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Sustaining China’s Economic Growth: New Leaders, New Directions?

Penelope B. Prime

(Under review at Eurasian Geography and Economics)

Introduction

With costs rising, growth slowing and a new leadership at the national level, the citizens of China face many uncertainties. While progress in many aspects of life has been impressive since reforms began, the challenges must seem daunting. There is much discussion within academic and policy circles in China of how to avoid getting stuck in a middle-income trap, about whether the current slowdown is primarily due to spillovers from global crises or is more fundamental to China’s circumstances, and whether new solutions to old problems will be politically and institutionally possible. For the average person, the TV shows and tabloids dwell on measuring happiness and the meaning of life, as well as how to finance a home and obtain the best education possible for one’s children.

These policy and personal concerns are closely related. To date, producers have been favored over consumers, state companies have been favored over private firms, and production of export goods has been favored over provision of household services. These priorities have resulted in mammoth change in China’s economic capabilities and have delivered much improved living conditions for many. However, many analysts inside and outside of China have argued that the benefits of these priorities have run their course, and a so-called “re-balancing” of the use of resources and policy priorities is in order.

The re-balancing discussion is not new. Coined “harmonious society,” it has been the hallmark of the Hu Jintao leadership. But Hu’s presidency ends with many of the problems left unresolved. The 18th Party Congress selected Xi Jinping and six others to the Politiboro Standing Committee, the highest level government group in China, with the economy at the top of the list of urgent matters to tackle. The purpose of this article is to review the reforms leading up to Hu’s agenda, to assess how healthy the economy looks at this point, and to speculate on what options and obstacles the next leadership team will face. The thesis argued is that achieving more reforms and improving technology will be essential to sustained growth, but that it is likely that more reforms will be needed before sustained innovation can take root. The next section will briefly review the development strategies under the three main leaders since reforms, Deng, Jiang and Hu, that led to successful growth and engagement with global markets. The third section analyzes pressing problems and possible remedies, arguing that the key drivers of growth are exhausted—high savings funding high investment, low population growth and high exports. The fourth section speculates on possible paths the next leadership team may take.
Reform-led Development Strategies

Under Mao, socialist goals of security and equity were achieved at the expense of incentives for efficiency and innovation. These goals were taken to extremes during the Great Leap Forward campaign (1958-62) to build socialism quickly in the countryside, and the Cultural Revolution (1966-76) that shook up the bureaucratic and institutional status quo. As a result, over time, rather than playing a leading role in the world as Mao had envisioned, China became isolated with its economy falling behind other countries in the region.

*Deng Xiaoping launches economic reform*

Mao’s death in 1976 created the political possibility of following a different approach. After struggles within the Chinese Communist Party, supporters of Mao’s strategy were defeated and the reformers gained the upper hand, led by Deng Xiaoping.

The *People’s Daily* online has this description relating to Deng’s role in economic reform:

Following the Third Plenary Session of the Eleventh Central Committee, he became Vice-Chairman of the Central Committee, member of the Standing Committee of its Political Bureau, Chairman of the Central Military Commission and chairman of the Central Advisory Commission. He has played a major role in important policy decisions by pointing out the correct orientation with regard to key questions that have arisen in the course of formulating the line since that Session. People regard him as the chief architect of China's reform.

Once Deng consolidated power after Mao’s death, economic growth became the main priority. The Third Plenum of the 11th Central Committee, in December 1978, is recognized as the official beginning of economic reform. Drawing on previous initial discussions in China on reform, Deng characterized the areas of needed change as the “Four Modernizations,” covering agriculture, industry, technology and defense. This created some continuity between the Maoist era and the reform period, but the political and ideological challenges of this transition were unprecedented. The economic benefits received by various interest groups at each stage in the reform helped push the implementation of the changes and keep them going (Shirk 1993). Early on the collectivized agricultural system was decentralized to the household level, where families could contract with the state to use plots of land in return for selling a portion of their output to the state at planned prices (Naughton 2007, pp.89-90). Any surplus could be used by the family or sold on the market. This seemingly simple change caused agricultural output to jump, and helped relieve some of the worst poverty and hunger resulting from the stagnating economy in

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the 1970s. By some reports grain output was one-third higher in 1984 as compared with 1978. These successes also helped to spread this institutional change quickly throughout China.

