How Will China Change Its Development Model?

Author Long Ke

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Up until 2011 the Chinese economy was growing rapidly, but it entered a slowdown phase in 2012, the last year of the Hu Jingtao administration. China has realized 10% growth annually during the past 10 years; its growth rate is now only about 7%. Does this mean that the miraculous development of China has finished? Premier Li Keqiang has told the members of the party's central committee that the current 7% growth rate is acceptable. Zhou Xiaochuan, the governor of the central bank, the People's Bank of China, announced that financial policy would not be changed this year. The thrust of the policy is to maintain the stability of macroeconomic development focusing on certain industries, and to stimulate the microeconomies.

That means the government will not enforce an unfocused stimulative policy in order to raise the economic floor back to 10% growth. It is obvious that the Chinese economic development model is not sustainable. For this reason, Premier Li has introduced his own brand of economics, dubbed "Likonomics". The problem is how to sustain growth and iron out volatility. Likonomics includes plans to sustain economic development without overly supportive policies, to improve de-leverage, and to change the development model.

Li seems very confident in his ability to build a real market-oriented economy. Less than six months ago, he announced that he planned to establish a free trade zone in Shanghai, the biggest commercial city in China. He is also putting a lot of effort into improving deregulation. The establishment of a free trade zone will no doubt help China become a real global market. Improved deregulation will strengthen industrial productivity. Basically, Likonomics intends to help change China's industrial structure and development model. Former premiers Zhu Rongji and Wen Jiabao also announced many times that they would change the development model during their term in office, but both of them failed.

Of course, changing the model will not be easy for Li either. Everyone understands that China cannot sustain its economic growth depending only on exports, because international demand is not stable. It is hard to imagine that any country could import goods and products from China constantly. The key to international trade is balancing exports and imports. China's export costs are increasing due to the renminbi appreciating and rapidly rising labor costs. It is necessary for China to shift the economic driving force from external trade to domestic demand. The problem is how to realize that goal.

Conflict Between Central & Local Government

The Chinese political system is a communist party monopoly system. Theoretically, under the monopoly system the central government is the policy-making leader. If, however, the central government cannot reach a consensus on a policy with the local governments, the policy will not be enforced completely at the local level. In Chinese, this is called *Shang you zheng ce*, *Xia you dui ce* ("There are policies at the central government level, but the local governments have their measures."). It is not difficult to find cases of policies and strategies not being enforced over the past decade in China. Hu Jingtao emphasized the realization of scientific development, but China's economic development obviously has not been scientific. One of the reasons for this is the protectionism of local governments. Every province in China is like an individual country in Europe. The economic benefit for local governments is more important than that for the central government. Another reason is that state-owned enterprises monopolize the market. It is unlikely that the central government can control the local governments and the state-owned enterprises directly associated with them. The key point here is how to obtain a consensus between the central and local governments.

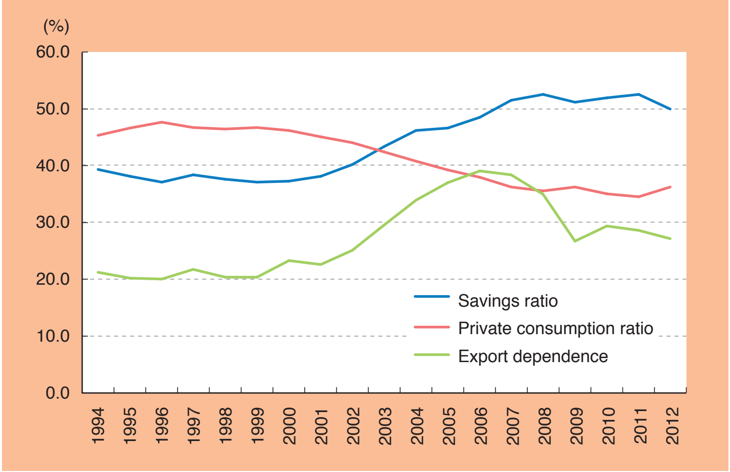
Let's go back to take a look at the process and agenda of the open-door and reform policy enacted 34 years ago. Former Chairman Mao Zedong died in 1976, which became a turning point in Chinese society. Since then Deng changed the course of the economy toward a free market economy. Decentralization improved the productivity of the agriculture and manufacturing industries. But the most significant reform was allowing foreign companies to invest in China freely. For Chinese state-owned enterprises, foreign investment companies were simultaneously competitors and business partners. As a result, foreign investment companies were a strong force that pushed the government to decentralize and to liberalize the state-owned enterprises in order to increase their competitiveness.

