

ARTICLE FOR THE EDGE

CHINA: HOW SUCCESSFUL CAN IT BE IN SHIFTING TO HIGHER QUALITY GROWTH?

China has had a good start to the year. Economic data showed that it had overcome the worst threat to its economy in decades – the COVID pandemic – and emerged as one of the few economies that managed to expand in 2020. The lead indicators for the economy show that it will rebound strongly this year. Indeed, most forecasters believe that it would have largely made up for the losses induced by the pandemic by the end of this year. As President Xi Jinping prepares to celebrate the 100th anniversary of the founding of the Chinese Communist Party which he leads in July, he and his colleagues in China's leadership have every reason to be confident about future prospects.

Nevertheless, the Chinese economy confronts several challenges from both external as well as domestic sources. China demonstrated some of its formidable strengths in the way it came through the pandemic. But achieving China's "centenary goal of fully building a modern socialist country" will require more courageous – and sometimes risky – policy reforms.

China's challenges have grown

As China gears up to publish its 14th Five Year Plan when the National People's Congress meets in March, its planners are only too aware of the considerable headwinds they face:

First, the external environment is turning hostile. It is clear from President Biden's recent comments and those of his Secretary of State Antony Blinken that the new American administration is preparing to confront China on many fronts. Both Biden and Blinken eschewed the usual polite diplomatic noises and chose to make pointed criticisms of China and its leaders. The trade, technological, diplomatic and other obstacles that former President Trump hurled at China are not likely to be eased. If anything, the Biden administration could pursue a strategy of containing China with more effectiveness than the previous administration managed – given the outstanding quality of the officials Biden has appointed and his strategy of working better with old allies and building new alliances.

Second, China has a huge demographic problem. Its population is barely growing and will soon decline. Its working age population – which is what matters for economic growth – has been declining for several years now. And it's going to get worse. The China Population and Development Research Centre projects that, over the next five years, China's will barely grow and that India could overtake China as the world's most populated country in 2027. Chinese mothers gave birth to 14.65 million babies in 2019, the lowest level since 1961, during the famine caused by the failed Great Leap Forward. Data just out last week showed the number of new-born babies in Guangzhou in 2020 was the lowest in nearly a decade and a third below the 2017 number. It was pretty much the same picture all over China's cities. Without labour force growth, China's economy can only grow as fast as productivity grows.

And this is China's third big challenge: productivity growth is falling, not rising. When one looks at total factor productivity or TFP, the broadest measure of productivity, China's performance has deteriorated. In fact, the slowdown in TFP growth subtracted around two percentage points from aggregate labour productivity growth in the 2010–2019 period. If this persists, China's economic performance will turn decidedly mediocre.

What are the roots of China's growth dilemma?

The causes of this declining productivity performance lie deep in China's structure and will not be easily overcome. The fundamental problem is the inefficient allocation of resources in the economy – if capital, labour, land and other resources are channelled to areas which manage them poorly, they will not add much to the economy. There are many reasons why this could happen, but two are most important for China. One is the dominant role that state-owned enterprises (SOEs) play in the economy relative to privately-owned companies (POEs). And the other is the over-allocation of capital to certain activities which create little value.

SOEs are a major problem. They get a disproportionate share of bank loans, for instance – because more than 70% of city commercial banks are owned by the state and these state financial institutions tend to favour SOEs over the more efficient POEs. SOEs also tend to get more favourable treatment from regulators. Despite all these advantages, SOEs' labour productivity is generally 20% below that of POEs. Their return on assets is half that of POEs and declining.

Another critical factor is the huge flows of capital to infrastructure and real estate. A study by Oxford University found that more than half the infrastructure investments made in China in the last three decades generated negative returns. The study's conclusion was that the typical infrastructure investment tends to destroy economic value in China due to "poor management of risks that impact cost, time, and benefits". Similarly, over the past two decades, a disproportionate share of fixed investment was devoted to property development. While real estate construction in the big cities which are attracting large population inflows from rural areas probably generated positive economic value, the same cannot be said about the vast amounts that were spent building homes in third tier and fourth tier cities, many of which have stood empty for years.

Will the strategies being proposed resolve these challenges?