As in agriculture, reforms in industry used a “dual-track” approach where state-owned enterprises could increase their production beyond what was required to fulfill the plan targets and sell this excess on the market at (usually) higher prices. This was the beginning of pushing managers towards working within a market context, paying attention to costs, quality and market demand. For four decades this type of management was unnecessary and even frowned upon, so the change needed in this sector was daunting. Another enterprise ownership category was “collectives,” which meant ownership by local governments such as villages, townships or counties. These enterprises were initially established under the Maoist period as the “small five industries” to serve agriculture, and included chemical fertilizer, cement, iron and steel, hydroelectric power and farming tools (Naughton 2007, p.273). In the 1980s, these enterprises moved into consumer products and other agricultural and construction inputs, such as bricks, to meet these growing demands. Private enterprises were also established for the first time in many decades. Many of these companies did very well during this period, and helped raise tax revenue for local governments and to create wage-paying jobs for members of farming families.

As part of the development of capital markets, the Shenzhen and Shanghai stock exchanges were established in the early 1990s. In the beginning only select state companies were allowed to issue some of their shares on one of these exchanges. Trading of shares represented partial privatization of these companies, although the government kept majority control. Meanwhile, many small state enterprises and collective enterprises were bought out by employees or other private investors, and more home-grown entrepreneurs started private companies. These companies have grown primarily on informal financing channels such as borrowing from family and friends, as they have not had full access to bank loans or been able to easily list on one of the stock exchanges. Yasheng Huang argues that this was the peak of privatization in China with the most conducive policy environment, and that support for private development has dwindled since (Huang 2008).

The third modernization, technology, was tackled initially by both importing domestically unavailable technology and by sending scientists, scholars and engineers abroad for training. The Maoist approach had been referred to as “walking on two legs,” meaning a dual strategy of utilizing basic technology (such as in the rural industrial sector) combined with government sponsored research efforts to promote more sophisticated technological development. While the country saw some breakthroughs in scientific achievement, the economy overall did not benefit much from innovation or even from dissemination of what was already known.

The defense sector, the fourth part of the Four Modernizations, was most often the beneficiary of these technology efforts (Naughton 2007, p.353). China tested its first atom bomb in 1964. In fact, much of the strategy pursued in China under Mao can be understood better in
the context of national defense. China and the Soviet Union were allies in socialist ideology and pursuit of socialism against the capitalist, imperial world until the late 1950s when they parted ways. After that, Mao’s policies looked upon the Soviet Union as an enemy, along with the western world. In the 1960s, Mao insisted on building industry throughout the country—the so-called “third front”—for defense reasons, and also pushed each province to become economically self-sufficient in everything from food and energy to consumer and producer goods (Naughton 1988). These policies were devastating in terms of economic output and efficiency, but indeed did build production capacity in remote areas across China. As part of the initial reforms in this sector, many military factories converted production to much desired consumer goods such as televisions and bicycles. Later the military sold or closed these factories, and evolved toward a modern, professional military that focuses on national defense and is funded via the national budget rather than from its own businesses.

A very important aspect of reforms in China in the 1980s was the various initiatives to open China’s economy to trade and foreign investment. Mao focused the country on gaining self-sufficiency in part due to suspicion of the international, capitalist economy. As a result, China did not participate in international trade and investment for the most part. Hence, allowing foreign investment into China was controversial, to say the least. To get around this ideological constraint, the initial opening reforms created four Special Economic Zones (SEZs) in 1979 in southern China near the border with Hong Kong (Vogel 2011, p.398-99). Guangdong and Fujian Provincial leaders were allowed the authority to build infrastructure and offer tax and other incentives to encourage foreign firms to invest and export. These zones had their own borders, however, with special permission needed to enter and exit, which helped mollify those who were against them. They were also seen initially as isolated experiments, rather than policies for the whole country (Vogel 2011, p.400). The zones required most of the output to be exported, partly because the country had very little foreign exchange at the time and partly to protect domestic enterprises. Hong Kong firms flocked to these zones to manufacture with the vastly cheaper labor. Companies from other parts of the world soon followed suit. Success in the zones led to a furthering of the opening policies in the mid 1980s when foreign investment was allowed in fourteen cities along the coast.

