China’s Economic Growth Pattern and Strategy

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Abstract

This paper tentatively characterises the existing economic growth pattern and problems in China; summarises how the governments wants to adjust its growth strategy; introduces some key features of the policymaking process and some of the institutional and political economy problems; and looks at the outline for restructuring and rebalancing. China’s investment and industry heavy growth has allowed for steady growth but has also led to imbalances. China wants to adjust its growth pattern, as reflected in its 12th Five Year Plans (5YPs). China wants to rebalance growth towards consumption and services. It also wants to upgrade the industrial structure. This calls for an extensive set of reforms. So far the progress on this agenda has been mixed. Some of the key obstacles to further progress are of an institutional and political economy nature. In the face of the challenges it remains uncertain how rapidly China’s pattern of growth will be rebalanced.

Key Words

China, growth pattern, policy process.

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1 Introduction

China is leading the shift in the centre of economic gravity towards Asia and the economic prospects of economies throughout the world have become increasingly dependent on sustained demand in the Asian giant. Continued success cannot be taken for granted, though. We know from history that growth trajectories are not sustained on auto-pilot.

Indeed, China is aiming at adjusting its growth and development strategies to deal with problems that have emerged and major challenges ahead, as reflected in the 12th Five Year Plan (5YP). However, adjusting a growth and development strategy is complex and difficult from both economic and political economy perspectives. Thus, there is a lot of uncertainty about the direction of policy and about whether and how China will adjust its pattern of growth.

In section 2 we tentatively characterise the existing economic growth pattern. Policy-wise, China combined opening up and gradual market-oriented reform with a strong role of the government in channeling resources to industry and investment. Indeed, growth has been particularly industry and investment-oriented. This has served China well in important regards, allowing for sustained high growth without major macro stress. However, it has also led to important imbalances.

Section 3 discusses how the governments wants to adjust its growth strategy to sustain growth and development and meet domestic and global challenges. The 12th 5YP reflects those aims. China wants to transform the pattern of growth towards consumption and services in order to reduce the imbalances. A second major objective is industrial upgrading and moving up the value chain. This calls for reforms to channel new resources to new sectors and products, and support more full migration to the cities. The section ends by briefly discussing the progress in different reform areas.

Section 4 tentatively brings up institutional and political economy issues. Some of the key obstacles to implementing the 12th 5YP are of an institutional and political economy nature. Some features of China’s governance system seem to have supported the consistency and comprehensiveness of policymaking and planning and to have aligned the incentives of different parts of the government and individual officials in recent decades. However, it remains to be seen how quickly China’s policy making process can successfully deal with a changed and wider set of policy objectives.

Section 5 tries to make some points about the outlook for restructuring and rebalancing.

2 Current Growth Patterns and Challenges

China has seen rapid growth, development and opening up in recent decades. It has combined rapid economic growth with substantial improvements in living standards, poverty alleviation, and health and education indicators.

2.1 Reform Since 1978

Opening up and gradual market-oriented reform were key to China's impressive industrialisation and growth performance over the last decades. Since 1978 China introduced a sequence of market-oriented reforms that dramatically improved economic incentives and efficiency and reduced distortions. In line with the Washington Consensus, and motivated by an increasingly open and transparent multilateral trading system, opening up to foreign trade and promoting exports were key elements, accentuated by the WTO accession in 2001[1]. In line with both the Washington Consensus and strategies of other East Asian countries, China also increasingly pursued orthodox macroeconomic management.

However, China explicitly pursued investment and industry heavy growth, with a strong role for the government (Table 1). In its transition from a centrally planned to a market economy, China diverged from the "shock" approach to reform used in the Soviet Union. China followed the successful East Asian economies in combining export-oriented opening up to the global economy with maintaining a leading role for the government in allocating and mobilising resources towards selected industrial sectors and investment, including infrastructure. The government also encouraged and subsidised saving, especially by companies; forfeited dividend from SOEs, channeled cheap credit to industry; underpriced key industrial inputs—energy, resources, land, and the environment; and managed the exchange rate.