Chinese companies learned a lot from their business partners, not only in terms of technology, but also in terms of management knowhow. At the end of the 1990s, the Chinese government privatized most of the small and medium-sized state-owned enterprises.

To attract more foreign companies to invest in China, Deng decided to establish special economic zones (SEZ) in coastal areas, including Shenzhen in Guangdong Province and Xiamen in Fujian Province. Foreign companies could invest in the SEZ freely and enjoy their preferential treatment policies. For example, corporate taxes for foreign companies in the SEZ were lower than those for local companies. Thousands of foreign companies have invested in China since the 1980s, although there were many restrictions — for example, foreign companies were not allowed to establish their own Chinese corporations independently, but were forced to establish joint ventures with Chinese companies. Most of these business partners were state-owned enterprises. These requirements by the Chinese government are thought to be an attempt to push foreign companies to transfer their technology to Chinese companies.

CHART

Savings ratio, private consumption & export dependence in China



Source: ADB, key indicators 2013

In the first step of the open door policy, from 1978 to 2000, the government succeeded in attracting thousands of foreign companies to invest in China. As result, China became a global manufacturing center by the end of the 1990s. Cheap labor costs and the undervaluation of the renminbi contributed to maintaining the strong competitiveness of Chinese manufacturing industries. China entered the World Trade Organization (WTO) in 2001 and promised to open its market fully to foreign companies. Since then China has gradually shifted towards becoming a global market. Nowadays China is one of the main engines driving global economic development. But we still find that China's economic development relies chiefly on exports of products from labor–intensive industries, such as toys and textiles. It is clear that China needs to upgrade its industrial structure, but most local governments still want to maintain their hold on the old industrial structure. China needs to strengthen its industrial innovation.

Ironing Out Volatility in Economic Development

Theoretically, in any economy there are three engines driving economic growth: domestic investment, private consumption, and external exports. In the past, the Chinese economy depended heavily on exports to drive its development. China's income distribution concentrates most of the wealth at the top: the wealthiest 3% of the population own 80% of the wealth in the country. About 60% of the population is in the low-income class; they have strong demand, but not enough income. Additionally, the government has to attract more foreign companies to invest in China in order to spur high-speed development. In the early years of the open-door policy, much of the foreign direct investment was in labor-intensive manufacturing. As a result, foreign direct investment (FDI) contributed not only to economic development but to employment as well. Before China entered the WTO, foreign companies were required to use domestically the parts and materials they made in China and to export their products at certain percentages. In order to encourage foreign companies' exports, the government established a bonded lot area to lower the costs of the exports.

Why is the Chinese government so aggressive in encouraging FDI inflow and pushing exports? One historical reason is that China faced a serious shortage of foreign currency until the end of the 1990s. China's leaders were concerned over the shortage of foreign reserves. Chinese companies wanted to buy technology and equipment from foreign companies, but the shortage of foreign currencies was a bottleneck for Chinese economic development.

However, foreign demand is usually unstable. East Asian nations experienced a currency crisis in 1997, one lesson of which is that we cannot expect economic development to rely only on foreign demand. To realize sustainable economic development, it is necessary to strengthen household consumption, with foreign demand playing an important complementary role. *Chart* shows the savings ratio, private consumption, and export dependence in China. Zhu Rongji suggested building an extensive development model rather than an intensive one. An extensive model means that economic growth involves increased input of labor, energy, and natural resources. Such models often lead to a waste of increased resources; they are ineffective and unsustainable. By contrast, an intensive growth model involves effectiveness, quality, and efficiency of these inputs usually measured as growth of total factor productivity. Unfortunately, Zhu could not see the necessary change until he retired.