All of these policies represented dramatic change in socialist China, and most led to rapid growth and rising incomes. Inflation and corruption, however, were additional by-products. These concerns, combined with new individual freedoms, contributed to demonstrations and sit-ins throughout May, 1989. This willingness of ordinary people to confront the Chinese government was unprecedented, and unacceptable to the power elite. These pressures culminated in the June 4th Tiananmen incident where the Chinese army attacked the students and others in order to clear the square and end the confrontation. This event, not surprisingly, pushed some foreign countries away from further interactions with China for some time, and created a political crisis within China. Speculation was rife that economic reform had come to an end.
Then, in January, 1992, Deng Xiaoping traveled to southern China to observe first-hand the SEZs and economic development there. As a result of that trip, but after contentious debate and jockeying within the Chinese Communist Party, by March 1992 the leadership announced via national news that further reforms would be continued to maintain rapid growth (Vogel 2011, 669-681). Thus began a second phase of reforms in China that have led to world records of foreign investment, exports and growth of 10 percent or more throughout the 1990s and into the 21st century.

Deng used his vast power and networks to accomplish these significant changes, even though he was not technically the leader of the government during these years. In 1978 Hua Guofeng held the positions of chairman of the party and premier. From 1983 to 1988, Hu Yaobang was general secretary of the party and Li Xiannian was president with Zhao Ziyang serving as Premier, followed by Yang Shangkun as president (1988-92) with Li Peng as premiere (1987-98). When Jiang Zemin became president in 1993 at the 14th Party Congress, a regularized, ten-year term was established for the top leadership. The end of lifetime appointments had been one of Deng’s goals for political reform (Vogel, 2011, p.687). Serving with President Jiang was first Li Peng and then Zhu Rongji in the position of premiere. The economy falls primarily under the Premier’s portfolio.

**Jiang Zemin Takes the Lead**

During Jiang’s leadership, reforms were characterized by further development of market institutions that would help guide the economy instead of planning as under Mao, or lose control leading to inflation, as during the first phase of reforms. Key to this goal was developing modern banking and taxation systems. Although already under development before Jiang became president, the major financial sector reforms were launched in 1994 (Wu, 2005, pp.222-225; 269-274).

In banking, the People’s Bank of China was designated as the central bank, much like the Federal Reserve Bank in the U.S., and the other banks were to be reformed to behave as profit-seeking companies with incentive to make careful loan decisions. The People’s Bank has the responsibility to set monetary and exchange rate policies to indirectly influence investment and consumption behavior. While these changes have not been fully successful and are still far from complete in replacing top-down directives with indirect measures to influence market behavior, these steps have helped smooth out the booms and busts of growth and inflation experienced during the first phase of reform.

In taxation, after years of a unified system, separate local and central tax bureaus were created to collect their respective tax revenues, and expenditure responsibilities were readjusted to reflect the new needs of the society. The Central government’s fiscal responsibilities focused on national infrastructure projects, national defense, and redistribution priorities, while local
governments’ responsibilities focused on K-12 education, local infrastructure and promotion of a good business environment to create jobs for their constituents.

Housing reform took place during this period, transferring ownership of apartments to individuals in the urban areas. Today there is a vibrant real estate market, although housing values have increased so much that many cannot afford to buy even a small condominium. Although land still cannot be privately owned, the rights to use land are sold for fixed time periods ranging from 50 to 70 years. To reflect these changes, in 2004 the National People’s Congress incorporated the right of private property ownership into the Chinese constitution.²

One of Jiang’s legacies was to develop the theory of the “Three Represents,” reportedly at least in part as a result of touring the more advanced southern and eastern areas of China’s development in 2000.³ The idea was that the CCP would no longer represent just the workers, soldiers and peasants as was the case under Mao, but would broaden its scope given new developments in Chinese society to include the “advanced productive forces, an advanced culture, and the interests of the majority of the people. One of the groups included in the “majority of the people” were those who contributed in commercial ways to society, and therefore entrepreneurs in the private sector could be counted as productive members of society. They also then could become members of the Chinese Communist Party. This was seen as a major ideological step in politically rationalizing the economic reforms.