In the past few months, Chinese officials have released a large number of policy statements that give us a sense of how China intends to achieve its ambitions to become a prosperous nation. Some of these plans are encouraging.

The key will be to make the market work better – and much is happening in this area. Just last week, for example, the China's cabinet, the State Council, issued its "Action Plan for Building a High-Standard Market System". The long and short of this document is that the government appreciates the need to make the market work more efficiently so that the misallocation of capital described above is diminished. It promised to do better in protecting property rights

including intellectual property and implementing competition law. It also promised to reduce restrictions on the free movement of labour, something which economists have been imploring the government to do for decades.

Separately, the People's Bank of China has been working hard to improve the functioning of the financial markets. Effective the beginning of this year, for instance, it removed the upper and lower limits on credit card interest rates so as to let markets set rates. The authorities have also been progressively opening up China's financial sector, allowing more outflows and inflows. Central bank governor Yi Gang has promised to make bank deposit rates more market-driven this year. The financial regulators have also been allowing more defaults even by state enterprises – this carries risks but if it is done in a calibrated manner, it will incentivise banks and bond markets to be more discerning in channelling credit to companies. More generally, Yi Gang has vowed to ensure that savers get a positive real return on their savings by avoiding the negative interest rates that some central banks are pursuing.

Chinese policy makers have also shown a keen understanding of the risks created by excessive real estate investment. Guo Shuqing, chairman of the China Banking and Insurance Regulatory Commission identified Chinese banks' excessive exposure to property as the "biggest grey rhino risk" facing the stability of China's financial system. He vowed to take steps to limit "bubbles" in the sector. Chinese policy makers' dictum that houses are meant to be lived in, not become objects for speculation is something more regulators around the world should take to heart.

In other areas, however, it is not clear whether enough is being done to rectify weaknesses.

- **China's unbalanced economy:** If it is to achieve an economy that is less reliant on exports and investment, China needs to raise the unusually low share of private consumer spending in its economy. But to do this, it has to lift the share of wages in the total economy. That is easier said than done in an economy where the profit share dominates. Some of this is due to the inordinately large share of profits in the SOE sector. Despite much rhetoric, little has been done to improve the distribution of income in favour of wage earners.
- **Liberalising the status of migrants in urban areas:** About 36% of the work force comprises migrants from rural areas who live in urban areas. However, under China's *hukou* system of resident permits, these migrants have few rights in the towns – they are paid much lower wages, face rules limiting their ability to own property and find it hard to access education for their children. Some studies show that liberalising the *hukou* would result in a substantial rise in the share of consumer spending in GDP. There have been recent moves to ease the plight of the migrant workers but the deregulation does not apply to China's biggest cities which is where most migrants want to live. This is because the larger cities do not want a flood of migrants coming in – and they have the political clout to slow much-needed reforms in this area.

- **The balance between the state and the private sector:** Another area of concern is the treatment of the private sector. The recent controversies surrounding Jack Ma and companies he founded such as Alibaba and Ant Financial have raised worries about the prospects for the private sector. The ease with which shareholder value was destroyed at the stroke of the pen by policy makers will make all private sector entrepreneurs deeply concerned about how secure their assets are. If China is to engineer more productive growth, it has to come from the private sector. But if private entrepreneurs lose confidence in their ability to preserve their hard-earned wealth, then China would lose a critical source of efficiency and innovation.
- **The pursuit of technological self-reliance:** In response to American restrictions on technology exports to China, China has been forced to embark on a programme to build self-sufficiency in technologies that are vital to military defence and in sectors that are important in the economy such as semiconductors. Massive amounts of money are being promised in this regard. But if the problems that caused SOEs to be so wasteful and public infrastructure projects to destroy economic value appear in these technological ventures, then we could see a lot of unproductive spending that could set China back.

Conclusion: China needs to do more to achieve its goals

These four big concerns – raising the consumption share in the economy, giving migrant workers a fair stake in urban areas, protecting the private sector and making sure that the drive for technological self-reliance does not result in terrible waste – must be addressed satisfactorily if China is to overcome its challenges. However, these efforts involve sensitive political issues which may take time to resolve. If the right decisions are made, then China will be set on the path to becoming a prosperous and developed nation by 2050.

**Prepared by Manu Bhaskaran
CEO, Centennial Asia Advisors**