Extensive growth usually means unstable growth. It is still very difficult for policy-makers to iron out the volatility of such economic growth: if the central bank tightens monetary policy, the economy will turn toward recession, but if the central bank generates liquidity to stimulate economic growth, the economy may overheat. Although China realized 10% GDP growth annually over the past decades, its growth was highly volatile.

Role of the Government & Role of the Market

Since the Deng era, the Chinese government has liberalized the economy in some sense despite remaining a communist country. The state sector still plays a predominant role in the economy, but the government cannot control economic activity directly; the prices of consumer goods are basically decided by market mechanisms. The government has downsized state-owned sectors since the Deng era. The liberalization of the economy promised free access to the market for non-state-owned enterprises, but there are still many invisible and implicit hurdles for private companies trying to access the market. For example, financial institutions usually refuse to lend money to private companies, and private companies face difficulties in accessing markets to supply public utilities like electricity, water, oil and gas.

It is difficult to characterize the current economic system in China. The government often emphasizes that the economic system is a socialist system but is market-oriented and has a unique Chinese character. It is difficult to understand the difference between the Chinese market-oriented system and the market-oriented systems in developed countries. Perhaps one of the differences is that China still maintains its monopolistic political system and the government still controls the economy directly. That means that China is not a real market-oriented economy yet. No doubt the government played a very important role in realizing the economic development of the past decades. The private sector still plays a complementary role despite contributing more than 70% of job creation.

As a result, the Chinese economy is a government-oriented economy: the central government controls 130 state-owned enterprises (SOEs) directly, and local governments control many state-owned enterprises, too. Theoretically, all of the state-owned enterprises have been reformed into incorporated companies — with the government as one of the shareholders. The trend of *Guo jin min tui* ("the state companies advanced, the private companies retreated") was strengthened under the Hu administration. Wen Jiabao talked a lot but did little about economic reform, especially privatization of SOEs. Economic development has to be maintained by depending on fiscal investment and external trade, but this is obviously not sustainable.

If China wants to sustain its economic development, the government must reduce its control over the economy, and the private sector needs to play a more significant role in supporting economic development. Nowadays, most of China's small companies are privately owned. China needs to promote and improve deregulation and liberalization to show these private companies that they can compete fairly with SOEs. Premier Li is now undertaking such efforts to improve deregulation and remove the invisible hurdles from the paths of private companies. This is good news for China from the perspective of sustained, long-term economic development, but deregulation of government control will not be easy due to opposition inside the government.

The state sector, including state-owned commercial banks, is protected by the government and benefits greatly under the market monopoly system. This group expects the government to maintain the monopoly system, despite the inefficiency of the market. Over the past three decades, Chinese economic development depended on the input of cheap labor and natural resources, but this model is no longer sustainable. Extensive economic development has also severely damaged the environment. The only effective solution to overcome the inefficiency of the economy and industry is to build a real market-oriented economy.

Competitiveness of Manufacturing Export Sectors

Over the past 30 years, the Chinese government has established many SEZ in coastal areas including Shenzhen, Shantou and Zhuhai in Guangdong Province and Xiamen in Fujian Province. The government promised that foreign companies investing in the SEZ would be treated preferentially, with tax exemptions and tax cuts. Such policies were very attractive for foreign companies, especially overseas Chinese companies. During the first stage of Deng Xiaoping's open door policy, China faced the difficulties of a foreign currency shortage and lack of technology, and so FDI helped China bring in more foreign currency and obtain technology transferred from foreign companies, enabling the Chinese economy to catch up successfully.

China had the advantages of cheap labor resources and an undervalued currency. It pegged the renminbi to the US dollar until 2005, thereby attracting many foreign companies to invest in China directly to establish factories for toy and textile manufacturing and machinery assembly. Meanwhile, original technologies were transferred from foreign companies to their business partners in China. The comparative advantage strategy succeeded in helping China's economy catch up during this first stage. In the 1990s in particular, the Japanese economy faced deflation and the yen appreciated much more than expected. Japanese companies started to move their factories to China and ASEAN countries in order to maintain their competitiveness in manufacturing costs and product price. Compared with ASEAN countries, China had the advantage in labor costs.

