Chinese Economists Outline Nation's Ambitious Growth Policy

by William Jones

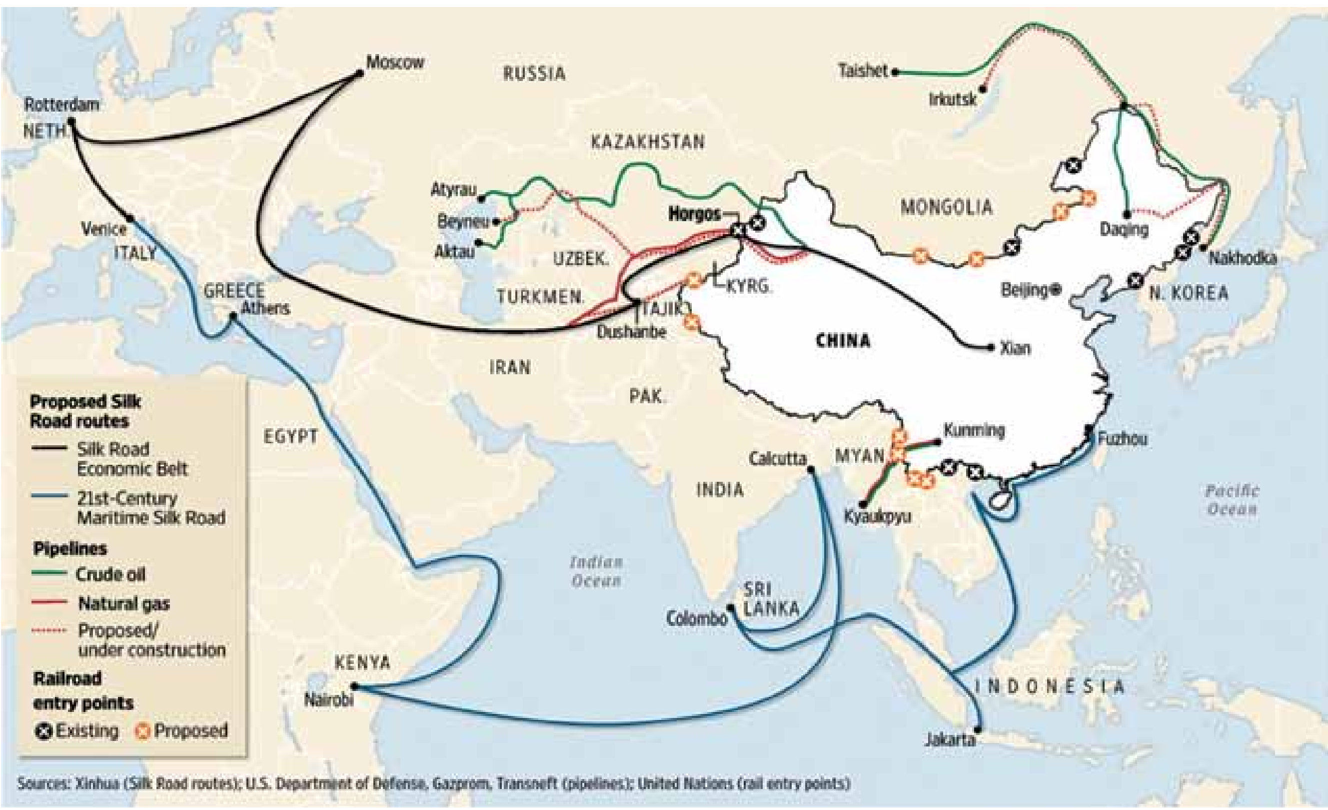
Jan. 10—Several prominent Chinese economists presented that nation's revised economic policy for 2015, at the National Committee on U.S.-China Relations (NCUSCR) in New York City Jan. 7. Over the course of the half-day's forum, the speakers laid out the success of the program outlined at the Third Plenum of the Central Committee of the Chinese Communist Party in 2013, and indicated some of the obstacles that remain to making China a "well-off society" by 2020. They also made clear that the Silk Road Economic Belt and the 21st Maritime Silk Road will play a key role in transforming the Chinese economy into a center of high-tech production (**Figure 1**).

The highlights of their remarks are presented below, and sharply contrast with the prevailing hype in the U.S. news media about how the Chinese economy is heading for a "hard landing." They give a unique insight into the government's thinking.