In terms of the international economy, under Jiang and especially Zhu Rongji, China became even more integrated into the production networks of Asia and beyond (Zhao and Zhang, 2007). As a center for manufacturing, China has held a trade surplus with many developed countries such as the U.S. and the E.U. Approximately half of these exports from China originate in companies with foreign investment. In another sign of normalizing economic relations and building a market economy, after many years of negotiation and revamping relevant laws and regulations to suit international norms, China joined the World Trade Organization in 2001 (Prime 2002). Implementation of this agreement has opened the central and western parts of China to foreign investment, and has phased in new sectors where international competition is allowed.

Due to surplus labor in the agricultural sector, new opportunities in the cities and a relaxation of the prior household registration system or hukou, estimates of over 140 million people travel for temporary work, referred to as the “floating population.” These are primarily people with permanent rural residences who travel to find work in manufacturing, construction or other services in urban areas. Since their official places of residence are in villages and towns,

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they make up the majority of the informal urban sector in China. Increasingly these people are settling permanently in their new urban locations.

The *hukou* policy and system continue to evolve, as the need for the labor services of rural people grow owing to the demands for factory, construction, and transportation workers in the burgeoning cities, especially in the coastal provinces of the east. China has now crossed the 50 percent threshold of urbanization, and the growth of cities and towns continues in step with the rapid economic growth and structural shift from farming to industry to service activities (Chan, 2012). These temporary migrants are not entitled to the privileges and services afforded to city dwellers with non-agricultural and urban residential *hukou* status. Such privileges as employment in the state sector, state-supported health services, and free education for their children are typically not available. Temporary migrants in fact are second class citizens in a two-tiered system, and there are increasing calls for modification or even termination of this policy. Yet the policy has served China well to ensure an almost endless supply of low-cost labor to man the factory jobs related to export-oriented industries and to keep the cost of construction and many other low-end service jobs in cities at a very low wages (Chan, 2009). This disparity between the two groups of citizens is one of the main reasons behind the rising gap in income.

Under Mao’s socialist leadership, which restricted labor mobility and private ownership, income inequality was very low. The market reforms have led to a rising Gini coefficient from 29.1 in 1981 to 42.5 in 2005, which is now on par with that of the United States which was 40.8 in 2000. In addition to the inequalities arising from the *hukou* system in urban and rural areas, disparities between geographical regions have developed as the east coast was favored in terms of policy and historically had better endowments of capital, infrastructure and educated labor (Zhu and Wan 2012). Beginning in 2000, the central government began a “Develop the West” program that channeled national government funding into infrastructure, resources, education and health in the western provinces and autonomous regions to begin to address the substantial geographic inequalities that have emerged (Chin 2004).

**Hu Jintao redefines progress**

Building on the “Develop the West” goals, President Hu put forward a platform around building a “harmonious society.” The 6th Plenum of the 16th Central Committee meeting of the CCP in the fall of 2002 issued “The Resolution on Some Issues in Building a Harmonious Society” (Herschler 2007). Hu’s agenda can be thought of as a focus on social reforms to rebuild the social services that collapsed along with central planning, and to help those falling behind in income and employment options despite the rapid growth of output. Central to this strategy is a phasing out of low-wage, labor intensive manufacturing for export in the coastal areas, replacing

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this with higher value-added, higher wage production especially in central and western China, in addition to expanding domestic demand. The goal is to generate domestic income and consumption so that China will be less dependent on exports and investment to drive growth.

Another part of the rebalancing effort is to invest in the quality of life aspects of the economy such as education, healthcare, retirement and the environment. The rapid reforms that occurred in the first thirty years focused on production and not on services, and especially neglected household services as well as the safety net and welfare programs that governments typically provide. Numerous experiments with reforms have taken place in these spheres during Hu’s leadership, and this approach was officially endorsed in the 12th Five-year Plan in March 2011 (Roach 2012a).

