looks at the reform blueprint designed by the new leadership, disclosing and discussing some of its main implementation challenges.*

**Keywords:** *China, development model, structural imbalances, economic rebalancing, economic reforms.*

***J.E.L. Classification:*** *O21, O41, O53, P21, P27, P33, P35.*

## 1. Introduction

China is now at a crucial stage of its transformation, with its old and successful economic model having reached its limits and having generated critical negative externalities and structural imbalances. Thus, the need for a new model, resting primarily on domestic demand and focussed on innovation and quality, becomes an imperative. This is a complex and challenging endeavour, trying the government's ability to avoid the middle income trap, steer China to sustainable growth and make it a member of the highly developed economies elite. It is a vital challenge for China, but also for all the other actors on the global stage, as this country's status and positioning in the world economy makes its every move important by its consequences for each and every member of our globalized world.

## 2. The Chinese economic model - from the “miracle of rapid growth” to “running out of steam”

The investment and export-driven economic model followed by Chinese governments served very well their catching-up vision. For over three decades China managed a nearly 10% average growth rate, becoming the second largest economy in the world, the number one industrial producer, the first exporter, the second importer and the holder of the largest foreign exchange reserve globally, while Chinese companies and banks took top positions in many global markets and in various international rankings.

China managed an impressive industrialization, urbanization and modernization process, it largely diversified its industrial set-up, it developed powerful cities, with bold architecture, interconnected by extensive and good quality infrastructure. It created yearly tens of million jobs and it pulled out of poverty some hundreds of million people, it increased life expectancy and the living standards at home and it became an engine of growth for both Asia and the world. No other country has ever managed such a performance in terms of high growth rates, for such a long period of time, with such impressive results, but…

This unprecedented race to the top also had its flaws and drawbacks, leading to negative externalities and multiple structural imbalances. The main weakness of the model lays in its flawed resource allocation, with excessive investment (and the resulting overcapacities) in resource-intensive industries and in infrastructure, on the one hand, and frugal domestic consumption, weak public services and underdeveloped social protection, on the other. Also, the model encouraged excessive investments in capital, natural resources and energy-intensive industries which produced huge pollution, damaging badly the environment, in parallel with the underdevelopment of innovation and knowledge-intensive industries and services. At the same time, resource allocation in China displayed an excessive bias for the - often inefficient – state-owned enterprises (SOEs), which enjoyed favourable access to cheap financing, various exemptions and low accountability, strengthening their monopoly positions and distorting competition, while the backbone of the economy, the small and medium-size enterprises (SMEs) were forced to restrictions, having little or no access to financing and facing a harsh business environment.

The root-cause of the massive capital misallocation in China and of its resulting economic imbalances was price controls, especially the control over the fundamental prices in any economy: the interest rate (which was kept at low, even negative real levels for deposits, to allow a transfer of wealth from depositors, mainly households, to borrowers, mainly privileged state companies); the exchange rate (which was used as an export drive by artificially keeping the yuan undervalued); the price of energy and, to a certain extent, the price of land and the price of labour (wages), all of which helped China maintain significant competitive advantages, so that it attracted large foreign capital investments and it kept increasing its exports.

Another significant weakness of the Chinese development model was (and it still is) its high dependence on the external demand and the resulting vulnerability of the Chinese economy to the external shocks, while, at the same time, the domestic demand was chronically neglected and the consumption ratio to GDP kept ranking among the lowest worldwide. The true weight of this vulnerability was abruptly revealed in 2008 at the outbreak of the global economic crisis, when all the most important three markets for Chinese exports – the EU, the USA and Japan – collapsed simultaneously, leaving Chinese exporters without orders. This led to tens of thousands of factory closures, bankruptcies, a sudden and huge increase in unemployment and an abrupt contraction of growth, inducing the cabinet to implement a vast fiscal and investment programme, amounting to about 586 billion US dollars (4 trillion yuan). If not for everybody at the time, in retrospect, many have come to the conclusion that the short-term efficiency of this oversized intervention (mainly the quick return to a two-digits growth rate) was not worth its longer-term consequences, some of which are still unsolved.