Table 1 – Economic Growth Strategy: Some Characteristics

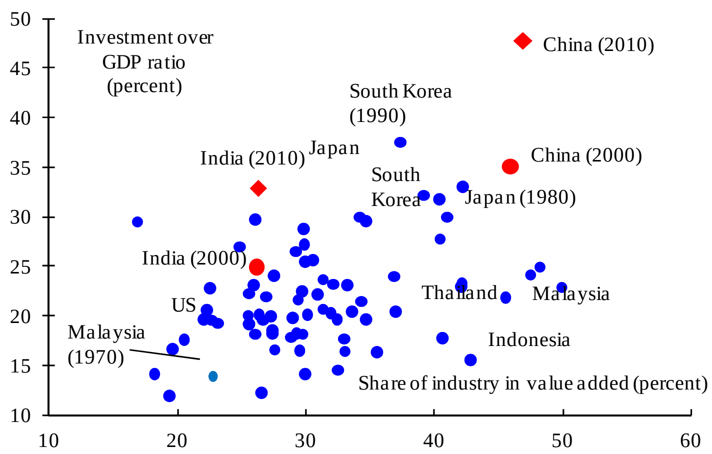
Policies (in reform period)
Steady opening up to global economy, emphasis on export promotion
Active role govment mobilizing resources
Explicit preference and encouragement of industry and investment
Emphasis on infrastructure
Strength
Strong supply side ? rapid growth without macro tension
Weakness
Has led to economic, social, environmental and external imbalances

Source: RBS.

[1] Coined by John Williamson of the IIE, the Washington Consensus is a set of economic policies that the IMF and the World Bank have recommended to developing countries, such as orthodox macroeconomic policies, trade liberalisation, privatisation and deregulation to strengthen the role of markets and limit that of the government.

In this policy setting, investment reached a very high share of GDP while industry rather than services drove much of the growth (Figure 1). With the link between production and consumption loosened by access to the open multilateral trading system, China became an export powerhouse. Industrial companies became increasingly profitable under this pattern of growth, which also benefited parts of the government, directly or indirectly. Thus, a constituency was built up in favour of maintaining the pattern of growth.

Figure 1 – A particular pattern of growth



Source: World Bank Development Indicators, National Bureau of Statistics (China) and Statistics India.

China's growth model has been very good for the supply side. Looking at the drivers of "potential" GDP (production) growth, reflecting China's towering investment to GDP ratio, the contribution of capital accumulation has been very high (Table 2, Box 1). An important driver, particularly since the late 1990s, is that in a policy setting favourable to industry and capital, flourishing industrial firms ploughed back increasingly large profits into new capacity. With wage increases lagging productivity growth, the share of companies' profits in GDP could rise—pushing up the national saving rate.

Table 2 – Growth Accounting for China

	1978-94	1995-2011
Potential GDP growth */	9.9	9.9
Employment growth	2.4	0.7
Labor productivity growth	7.3	9.1
From TFP growth	3.2	3.1
From higher H/L	0.5	0.6
From higher K/L ratio	3.5	5.3

Source: CEIC, RBS

* Methodology as in Kuijs and Wang (2006).

Box 1: Accounting for Growth and Output Using A Cobb Douglas Production

Building on earlier papers by Kuijs and Wang (2006), He and Kuijs (2007) and Kuijs (2010), we use a Cobb Douglas production function to explore the contribution to growth and output of (i) accumulation of physical capital via investment; (ii) employment, as largely determined by the size of the population between 15 and 64; (iii) human capital per worker, largely determined by education; and (iv) total factor productivity (TFP). We later also use the production function to project potential output in the coming decade.

Our key assumptions are in the middle of the range found in the literature: a starting capital-output ratio of 2.4 in 1978, a capital share of 0.5, a depreciation rate of 5% and a (Barro and Lee type) rate of return on education of 10%. For details, justification, and references on the specification and key assumptions, see these earlier papers.

The growth accounting results are not materially sensitive to reasonable changes in the assumptions. Bosworth and Collins (2007) assume a capital share of 0.5, a depreciation rate of 6%, and a rate of return on education of 7%. Annex Table 3 in He and Kuijs (2007) shows how the results—on TFP growth and the contribution of capital accumulation—depend on the assumption on the capital share and the starting assumptions on the capital stock, but not in a way that changes any of the conclusions. We estimate this production function over 1978-1994 and 1995-2011 (Table 2).Tthe second period starts after the trough of macroeconomic turmoil they both went through in the early 1990s.

At the same time, "total factor" productivity (TFP) growth has—at more than 3% per year, after subtracting human capital accumulation—been high, in comparison with other countries[2]. It reflects a gradual sequence of reforms, good infrastructure, reasonable health and education, and effective economic governance generally. Combined, the massive capital deepening and high productivity gains allowed China to grow 10% per year for 3 decades without running into macroeconomic stress such as high inflation or external deficits.

However, rising imbalances suggest the investment and industry heavy growth model is not sustainable. First, as a mirror image of the rising profit share, the share of wage income in GDP has declined. Combined with low deposit rates and a rising household saving rate – in no small part due to rising income inequality accentuated by this growth pattern – this reduced the share of consumption in GDP (basically, the capacity to consume has lagged the surging capacity to produce). For a while, rapid export growth absorbed the surge in production, driving up the current account surplus. However, international

[2] See He and Kuijs (2007), Annex Table 2 for comparisons across the world.

friction and more subdued global demand signal the limits of this avenue. External surpluses have come down recently, but that could be temporary in the absence of rebalancing.