A 'New Normal'

With the collapse of the U.S. and European markets, China has been forced to rely for its growth on an in-

FIGURE 1
'One Belt, One Road' Regions



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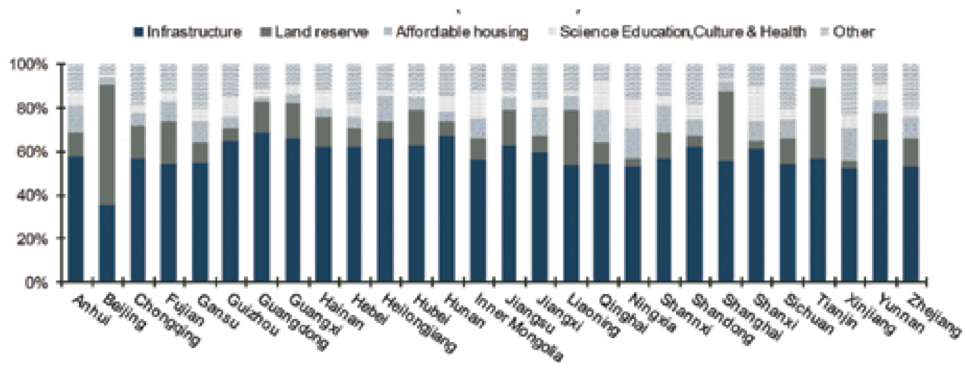
crease in domestic consumption, the so-called "new normal." In addition, China has implemented a conscious policy of raising the quality of labor power from the low-wage production which propelled much of China's economic rise, to production of high-value products, spurred by technological advances coming out of its wide-ranging science and technology programs, including its very successful space program.

FIGURE 2
Spending Structure of Local Government Debt
(as of 06/2013)



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The policy has been marked with tremendous success, which is there for all to see. But many problems remain. While 680 million people have been brought out of poverty in China, as economist and former World Bank vice president Justin Lin told his audience, almost half the population is still living in rural areas under difficult, albeit improving, conditions. And it may take decades to bring them all up to a modern standard of living. But the government of President Xi Jinping is intent on doing just that.

While some of the problems stem from the conditions of underdevelopment which still plague China, some of them are unavoidable effects of the conditions under which the Chinese economy developed during the last three decades. Most striking, of course, and the one most talked about, is the environmental pollution. While China accepted entry into the "world economy" as a low-wage manufacturing center, the unpaid costs of that production took their toll, leading to the air and water pollution which will require major measures—and a considerable amount of time—to completely resolve.

With the shift away from coal to natural gas and to non-fossil fuels like nuclear, China hopes in time to repair some of the damage to the air quality. And the just-completed second stage of the South-to-North water project, bringing water from the lush Yangtze River region to the arid northern regions, is a major attempt to resolve the water situation countrywide.

Other problems are of a socio-economic nature. The rapid growth of the cities has been funded by extensive lending by the local and regional governments, and many of those loans have now become due. The lack of efficient central government supervision of local government spending and the rapid rise in land prices often led to excessive construction in many areas, often in projects which may never bring a sufficient return. This was especially the case in housing, and has helped create a housing boom, which threatens now to go bust. With wages not keeping pace with the rise in housing prices, many families have not been able to buy new apartments, and many are now sitting empty (**Figure 2**).

This unregulated "gilded age" in China's development has also helped to foment rampant corruption, which President Xi has now targeted for eradication in a nationwide campaign. Much non-farming land in rural areas was expropriated by the municipalities and sold for housing and office space and other construction, yielding a hefty profit for all involved, except for the farmers, who lost some of their living space as a result. (Arable farmland in China cannot be touched by the local governments, but other non-rural land can be, and has been, extensively.) The issue of the local and provincial debt was a topic of discussion at the New York forum.

But the mood of the Chinese economists was generally upbeat. While there is general agreement that the collapse of the export markets in the U.S. and Europe has taken its toll, the growth rate for China during the next year is still estimated at 7-7.5%, down from its earlier 8%+ highs. After the 2008 collapse of the markets, China initiated a major investment program to take up the slack. That program is now largely completed, Lin said, but consumption is still strong. "China will maintain a 7-8% growth," Lin said, "depending on an international recovery and the boosting of domestic demand."

While the "international recovery" is still a myth, the determination to boost consumption growth in China is a key element of government policy. "We have to improve labor productivity," Lin said, "and this will require continued investment." He also indicated that there is a ongoing transition, relocating labor-intensive industries to other Asian countries and replacing them with higher-value production.

"China is a developing country, and we know that for developing countries and developed countries, if you want to have sustained growth for a long period of time, you need to have a continuous stream of technological innovation, and also an industrial upgrading," Lin said. "That is the only way to have sustainable long-term growth." This strategy has been successfully implemented in the rapid development of China's high-speed-rail systems, which are quickly becoming the hallmark of Chinese high-tech export.