Evidence of progress has been mixed. Many analysts talk of lost opportunities under the Hu regime in terms of improving political institutions, the functioning of the market system, and the coverage of social programs (Anderlini 2012, Bhattacharya 2012, Rabinovitch 2012a). Nonetheless, there are signs of tentative success in some arenas. For example, the share of exports has fallen as has China’s trade surplus. Today China’s trade surplus is about 4.3% of GDP down from a high of almost 8% (Beattie and Ross, 2006). This is probably largely due to decreases in foreign demand as a result of weak economies overseas, but still is moving China in the desired direction. More importantly, perhaps, monthly growth figures for inland and western provinces are substantially higher than coastal areas in 2012. For example, for the first 8 months of the year, Shanxi, Henan and Hunan grew 11.4, 14.9 and 14.9 percent respectively while Beijing, Shanghai and Guangdong grew only 6.0, 2.1 and 7.3 respectively. One of the goals of the re-balancing is to help slow down, and possibly reverse, the growing unequal income distribution between households on the coast and those further inland. These differentiated growth rates represent a step towards that goal. Another piece of evidence of progress was that China’s ranking in the global competitiveness comparisons for health and basic education rose to 35. Supporting this, recent reports on progress in pension coverage claim that over one-third of citizens are covered with a big push to cover more families quickly.

Feasible Policies for Pressing Challenges

Despite some evidence of re-balancing, China’s leaders are well aware of the small gains in this regard, as well as the many challenges facing further growth in its economy. A World

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Bank report, in cooperation with Chinese analysts, discusses a series of reform options in response to what it calls an inflection point in China’s growth (World Bank 2012). Analysts in China have been involved in a lively debate on how likely it is that China would fall into a “middle income trap” where incomes stagnate, and what would be needed to avoid such a fate (Woo 2012). How the next leaders decide to deal with the economy will profoundly affect China’s growth path and China’s relationship with the global economy.

To understand the nature of the growth barriers going forward, it is helpful to look at the factors that propelled growth so far. Key growth variables that lead to rising living standards for economies include increasing the use of capital relative to labor, expanding exports, improving the efficiency of an economy through market reforms, and advancing the available technology. China has relied heavily on the first three. Reforms have moved China from a planned economy to a semi-market one, improving overall economic efficiency. China’s export growth has also been very successful. As a share of gross domestic product (GDP), exports rose from less than 5 percent in the 1970s to 31 percent in the 2000s (figure 1). The linkages between exports and growth are many—tapping global demand and economies of scale, increasing efficiency through competition, earning foreign exchange to pay for needed inputs, raw materials, energy and technology, among others.

But the strongest contributor to growth in China has been high savings that funded investment combined with a slowing growth in population. Population growth fell from 2 percent in the 1970s to .6 in the 2000s, while savings grew to 46 percent of GDP and investment to over 40 percent (figure 1). These trends raise the capital-output ratio throughout the economy, which directly raises living standards by increasing output per person.8

These are impressive numbers. China’s challenge now is how to keep this going. Although China does not need to maintain a 10 percent growth rate going into future, a healthy 7 to 8 percent will be necessary to employ the active labor force. High savings and investment can support growth for some time to come, but the rate of growth would be expected to fall as development goes forward due to falling marginal productivity. In other words, without access to new resources or improved inputs, or to technological change, additions to output fall over time. To overcome this trend based on the growth model to date, a higher savings rate, more exports or a lower population growth rate would be required. None of these are desirable, or perhaps even possible.

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8 The background of this discussion is the Solow growth model (Solow 1956).
Figure 1: Factors Contributing to China’s Growth, averages by decade

<table>
<thead>
<tr>
<th></th>
<th>1970s</th>
<th>1980s</th>
<th>1990s</th>
<th>2000s</th>
<th>2010s</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth (annual % change)</td>
<td>7.4</td>
<td>9.8</td>
<td>10.0</td>
<td>10.3</td>
<td>9.8</td>
</tr>
<tr>
<td>Savings (% GDP)</td>
<td>30.4</td>
<td>35.4</td>
<td>41.2</td>
<td>45.8</td>
<td>52.3</td>
</tr>
<tr>
<td>Investment (% GDP)</td>
<td>30.5</td>
<td>36.0</td>
<td>39.0</td>
<td>41.3</td>
<td>48.3</td>
</tr>
<tr>
<td>Consumption (% GDP)</td>
<td>60.6</td>
<td>50.0</td>
<td>44.0</td>
<td>39.7</td>
<td>34.5</td>
</tr>
<tr>
<td>Population Growth (annual % change)</td>
<td>2.0</td>
<td>1.4</td>
<td>1.1</td>
<td>0.6</td>
<td>0.5</td>
</tr>
<tr>
<td>Exports (% GDP)</td>
<td>4.7</td>
<td>11.8</td>
<td>19.6</td>
<td>31.1</td>
<td>30.5</td>
</tr>
<tr>
<td>Imports (% GDP)</td>
<td>4.8</td>
<td>12.3</td>
<td>17.5</td>
<td>26.5</td>
<td>26.5</td>
</tr>
</tbody>
</table>

