IN-DEPTH ANALYSIS

China: Economic outlook, 2015

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ABSTRACT

China stands now at a crossroads, where factors that for many years contributed to its growth have nearly – if not completely – exhausted their potential. As domestic economic challenges grow more pressing, Beijing has embarked on a new development strategy to 'rebalance' its economy and reinforce its integration into global markets. A number of elements of this strategy – including the 'One Belt One Road' initiative – are likely to have a major impact across the globe.
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1. China's 'new normal' economy

Despite its economic slowdown, China has won its race with the US for global economic leadership. Extreme poverty has declined sharply in China.

Two decades of double-digit growth secured China's ascension to economic records. In 2013 China achieved the status of world's largest trading power, accounting for over 10% of global trade. In 2014, China broke another record: the country recorded the globe's largest economic output in 'purchasing power parity' (PPP), i.e. taking into account differences in prices for goods and services across countries. According to IMF estimates, the country's GDP in PPP reached USD 17.6 trillion that year, slightly surpassing the USD 17.4 trillion of the United States – the uncontested global economic leader for over a century. When its GDP is measured in current USD prices, China is only the second largest – but there too the gap is narrowing.

Along with economic growth China also has managed to cut sharply the proportion of people living in absolute poverty. When Beijing began implementing market reforms in 1979, over 80% of the Chinese population lived in absolute poverty. This share dropped to less than 10% by 2013.

![Figure 1: Percentage of Chinese living in extreme poverty, defined as living on less than USD 1.25 per capita in PPP terms](source)

China's impressive economic performance has, however, shown steady signs of abating in the aftermath of the global financial crisis. When China's GDP was growing at an accelerating rate, it reached its maximum –14.2% – in 2007. As global demand fell, so did China's growth rate, hitting 7.4% in 2014 and 6.8% in the first quarter of 2015. Estimates for the coming years confirm a decline in Chinese output, is projected to drop to 6% by 2018.

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1 http://www.ft.com/intl/cms/s/2/d79ff88-cf07-11e3-9b2b-0014f870440.html#axzz3cYf39IfE While several voices in the scientific community pointed out flaws in the estimation and comparability of China's figures in PPP.

2 World Development Indicators 1981 to 2009, OECD estimates from 2009 onward based on the estimated national income distribution.
There is little likelihood that growth will rebound.

Some analysts say the country will remain caught in a 'middle income trap', while others argue that growth in absolute terms is still impressive.

The Chinese government has called China’s lower growth the ‘new normal’.

The ‘new normal’ economy should shift towards more consumption, services and

The country’s economic slowdown, which began in 2010 and has shown no signs of rebounding, has fuelled the debate over whether China has reached a turning point in its development path.

Some analysts argue the country is stuck in a ‘middle income trap’, unable to sustain high-speed growth. These observers stress the ‘structural’ nature of the country’s slowdown and point to development bottlenecks (e.g. labour market issues, inefficient capital allocation, the limits of China’s comparative advantages in labour-intensive and low-technology production).

Other scholars, on the other hand, argue that, despite the declining growth rates, the size and the global impact of the Chinese economy remain strong in absolute terms. To put matters into perspective, these analysts say, if China grows at 7%, its additional output would be EUR 595 billion – almost three times the EUR 206 billion it added ten years ago, when the country’s growth rate was 12%. Moreover, even with slower growth, China is likely to become a high-income country by 2020. This school of thought further interprets China’s recent growth as reflecting a greater reliance on domestic consumption.

This interpretation is in line with the official position of the Chinese government. According to Beijing, China’s more muted economic growth stems from a ‘rebalancing’ towards a ‘new normal’, a phrase first used by President Xi Jinping during a trip to Henan in May 2014. The government’s
policy efforts to 'rebalance' aim to prioritise people's wellbeing over growth targets, countering the risk of the 'middle-income trap' by fostering entrepreneurship and innovation and by increasing the supply of public goods and services and ensuring that people's income grows as rapidly as GDP.

The 'new normal' economy represents a shift from one driven by investment and labour-intensive exports to one based on domestic consumption and services. Yet this transition is proving difficult. While a sharp fall in global demand has lowered the growth of China's export volumes, increases in local consumption have been very modest (see Figure 3).