Taking on the Big Issues

Tang Min, an economist and counselor of the State Council, indicated some of the major bottlenecks which the Chinese government is now facing, and the measures that were being taken to deal with them.

On the short-term list is the $20 trillion of local government debt. Nearly 50% of new borrowing by local governments is now going to debt repayment. Related to this is the problem of the real estate bubble and the creation of shadow banks, i.e., banks and non-bank lending institutions which provide loans outside of the official banking system, normally at much higher interest rates. Longer-term problems include the aging of the population, inequalities in income distribution, and environmental pollution. Tang noted that 80 tasks demanding solutions which had been set at the Third Plenary Session had been basically completed. In addition, 108 other tasks had been accomplished by the various ministries.

Among the reforms were consolidating the debt service of the local governments in the annual government budget. Financing the debt is to be accomplished by partially using the income of the capital of the local State-Owned Enterprises (SOEs) and allowing local governments to issue bonds for their funding, rather than taking out bank loans. In some of the more prosperous provinces, the local governments would be allowed to float the bonds themselves. In those provinces which were financially strapped, the sale would be administered for them by the central government.

Restrictions have also been placed on the purchases of second homes. As in the U.S., with the growth of the housing bubble, investment in real estate had become a prime means of making money, fueling the rise in housing prices. This will now be curtailed. In addition, more rural non-farm land will be allowed to enter the official land market, giving the land users rights to remuneration for any transfer of property. Low-cost housing construction will also be expanded.

More problematic measures involve the "financial reforms" indicated by Tang. While raising restrictions on lending rates is certainly to be lauded, the entry of five private banks on the Chinese market may prove a dubious venture if banking regulation does not keep pace. There has been much ballyhoo about connecting up the Shanghai and Hong Kong stock exchanges, the so-called Hong Kong-Shanghai Connect, making it easier for Chinese citizens to park their funds in stocks.

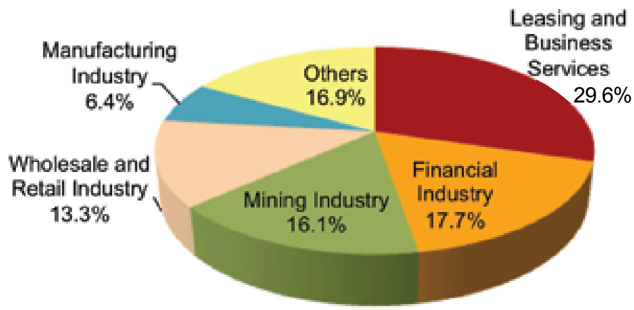
But as we have seen in the Western markets, unregulated exchanges can wreak havoc on an economy, and also provide an opening for the entry of international "hot money," which, under the present conditions in the Western economies, is eagerly looking for places like China to reap quick profits. Without a major reform of the international financial system in line with a Glass-Steagall model of regulation, "opening up" could become a recipe for disaster, as the entry of the hot money could spark rampant inflation in China.

Securing People's Livelihood

Among the areas crying out for reform is the *hukou* (registration) system, which has hitherto been detrimental to the millions of migrant workers coming to the cities looking for jobs. Those residents who have the *hukou* have access to benefits like health care and schooling, while those who are there temporarily, and have their registration in their home villages, do not. Recent reforms will make available to migrant workers medical and other benefits. China has also liberalized its controversial one-child policy in the hopes that families will have more children. Thirdly, the government has unified a basic rural and urban pension system, and is increasing subsidies to rural and urban medical insurance.

China will also attempt to open up new growth areas in the economic sphere and create a more equitable geographic distribution of economic activity. In addition to the development of the western regions of the country, which will benefit greatly from the construction of the new rail links westward under the Silk Road Economic Belt project, the government is also making a concerted effort to build up the old northeastern region in Heilongjiang-Jilin province, which was once the manufacturing center of China, but has through the years been transformed into a veritable rust belt, similar to areas of western Pennsylvania in the United States.

FIGURE 3
ODI Breakdown by Industry



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'Going Abroad' Creates Development at Home

Most important for China's development, indicated Qin Xiao, chairman of the Boyuan Foundation, is the new "going abroad" policy, in particular, President Xi's policy of the two Silk Roads and the interlinked Asian Infrastructure Investment Bank (AIIB).