Second, by creating fewer jobs than a labour-intensive, services-led growth pattern would have, the pattern of growth has limited the absorption of surplus agricultural labour and contributed to the rising rural-urban income inequality, a key source of rising inequality.

Third, with the government for long channeling as many resources as possible to investment, other public spending has been under downward pressure. Access to education, health, and other public services worsened during the reform period, with access in poor areas, and for poor people generally, substantially worse than in better off areas and for better off people. The inequality in access to public services accentuates the income inequality. It could also become a constraint on growth in the future, as large sections of the population do not receive the basic education and health services needed to be productive members of society.

Fourth, the capital-intensive, industry-led growth has also been particularly intensive in energy and natural resources, and tough on the environment. After 2 decades of growth along this pattern, the disadvantages are starting to outweigh the advantages.

3 Government Plans and Policy Implications: Aiming for Rebalancing and Moving Up the Value Chain

The key objectives of the 12th 5YP are rebalancing and industrial upgrading

The plan's first objective is to transform the pattern of growth more towards consumption and services. Such a shift means more labor-intensive growth, with more urban employment creation. Boosting the share of wages and household income in GDP would increase the role of consumption in a way that is economically sustainable. It would also lower the tendency for external surpluses. With a smaller role for industry, such rebalancing would also help make growth less intensive in energy and resources and less detrimental to the environment—additional objectives of the plan. The 5YP also focuses on livelihood issues and the GDP growth target for 2011-15 was reduced to 7%.

The plan's second objective is industrial upgrading and moving up the value chain, with an emphasis on technological upgrading, investment in "new strategic industries", and innovation. This is in part motivated by the desire to avoid falling into (one version of) the middle income trap. Reflecting a traditionally strong role for the government in channeling resources, the 5YP envisages the government doing more than providing an enabling framework for upgrading the industrial sector and moving up the value chain. It discusses the role of the government in leading the industrial upgrading and promoting the development of new industries.

There is possibly tension between these two areas of emphasis. Depending on the exact approach, government-led industrial upgrading could boost investment and industry across the board. If government policy emphasizes such industrial upgrading rather than rebalancing, there might be little change in the pattern of growth, keeping it investment- and industry-driven, with limited progress towards a higher household income share, a larger role of consumption, and a lower external surplus. To successfully combine rebalancing, upgrading, and sustained growth China needs to implement a comprehensive set of reforms. There is reasonable agreement among experts on the list, even though emphasis varies. In our view, it is useful to distinguish two nexus of reform areas.

The first nexus of reforms is meant to improve the allocation of resources, ensuring they are channeled to new sectors, products and processes, and encourage innovation. These are:

- Removing subsidies to industry by raising prices of and/or taxes on inputs such as land, energy, water, electricity, and the environment.
- Leveling the playing field between SOEs and the private sector by removing barriers to several sectors, increasing private-sector participation; fostering truly independent regulatory bodies, and more generally delineating more clearly the role of the state and that of the market.
- Improving the allocation of capital by financial sector reform towards more competition and more non-bank financing, as well as better access to finance for SMEs and service-sector firms.
- Improving the pricing of capital by increasing the role for the interest rate in the conduct of monetary policy, allowing banks more freedom to set lending and deposit rates, and introducing more exchange rate flexibility.
- Continuing SOE dividend reform and actually channeling the revenues to the Ministry of Finance.
- Fostering innovation by encouraging an "open" innovation system with links to global R&D networks, ensuring protection of intellectual property and that investment in R&D yields commercially viable innovations that will help Chinese firms move up the value chain, and adopting an "open" technological development strategy.3

The second nexus of needed reforms is meant to support more full migration to the cities, with migrants able to behave and spend like other urban citizens to foster more labor-intensive, services-oriented and consumption-based growth:

- Increasing people's ability and confidence to consume by further increasing the role of the government in health, education, and social security.

[3] The innovation related policy recommendations draw on the China 2030 report by the World Bank and the Development Research Center.

- Liberalizing the hukou, or household registration system, and reforming the inter-governmental fiscal system to give local governments the means and incentives to fund public services and affordable housing for migrants. This calls for (i) changes to the performance evaluation system for government officials and (ii) a wholesale reform of inter-governmental relations to better match expenditure responsibilities with revenues, introduce stable revenue sources for local governments, and have more, rules-based redistribution from richer areas to poorer ones.
- Tax reforms to mitigate distortions and economic inequality and remove the industry-bias of local governments, including more taxation of assets (property, equity) and less taxation of labor, fully expanding the VAT to the services sector and levying VAT at the consumption location instead of at the production location.
- Pursuing land reform to increase the mobility of migrants and, by facilitating land consolidation and mechanization, boost per capita incomes and consumption in the countryside.