Thirdly, the banking system underpinning the real economy also got flawed, by granting cheap loans at political command, writing off non-performing credit for SOEs and promoting financial repression[1] through the interest rate policy. Additionally, in recent years, the official banking system seemed to not only overlook, but even take part in the development of "shadow banking", a parallel, un-official and high-interest rate banking system, which flourished against the backdrop of the financing shortages encountered by the SMEs. On the whole, all these developments rendered the Chinese financial system itself quite vulnerable.

Naturally, the flaws, asymmetries and imbalances developed in the Chinese economy were mirrored by the Chinese society, where social inequality and the income gap increased, while collusion, corruption and moral hazard worsened. Furthermore, the excessive focus on quantitative accomplishments speeded up the inefficient use of natural resources, often using highly polluting technologies which took a huge toll on the environment and on the population. Also, it generated a geographically imbalanced development, with highly developed Eastern coast regions on the one hand, and the central and Western regions lagging way behind, on the other.

Globally, the model also led to significant external imbalances, prone to escalate commercial frictions between China and its foreign partners, particularly with the EU and the US.

As all these flaws, imbalances and malfunctions added up – while further investments following the same pattern faced the prospect of diminishing returns, the "demographic dividend[2]" kept fading away, the rising prices for factors slackened competitiveness and the economic growth slowed down - it became increasingly obvious that the Chinese development model has reached its limits and was in urgent need of change.

## 3. The 4 "-uns" of the Chinese economy and the urgency of rebalancing

The best description of what lays now beneath the surface of a seemingly spectacular economy was given in March 2007 by the former premier Wen Jiabao, who contended that Chinese economy had become "unstable, unbalanced, uncoordinated and, ultimately, unsustainable".

Still, in spite of such a drastic diagnostic, not only did his cabinet do little to reform the economy, but on the contrary, as a result of the 4 trillion yuan fiscal and investment stimulus package, which it implemented between 2008 - 2010 to countervail the impact of the global economic crisis, the "*4 –uns*" worsened and the vulnerability implied by them was increased (Roach, S., 2013). By implementing the stimulus package, the Chinese government reversed the downward trend of the

[1] The term was introduced in 1973 by Stanford economists Edward S. Shaw and Ronald I. McKinon and refers to any of the measures that governments employ to channel funds to themselves, that, in a deregulated market, would go elsewhere. In this paper it refers to policies by the Chinese government to keep real deposit interest rates low, or even negative, and channel savings to privileged state companies by way of cheap loans from the state banks, given at political command.

[2] The term refers to a period of 20 or 30 years, when families have (from various reasons) fewer younger dependents (in China due to the "one-child policy") and fewer older dependents (in China due to shorter life expectancy of the older generations), so that the largest segment of the population is in the range of the productive working age. During this time span, the economy benefits from a large pool of labour, low wages, competitive advantage and economic growth. Such a demographic dividend was experienced by China in the last two or three decades. But, as the living standards improved, life expectancy increased and so did the number of dependant elders, while roughly the same number of young people entered the labour market, yearly. The result of these trends was a relative decrease of the working age segment of population and a "fading away of the demographic dividend", which could lead further to labour shortages, increased wages and a downward pressure on the economic growth rate. The recent decisions to give up the one-child policy aims at reversing this trend, but its outcomes will be seen in decades.

economic growth rate during the Q4/2008-Q1/2009, created a significant number of new jobs and managed to preserve social order but, at the same time, it triggered a host of unwanted, negative outcomes which aggravated previous economic imbalances and created some new ones.

In the short run, the huge amount of money poured into the Chinese economy through the enormous fiscal expansion and the loose monetary policy which accompanied it, pushed prices up, inflated speculative bubbles in the equity and real estate markets, encouraged poor lending practices and nourished a serious investment extravagance and waste, resulting in growing industrial overcapacities and unnecessary real estate and infrastructure building. At the same time, the flood of "easy money" furthered corruption and collusion, so that the well-positioned and well-connected families got richer and the income gap in Chinese society got deeper.