Qin noted that there was a tremendous growth of outward-directed investment (ODI), and that the collapse of the export industry had created a tremendous amount of excess industrial capacity which was seeking an outlet. The "One Belt, One Road" will, to a large extent, help provide that outlet, Qin indicated. Most of the ODI presently goes to the purchase of financial assets, and only a small amount to manufacturing and services. Only 8% of the non-financial ODI goes to manufacturing. But with the "One Belt, One Road" policy, this will start to change (**Figure 3**).

"ODI in manufactures and infrastructure will grow," Qin said, and the total figure could well surpass $350 billion by 2025, making China second only to the United States as an ODI provider. (The present figure for China's ODI is $120 billion.) The two Silk Road projects will be "the grand overseas object for China for the next decade," Qin said. "It is aimed at the needs of the region's infrastructure, and the initial funding will be taken from the foreign exchange reserves." The purpose is to "provide infrastructure," but the subsequent increase in cross-border trade will in turn "digest China's excess capacity."

"The "One Belt, One Road" is a part of the "going abroad" policy, Qin said, but there are a number of caveats to observe. Firstly, while the central government plays the major role in giving direction to the policy, it should not interfere directly in the business decisions, thereby making sure that the investment projects meet appropriate business requirements. Secondly, the companies must become acquainted with the laws of the host countries in order to avoid potential conflicts.

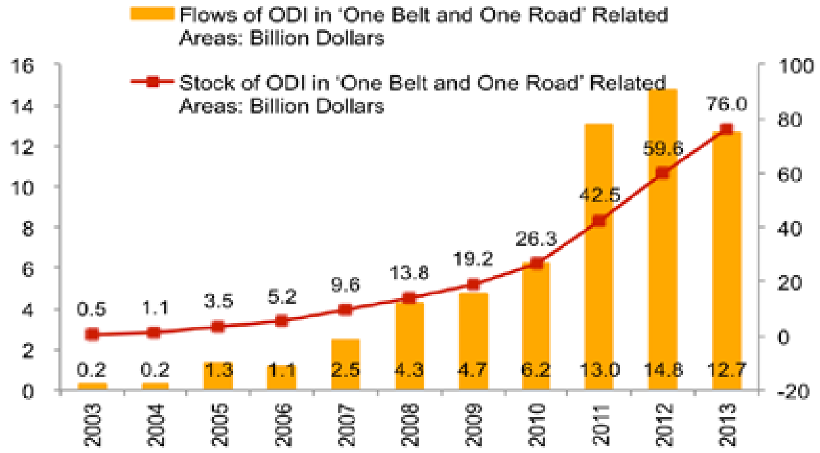
There are also political risks to be taken into consideration, he noted. There is the overall climate in many of these countries of a "China threat" syndrome, which has been fed by the propaganda spewing out of the Western capitals. There are also religious differences and tensions which have to be taken into consideration.

The danger from radical Islamists in some of the areas of the Silk Road Belts will also necessitate closer collaboration between Beijing and the regional governments to avoid and to thwart possible terrorist attacks. Both sensitivity to the cultural issues and considerations of the different countries' labor organizations and legislation will also have to be kept in mind (**Figure 4**).

China has coped with these problems in its numerous endeavors in Africa. While some mistakes were initially made—bringing in Chinese labor rather than training and utilizing the domestic labor, lack of oversight in lending, and failure to establish a working relationship with the local trade unions—valuable lessons have been learned, lessons that will no doubt be applied in this new grand undertaking. And the importance of the "One Belt, One Road" for the world today cannot be over-emphasized.

The bigger issue, and more significant problem, is the attitude of the United States to this lofty project launched by China. There is still too much of a sense in

FIGURE 4
Current Direct Investment in the Region



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the U.S. that the "One Belt, One Road" is just Chinese "geopolitics" and thus to be viewed with suspicion. President Xi's invitation to President Obama at the APEC meeting last November to join with China in this endeavor has still not received a clear reply. And as several economists at the New York event underlined, the ability of the U.S. economy to come out of the economic crisis could be the determining factor for the continued growth of the Chinese economy.

No one in China wants to see the U.S. economy go down the tubes. Chinese leaders clearly understand the close interconnection between the two major economies, and are keenly aware that if the U.S. is still bogged down in a crisis as this project takes off in Eurasia, the urge to make China a scapegoat for the mistaken policies of the U.S. Administration will ineluctably lead to a new round of "China-bashing" in the U.S. Congress.

We are all living in one world, they realize, and that world will either succeed in mastering the world financial crisis through infrastructure projects like the New Silk Road, or will descend into chaos and war through our failure to act on behalf of the common good. It would serve us well to be on the winning side and to join with China in developing the world.