So far, progress on this agenda has been mixed. A quick run-through the first nexus shows progress on pricing, with major steps outstanding; little progress on leveling the playing field; progress on financial and monetary reform with major steps outstanding; and slow progress on SOE dividends. In the second nexus, there has been substantial progress on scaling up the role of the government in health, education, and social security, as well as on encouraging wage growth; but little progress on the intergovernmental system, unambitious taxation reform, and no real progress on land reform.

4 Institutional Issues and Political Economy

The 12th 5YP clearly states the visions for the future that, broadly, rightly address the economic problems and challenges. Both have access to excellent policy advice. But the key challenges in achieving the objectives appear to be neither technical nor intellectual but rather institutional and political. Policy formulation and implementation are complex everywhere. They involve many institutions and interest groups, many of which have influence on policy outcomes.

China’s policymaking process has been successful in delivering impressive growth and development along the investment and industry heavy lines discussed above. Incentives in different parts and layers of the government and corporate sphere appear to have been well-aligned with the overall policy objective of investment and industry heavy growth.

However, it remains to be seen how well China’s policy making process can manage a different, wider set of policy objectives. The rebalancing objective has meant the inclusion of social, environmental, and external objectives. Recent experience suggests that operationalising and achieving these objectives is difficult because it means removing subsidies and benefits to sectors, groups and spheres that benefit from the current policy setting.

The difficulty in changing China's pattern of growth and raising the role of consumption is a good illustration. Raising consumption calls for reforming the policies behind the investment and industry heavy growth pattern along the lines discussed in section III. Raising consumption was an objective of the 11th 5YP adopted in 2006 but it does not seem to have been a prominent one. The government subsidised rural consumption of electric goods and has increased spending on health, education and social security. These measures encountered minimal political resistance and thus implementation was fairly smooth. However, there has been little progress on the politically difficult reforms of the policies noted above in the face of powerful vested interests such as industry, SOEs, other business interests and wealthier areas.

Some progress has been made, but institutional and political economy stumbling blocks remain. Higher consumption is a more prominent objective in the 12th 5YP, which envisages boosting household incomes, including by raising minimum wages by 13% per year and other fiscal measures to support household income. However, policies have not yet been able to address the root cause of a bias towards industry and investment. Key institutional and political economy reasons include:

- Strong, effective resistance from those that benefit from the existing policy setting;
- Limited understanding about the underlying reasons for the decline in the role of consumption;
- Local governments were often not on board because of a traditional mindset geared towards industry and the performance evaluation system for senior local officials;
- China's senior leaders lack a "reform" unit that can present the "big picture" to help guide policy making on complex issues with many stakeholders; instead, different agencies and interest groups all make their own cases, trying to steer the policy debate;
- In this setting, with policymaking consensus-driven and cautious, decisions on a change of direction are slow and policymaking takes the path of least resistance, towards measures that do not attract strong resistance from vested interests;

China will need to make institutional changes. Important aspects of China's current institutional set up are unlikely to be consistent with transition to a high income country. Key direction are likely to be a clearer delineation between the state and the corporate sector as well as between regulators and regulated entities; more generally a revision of the role of the state in the economy towards less active involvement in the market; and a better level playing field between SOEs and other companies.

5 The outlook for restructuring and rebalancing

How rapidly China's pattern of growth will change in the coming decade is hard to say.

Looking ahead, several of these reforms are complicated and difficult, with political economy factors especially binding in the areas where little progress has been made so far. Given the starting position and challenges, expectations of a rapid implementation of outstanding reforms are likely to be disappointed. However, given the experience of 2002/3 and Li Keqiang's reform views (Kuijs and Qiu, 2012)—the new government could possibly outline a more ambitious and comprehensive approach to rebalancing, restructuring and full urbanization.

In thinking about the evolution of the growth pattern in the coming decades, given the uncertainty about the extent of rebalancing it is appropriate to think about a range of outcomes. He and Kuijs (2007) present 2 scenarios based on CGE modeling—one on unchanged policies and one on rebalanced policies[4]. World Bank and Development Research Centre (2012) present an update of the scenario on rebalanced policies[5]. Here the share of the service sector and consumption in GDP would rise from 43% and 48% in 2011 to 48% and 60% in 2030 and rise further to 61% and 66% in 2030. However, in the unrebalanced scenario in He and Kuijs (2007), these shares would not materially change from current levels.

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