In the longer run, the interventionist programme of 2008-2010 led to a steep increase in the regional governments' debts, it entailed a worrisome rise of the non-performing loans and it contributed to the expansion of the parallel, unregulated system of *shadow banking.* All these developments made the Chinese financial system more vulnerable, worsened its structural weaknesses and deteriorated further the resource allocation in Chinese economy.

The great beneficiaries of the governmental interventions were again the SOEs, mainly the 136 "central companies" directly controlled by the government and managed by leaders appointed on political grounds. Between 2008-2010, these state companies enjoyed an even more favourable support than usually, to the disadvantage of the private sector, especially the SMEs, so that the stimulus program seemed to have generated a powerful new wave of "*state sector advancement while the private sector recedes"* (Tai, C., 2009), becoming an instrument for strengthening state companies and crowding out the private ones (Chan, E., 2010). State monopolies reinforced their dominance in key sectors of the economy, such as banking, telecommunications, energy, rail transport, shipping, petroleum, etc. and were helped to extend their global presence, both by trade and investments, while in contrast, private businesses had to face financial shortages and unfair competition from SOEs.

While the vast stimulus package implemented in the first years of the global economic crisis helped China cope very well with its downturn challenges, during the following years, especially in 2011 and 2012, the government had to focus on correcting the negative "by-products" of its previous massive intervention in the economy, primarily trying to cool down inflation and to defuse the speculative bubbles. Besides policies such as these, which were addressing precise urgent matters but were not solving the multiple structural imbalances of the economy, specific measures for changing the development model itself were included in the 2011-2015 five-year plan (FYP). Nevertheless, in spite of some accomplishments, the former cabinet didn't seem to push very forcefully for reforms, leaving this task to the next government, led, since 2013, by premier Li Keqiang.

Reforming China's development model and rebalancing its economy seems to be a complex three-pronged process of:

- *rebalancing demand*, namely of striking the right balance between domestic consumption, investments and exports, with home demand and domestic consumption playing a more important part as engines of growth, while relying less on foreign demand and exports, as well as on state investments;
- *restructuring supply*, which includes: striking a better balance between primary, secondary and tertiary sectors, with a focus on accelerating the development of services; rebalancing traditional, natural resources-intensive industries, which need production capacity adjustments, upgrading and repositioning in the global value chains, on the one hand, and the

higher-technology, knowledge and innovation-intensive industries, whose development need to pick up speed, on the other hand; also, striking a better balance between polluting and green industries; levelling the playing field for a fairer competition between state and private, foreign and domestic companies; breaking up monopolies and any other structures or practices which distort markets, encouraging SMEs and private start-ups;

- *rebalancing regional development,* by extending urbanization and levelling away the urban / rural differences in terms of incomes, opportunities and living standards; also by rebalancing the development of the Eastern and Western regions of the country and bridging the development gap between them.

Simultaneously, proper balances should be struck:

- *between economic growth and social stability*, by setting lower growth rate targets, adjusted to China's present development level and social needs, and by switching from quantitative to qualitative goals, higher living standards included; the state should be less of an investor in the economy, and more of an investor in public services development and social welfare;
- *between human needs and nature,* by trying to reasonably meet human needs without damaging the environment, by promoting green sources of energy, green technologies and industries, rational and efficient resources and energy consumption, by fostering innovation focussed on regaining a well-balanced environment, which is not harming human health, etc.
- *between domestic development and external relations,* by adopting development strategies, policies and regulations which consider not harming in any way other countries, or the global economy as a whole.

## 4. The New Season of China's Economic Miracle

While the former Chinese cabinet focussed on economic growth and quantitative accomplishments showing little propensity for reforms, the new government faces the complex challenge of completely changing the economic model, so that China avoids the *"middle income trap"*[3] and enters the highly developed economies elite. The recent positioning of China's new leaders shows that they are fully aware of the urgency of this endeavour, willing to reform and take on the challenge of steering China to a sustainable, more temperate growth, focussed on quality.