Note: Based on data from 1970-2011; savings is measured as gross national savings; investment is measured as gross capital formation; consumption is household final consumption expenditure. Source: World Bank, World Databank, [http://data.worldbank.org]; accessed November 8, 2012.

Decreasing the population growth rate is not desirable since it is so low already that the population has already begun to age. In fact, the main discussion is when the one-child per family policy will be lifted, which is expected to raise the population growth rate some. Increasing the share of exports is very problematic. China has a large trade surplus with mounting foreign exchange reserves that cannot be spent at home without undermining the currency value and creating inflation. World markets are saturated with Chinese goods, causing political tension with many trading partners. Increasing the saving rate further is also not feasible. Consumption as a share of GDP has fallen over time and is now very low—35 percent (figure 1). Increasing the consumption share could be the next engine of China’s growth, but not if savings continue to be so high. In addition, investment is already so high that many analysts
suspect that much of that investment is not used very efficiently and production overcapacity is already a problem.

The options, then, are two-fold: 1) move forward with reforms that would increase efficiency, such as promoting private business, modernizing the financial system and creating a market for land; and 2) increasing the technological base of the economy through innovation. Both of these improvements would add growth independent of the population, savings, investment or exports.

Academics and policy makers in China continue to discuss reform options; however, substantial change in policies or institutions appears to have stalled on many fronts and may be politically difficult to push forward. For example, the financial and property sectors are highly controlled by government entities, and have been very lucrative for those involved. Creating market reforms to make these sectors more competitive will entail sharing the profits much more broadly.

On the other hand, promoting innovation is politically easier in the sense that it moves China away from needing foreign investment and towards building itself into a world power. Indeed, innovation has been the talk of Beijing and one of the core elements of President Hu Jintao’s policy platform (McGregor 2010). Described as “scientific development” and “indigenous innovation,” promoting technological progress has been one of the pillars of President Hu’s “harmonious society,” along with helping to develop the poorer areas of the country and build health and retirement systems to supplement the uncertainties that have intensified along with market development (Fewsmith 2004). While innovation may not close income gaps, it would boost long-run growth.

In may be, however, that to spur innovation, reforms will need to come first. While the private sector is an engine of wealth creation, it is highly disadvantaged within the Chinese system in terms of its high cost of capital, poor protection of its assets, lack of access to certain business sectors and resources such as land, and even its legal status. There is also a lack of consumer confidence in the safety of products generally, which likely puts a damper on consumers’ willingness to experiment with new products. The stories of poor quality products, even dangerous products, sold in China (and abroad) abound (Gerth 2010). Institutional oversight of products and some formal consumer protection will be needed.

Nonetheless enterprising people are everywhere in China, and many of them are making money by identifying goods and services that people want to buy. But successful professionals and business people prefer in general to lay low, and will rarely agree to be quoted. The fear of increased taxes or being targeted for corruption investigations are part of the landscape. If one is successful, an attractive option is to take your wealth abroad where it will be safe from the uncertainties of the current political-economic system (Johnson 2012). Buying property and
sending one’s children abroad for school are two popular ways for families of even modest means to invest abroad.

These concerns and trends are telling, and underscore the desirability of progressive change in China to support sustainable growth into the future.

New Leaders, New Directions?