Another milestone for China in attracting foreign companies to invest directly was its entry to the WTO in 2001. China promised to open its market to foreign companies. Since then, not only manufacturing industries but companies from service industries have been investing in China directly. China has gained the status of a global market: foreign companies' investments in China allowed it to become integrated into the global economic community; it has strengthened the competitiveness of export manufacturing industries; and it now holds a foreign reserve of $3 trillion. There is no concern about payment risks, but some are worried that an economic imbalance in China would damage the global economy. China needs to make greater efforts to rebalance its economy.

China has lost its competitiveness in manufacturing costs over the past decade because of the renminbi's appreciation and the rise of labor costs. It is impossible for China to peg the renminbi against a key global currency like the dollar or euro. Nor can it indefinitely maintain its labor costs at such a low level. The currency must be revalued and labor costs adjusted to follow the country's economic development. Therefore, China needs to adjust its industrial structure. The conclusion here is that China cannot maintain the cost of its export industry: the only solution is to upgrade the industrial structure from labor-intensive to technology-intensive industries. Low-end product exports will not be sustainable; middle and high-end product exports will take their place. This is the result of economic and industrial development.

What Impact Will Likonomics Have?

The Chinese economy has been slowing down since 2012. The reasons for this slowdown are complicated. Some say that China has lost its demographic advantage because of the decline of labor. Others say the rising costs of the manufacturing industries lowered the competitiveness of exports. The government claims that the global financial crisis damaged the export industries. According to Professor Zhang Weiying of Beijing University, the real reason that the Chinese economy has slowed down is simply that the Hu administration postponed all reforms over the past decade, and China lost the potential benefits.

From a long-term point of view, it is reasonable to expect that the Chinese economy would slow down eventually, but it should not have happened this soon. Justin Lin, former chief economist of the World Bank, has stated that China could sustain high-speed growth for another 20 to 30 years. I don't know the theoretical or experimental basis of Lin's assertion, but from an economic standpoint it is unusual that the Chinese economy has slowed down now. As Zhang pointed out, the postponement of reforms over the past decade damaged growth greatly and could be the real reason behind the slowdown, rather than weak external demand.

Premier Li has emphasized again and again that China must improve deregulation and remove the invisible hurdles for private companies to access the market. Likonomics includes: (1) no enforcement of a stimulative policy, (2) improvement of de-leverages, and (3) economic and industrial structure change. The agenda of Likonomics could sustain economic growth for the next decade, but if the government does not enforce some policy mix to stimulate economic growth the Chinese economy will slow down and face a serious recession, which would lead to social instability. Improving de-leverages to rebalance the economy is indeed necessary, but the problem is how to improve deregulation. Under the Hu administration of the past decade, the government strengthened its control and regulation of the economy to a much greater degree than at any time since the open door policy of 34 years ago. It is hard to imagine that the government, including local governments, will change its mind about deregulation very easily. The goal of deregulation is a necessary one and would obviously be helpful in improving competition in China, but to realize this goal Li needs to take stronger leadership in reforming the economic system.

Finally, most people in China agree on the necessity of changing the economic and industrial structure, but the problem of how to change the structure remains. The state sector wants to protect its vested interests and will not easily agree to giving them up. To realize the goal of Likonomics, Li can open the market to force the state sector's reform.

The Chinese economy is slowing down not because of weak foreign demand, but rather because of the imbalance and inefficiency of its domestic economic and industrial structure. Of course, China needs to try to strengthen the competitiveness of its export manufacturing industries, but not by pegging the renminbi to the dollar or maintaining workers' salaries at low levels. The more feasible solution is to strengthen innovation. The development of technology- and knowledge-based industries will put a dent in employment, so to create more employment opportunities China needs to strengthen modern service industries such as distribution and information technology. Li needs to show the people a road map for reform in order gain support inside and outside the government.

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Long Ke is a senior fellow at the Fujitsu Research Institute and was formerly a professor at the University of Shizuoka.