Premier Li Keqiang acknowledged that Chinese economy is at a crucial stage of its transformation, it is steadily moving forward and its fundamentals are sound. He has also affirmed that his cabinet has a holistic approach in conducting readjustments and reforms that *"Reform and innovation is the running theme and spirit of the policies adopted by the Chinese government, and it is the banner that we will always hold high*."[4] and that "*Now the new season of the Chinese economic*

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[3] The **middle income trap** is an economic development situation, where a country which attains a certain income (due to given advantages) will get stuck at that level. As wages rise, manufacturers often find themselves unable to compete in export markets with lower-cost producers elsewhere. Yet, they still find themselves behind the advanced economies in higher-value products. This is the middle-income trap, which saw many countries languish for decades in what the World Bank call the "middle income" range (about $1,000 to $12,000 gross national income per person measured in 2010 money). Typically, countries trapped at middle-income level have: (1) low investment ratios; (2) slow manufacturing growth; (3) limited industrial diversification; and (4) poor labour market conditions. The problem usually arises when developing economies find themselves stuck in the middle, with rising wages and declining cost competitiveness, unable to compete with advanced economies in high-skill innovations, or with low income, low wage economies in the cheap production of manufactured goods. (Wikipedia, March, 2014);

[4] Premier Li Keqiang's Speech at the Summer Davos Forum opening ceremony , the Annual Meeting of the New Champions 2013 , Dalian, September the 11th, 2013;

*miracle, one of better quality and higher efficiency, is unveiled, and I guarantee you even more exciting stories to come."* [5]

Some of these pledges were substantiated at the 3rd Plenary Session of the Communist Party of China (CPC) Central Committee (CC) in November 2013, where China's new top decision makers unveiled the economic reform blueprint for the next decade. On this occasion, balancing the relationship between state and market - with the market playing the decisive role in allocation and the state intervening less, but more efficiently - was claimed to be the key idea and aim of the reform process. According to this blueprint, China was going to stick to the Party's leadership and to its socialist road, therefore no political reforms were intended, but a strong signal in favour of deep and comprehensive economic reforms was given. It was contended that "reform and opening-up" will decide the destiny of modern China and its adjustment to a rapidly changing global world.

In terms of *market reforms*, the commitment for fair, open and transparent market rules so that prices were decided by markets, was stressed upon; state control over economic sectors was going to gradually loosen, to the benefit of the private sector and foreign enterprises; companies were to operate independently and to compete fairly, in a modern market system; the SOEs were to be reformed, monopolies were to be broken and competition introduced; more state-owned sectors were to be opened to the private capital, including finance, telecommunications and railways; market barriers were to be cleared to improve efficiency and fairness in resource allocation; the *fiscal reform* was going to be in special focus, with a view to building a modern, transparent and efficient fiscal system, with improved legislation; SOEs were to have their profits taxed more substantially (with tax increases going from 0-15% at present, to 30%, by 2020) and the resulting funds were to be redistributed for social purposes; internal and external openness were going to be promoted by both *"going global"* and attracting foreign direct investments (FDI) policies; reforms and the new opening up policies were to be tested in free trade zones (FTZ), used as pilot areas for reform.

The Session also put forward *land reform*, with issues such as establishing property rights to farmers, the reform of the *hukou system*[6] of registration, the need for a unified land market between urban and rural areas and for new urban/rural relations. These reforms were to be complemented by the *reform of the local administrations,* aiming at streamlining the local/central revenue division and at allowing local governments diversify their budgetary sources by issuance of bonds.

Hugely important and urgent, the *financial reform* was going to introduce the interest rate and exchange rate liberalization, to allow the access of foreign and local private banks into the Chinese banking system and to regulate shadow banking.

[5] Idem.