After a rebound from the 2008 global financial crisis, a gradual slowing has occurred in the economy beginning in 2010. Figure 2 shows annual changes in gross domestic product from the year earlier by quarters. These quarterly figures translated to annual growth of about 10 percent in 2010, falling to 9 percent in 2011 and with an estimated 7 and a half percent in 2012. The quarterly figures show that growth averaged about 7.5 percent after the first quarter of 2012, suggesting that the decline had bottomed out (NBS). The economic plans under Hu Jintao incorporated some slowing of growth due to re-directing resources to support social services, clean up the environment and invest in projects with long-term returns. At the same time, the leadership does not want a so-called “hard landing,” meaning an adjustment where growth falls too far, too fast. The economic problems in the U.S. and Europe have hurt exports and other business ventures for Chinese companies, which are no doubt partly to blame for this slowdown. A recently released survey suggests that cuts in exports and construction have had a larger effect on the economy than previously thought, as shown in higher urban unemployment than the official figures reveal (Wall Street Journal 2012).

Figure 2: China’s Quarterly GDP growth, year-on-year, 2010-2012

<table>
<thead>
<tr>
<th>Quarter</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>11.9</td>
<td>9.7</td>
<td>8.1</td>
</tr>
<tr>
<td>2nd</td>
<td>10.3</td>
<td>9.5</td>
<td>7.6</td>
</tr>
<tr>
<td>3rd</td>
<td>9.6</td>
<td>9.1</td>
<td>7.4</td>
</tr>
<tr>
<td>4th</td>
<td>9.8</td>
<td>8.9</td>
<td>7.5 est.</td>
</tr>
<tr>
<td>Annual growth</td>
<td>10.4</td>
<td>9.2</td>
<td>7.6 est.</td>
</tr>
</tbody>
</table>


If true, news that the economy was bottoming out must have been welcomed by the newly appointed leadership. After spending billions of yuan for stimulus programs to counter
the 2008 financial crisis fall out, which exacerbated debt levels especially of local governments, spending even more on stimulus was no doubt not a happy prospect (Bhattacharya 2012). In addition, moves to calm the hot property market risked slowing the economy, but the growth figures for the second half of 2012 indicate these policies were successful without a huge cost.

With the short-term growth issues seemingly under control, the leadership can focus on medium and long-term growth. The Party speeches at the 18th National Congress recounted economic successes over the last ten years, as would be expected, but also called for continued reform. Growth targets were set in terms of incomes of both rural and urban residents, rather than overall output measures (Chang 2012). Seemingly a subtle point, growth in output has been much faster than incomes over the years, depressing the share of consumption in total economic activity. Again, an emphasis on consumers and households over producers would be a welcome, and many believe, necessary change. With the economy recovering, presumably the political environment would be more conducive for re-instigating reform than if growth continued to slow.

Leading up to the leadership changes, the general consensus has been expected conservatism rather than risk-taking social change. One line of reasoning is that none of these men would have made it to the top without being very, very careful. One stark case in point is Bo Xilai, who met his demise going outside of the normal paths of power and change. In another development, the governor of the People’s Bank of China, which serves as China’s Central Bank, Zhou Xiaochuan, has been viewed as a reformer in the midst of the conservative financial sector. After ten years, he has been replaced without being promoted (Rabinovitch 2012b).

On the other hand, among the top seven new leaders, there is a good deal of market economic expertise (Roach 2012b). Li Keqiang, tapped to serve as premier, is a Ph.D. in economics and was part of the team working with the World Bank on the China 2030 report. Before his appointment to the Politburo Standing Committee, Li served on the Central Committee as the second most influential player on the economy after Wen Jiabao (Rabinovitch 2012a). So Li has had extensive experience running the economy, including navigating the crisis, as well as first-hand analysis of what the economy needs to sustain growth. Wang Qishan has substantial experience in the finance sector and is considered a global player in banking. Several others have served as high-level leaders in major urban centers, giving them first-hand economic experience as well. In addition, the new President, Xi Jinping, is thought to have sufficient power to push through and implement major economic and social reforms, and that he understands the importance for China to do so now. For the last couple of years he has studied the system in Singapore as a model of a country with single party rule but with a flexible, open market economy (Wong and Ansfield 2012). His emphasis on anti-corruption in his initial speeches during the Congress may also be important, as reforms would have to overcome strong
vested interests. Singapore is a model to emulate with regard to strategies to keep corruption in check as well.