[6] A **hukou** is a record in the system of household registration required by Chinese law. In 1958, the Chinese government officially promulgated the family register system to control the movement of people between urban and rural areas. Individuals were broadly categorised as a "rural" or "urban" worker. A worker seeking to move from the country to urban areas to take up non-agricultural work would have to apply through the relevant bureaucracies. The number of workers allowed to make such moves was tightly controlled. People who worked outside their authorized domain or geographical area would not qualify for grain rations, employer-provided housing, education for children or health care. Hukou limited mass migration from the land to the cities to ensure some structural stability. By regulating labour, it ensured an adequate supply of low cost workers to the plethora of state owned businesses. At present, it is a system widely regarded as unfair, but there is also fear that its liberalization would lead to massive movement of people into the cities, causing strain to city government services, damage to the rural economies, and increase in social unrest and crime. (Wikipedia, March, 2014);

*The research and innovation reform,* encompassing - among other issues - a special concern for green technologies development and better environment protection, was also earmarked as one of the major objectives of the next decade.

Also, for a more equitable distribution of the benefits of development, *reforms in social affairs and education* had to be accelerated in order to set up a reasonable income distribution system and to increase domestic consumption. Further detailed reforms will follow. They will be designed by numerous think tanks and masterminded by a central leading team in charge with the general design of the reform.

## 5. Challenging old vested interests

The reform blueprint briefly presented above is unprecedented in scope and intensity and therefore widely considered the starting point of the greatest economic rethink since Deng Xiaoping. Putting it together was a big step forward, but many further challenges are to be faced in its run-down and, most of all, in its implementation. To our judgement, fulfilling the deep and comprehensive reform needed and intended in China will be a difficult, long and bumpy road, due to powerful vested interests which will surely oppose change and fight back, trying to preserve a profitable status quo. Just looking briefly at some of the major reform directions envisaged, one can figure out the most obvious opposing forces that might come to the fore.

On the subject of *reforming SOEs*, for instance, the opposition might be huge among the party elites, as these companies are controlled by powerful, politically high-positioned families, who have got very rich and won't give up easily their sources of wealth. Also, *by opening the state-owned sectors to the private capital* it can be expected that the members of the ruling elite who have benefited directly and hugely from a state-dominated economy will oppose once more, as market-oriented reforms directed to levelling up the competitive playing field would hurt their interests and diminish their privileges. At the same time, SOEs themselves will oppose to losing their subsidies and privileges, as well as to becoming more accountable, paying taxes, giving up dividends and facing competition under free market conditions.

The *financial reform* will most probably meet the opposition of the state banks themselves, as they will not happily agree to losing their monopoly positions and meet, instead, strong competition from potent foreign private banks. Nor will they easily accept to lose the protection and support they previously enjoyed, having to deal, by themselves, with piling-up non-performing loans. One could even speculate that, used to act on political command, under the protection of the state and of their monopoly positions, these banks might even lack the practice and boldness required when having to survive in a harsh, competitive environment, forced to make risky decisions on economic, not political grounds. Additionally, one could expect that some opposition to the financial reforms will come even from part of the academics, who will warn on the risks of economic crises, following interest rate liberalization and other measures.

Finally, many could also be reticent to *land reform* and to the *reform of the hukou system of registration.* The first to oppose to land reform are expected to be the local authorities, who not only financed local budgets by selling land, but also did this as a profitable business and source of richness for themselves. Clear property rights for farmers and a unified land market generating correct prices would deprive these local leaders of an important source of wealth and power. As to the hukou system reform, giving it up will meet both the opposition of the local governments and of the city dwellers, because this measure is prone to induce a huge pressure on the already overcrowded and difficult to manage Chinese cities.

## 6. Conclusions

At a crucial stage of its transformation, China embarks on a comprehensive, long and difficult reform path, which is both needed and inevitable. The set of reforms envisioned by its new leaders is the greatest economic rethink since Deng Xiaoping, meant to rebalance Chinese economy and regain the sustainability of its economic growth, while avoiding the risk of getting the economy stuck in the middle income trap.

This is a complex, difficult and risky endeavour, which will be hard to design and put together in every detail considering all the multiple inter-correlations, implications and influences between its components, but it will be even harder to implement, given the expected strong opposition of vested interests. Thus, the reform implementation will be the touch stone of the new Chinese leaders, while the reform itself and the radical changes it provides for will be a challenging test for the Chinese economy and society. Still, for China this is the only way forward and, considering its position and impact on the global stage, all its moves, its successes or failures, are of utmost importance for all the rest of the world.

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