Tellingly, in early December in his first major trip after winning power, Xi Jinping traveled to southern China to visit the SEZs where he talked about the necessity for reform (Wong 2012). Xi’s father, Xi Zhongxun, was part of the top leadership team that oversaw the establishment of the zones in the early 1980s. Hence Xi is familiar with the history, successes and problems relating to China’s opening and its relation with building markets. Reminiscent of Deng’s southern journey that re-enforced China’s reform path in 1992, Xi’s trip is highly symbolic. Xi invoked nationalism by talking about China’s national revival as the “Chinese dream.” The implication is that China’s success as a rising power will depend on moving forward with market reforms. In China’s context, this is a significant sign.

Since one of the suspected stumbling blocks to change has been the ability of vested interests in the state sector to gain advantages and keep competition at bay, a possible path to challenging these interests could be to put the international aspects of reform out front. International competition could indirectly create more competition in the domestic arena. Xi’s visit to Shenzhen indicates he is emphasizing more opening of the economy, while using China’s national strength as a rationale. Hence more opening could be his strategy for introducing domestic reforms as well.

Three parts of the international reforms include encouraging more Chinese firms to invest abroad, establishing the yuan as an international currency, and establishing a domestic stock exchange where foreign firms, and Chinese firms that incorporated abroad, could issue shares within China. All three of these policies have the potential to create competition for Chinese companies because they level the playing field and integrate China further with global markets.

Since 1999 when China’s Going Global Strategy was launched, outward foreign investment has steadily increased. By 2011 total outward investment reportedly reached over $424 billion, after registering only $29 billion by 2002 (Hu and Zhao 2012). At first the investments focused on natural resources but increasingly have branched out into all major sectors. Once operating beyond home borders, these companies face global competition head on. These experiences both help Chinese managers understand markets better, and learn what could be improved at home to promote business development.

With respect to the currency, China has pushed for more international transactions to be settled wholly in yuan as a step towards gaining legitimacy for the yuan as a reserve currency. To facilitate this, off-shore yuan markets have been set up in Hong Kong, with Taiwan and Singapore, and possibly London, to follow (Grant 2012). International bonds denominated in yuan, “dim sum” bonds, are also gaining traction. Officials in British Columbia, Canada, are considering offering yuan bonds as a way to diversify away from U.S. and Canadian dollars

Large foreign and Chinese companies are also issuing them as China’s domestic bond market is still closed to foreigners. The currency is trading in wider bands over time, prompting companies to consider hedging the volatility of currency values that is expected to follow (Wei 2012). Full convertibility and market value determination are probably still a ways off, but these moves are helping foreign companies do business in China as well as Chinese companies doing business abroad.

Finally, a new stock exchange is in the works where foreign companies could list and therefore have access to the Chinese capital markets. This International Board would allow foreign firms access to the Chinese capital markets and create competition for shares with the existing domestic A and B share markets (Ni 2012). Many countries simply open their capital markets to foreign portfolio investors, but Chinese policy makers want to prevent potential “hot money” flows by controlling the opening of its capital account. In lieu of this, establishing an International Board would create competitive pressure for Chinese domestic firms to perform up to global expectations as well as be more transparent about performance and management.

At this point, how much the new leadership team is giving lip-service to change without the ability or intent to change, is difficult to know. The leaders understand what needs to be done—the question is whether the difficult changes that will disenfranchise powerful people can be pushed through successfully. Given the urgency for change and the knowledge that this urgency is well-known both among China’s citizens and at China’s highest levels of leadership, it is more likely that serious attempts to deal with China’s challenges will occur than for those in the spotlight to paper over citizens’ concerns. Surveys show that more access to jobs and the means to insure against uncertainties matter a great deal to people in China (Easterlin 2012). The central government’s goal to provide a reasonably comfortable income level to all households is a broad-based goal with this in mind. The next step will be to flesh out the specifics of the policies intended to move China forward. Even if the new leadership utilizes more opening as a path to reform, change in the domestic economy will be needed eventually. To evaluate the likelihood of success, look for signs of the establishment of private sector legitimacy, a decline in state-sector monopoly power, and legal bases for the reform policies. Without these, reform talk will be much louder than true change.
References