**Figure 3:**
Contribution to GDP growth

Investment has been largely sustained by infrastructure. Investments in real estate (see Section 2.1) and manufacturing, on the other hand, have shrunk significantly, especially in the past two years (see Figure 4).

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8 Premier Li Keqiang's speech at the World Economic Forum (Davos, January 2015)

9 Gross Domestic Product by Expenditure Approach (NBS calculation) at current prices
China: Economic outlook, 2015

The economy is at risk of deflation, despite the government’s interest rate cuts.

A higher demand for quality services underpins increases in consumption.

The service sector is the

Along with slower growth, China faces the risks of protracted deflationary pressures. Deflation reflects downward pressure in several channels: overcapacity in the metals, mining and heavy industrial sectors; a contraction in the property market; and falling import prices.

In May 2015, China’s annual inflation rate softened to 1.2%, down from the 1.5% recorded the previous month. Food prices had increased by only 1.6%, while the increase the previous year had been over 3%. Non-food prices rose by only 1.0% in the year up to May 2015. The ex-factory price for consumer goods is now falling more rapidly than at any point since the peak of the global financial crisis, and the decline in the price of goods sold by heavy industries is even more pronounced.

To respond to lower growth, declining prices, higher debt and debt-service costs, the People’s Bank of China (PBOC) has cut its benchmark lending rate four times in the last six months. The latest cut (on 27 June) brought the benchmark lending rate down to 4.85%, while the one-year deposit rate was set to 2% \(^10\). The reserve requirements for banks lending to farmers and small businesses have also been reduced.

China’s nascent economic shift towards consumption is connected to the emergence of its sizable middle class and the country’s rapid urbanisation. The rise in consumption has also brought a higher demand for services – such as healthcare, education, tourism and financial services – at the expense of the consumption of manufactured goods \(^11\). While services still count only for 46% of GDP (see Figure 5a) – a sector that in many developed economy represents more than 60% of GDP – the service sector is growing at a fast pace and maintains a large growth margin. Its contribution to GDP growth topped 50% in 2013 and 2014 (see


\(^{11}\) In 2013 the services sector over took industry as the major economic sector.
most dynamic in the Chinese economy. Figure 5b) and has increasingly attracted a higher share of foreign investment – about USD 66.2 billion in 2014 (see Figure 5d). This expansion has had a positive effect on job creation, as the tertiary sector now accounts for the largest share of employment (see Figure 5c).

China’s economic slowdown and move towards a ‘new normal’ is felt beyond the country’s borders, with negative implications for commodity prices and trade flows. Commodity-producing economies have suffered from Chinese heavy industries’ downwards adjustments and reduced imports of commodities such as iron ore, coking coal, manganese ore and bauxite. The worst-affected countries, those heavily dependent on commodity exports to China, include Mauritania, Turkmenistan, Sierra Leone, Gambia, Mongolia, Mali and the Solomon Islands.

Other countries in the Asia-Pacific region – and particularly Japan, South Korea and Australia – may also suffer severely if China’s slowdown continues. These countries export a mix of products to China. For Australia, iron ore, coal, coal briquettes, copper, nickel, cereals, meat, wool, fur skins and hides are likely to be affected. For Japan and South Korea, electronic equipment (including for medical purposes), machinery, pumps, automobiles, chemicals, plastics, copper, steel and ferrous products are at
stake.

The United States and Canada are also affected, although through different channels. These countries are major manufacturing export partners for China in sectors including aircraft, space equipment, machinery, electronic equipment and vehicles.

In Europe the impact of China’s economic slowdown is mixed. The UK, Germany, France and Switzerland – the major European exporters of machinery and equipment to China – are the most exposed countries.

2. Domestic economic challenges

2.1. Real estate, local government debt and urban development

A major element dragging down economic growth in China is the current contraction in the real estate sector, which has been an important engine of growth for more than 40 industries – including steel, glass and cement – and for the economy as a whole. In 2014, real estate sales fell by 7.6%\(^{12}\), while residential property prices fell by 4 to 5%\(^{13}\) on average in big cities. Nationwide data suggest that the construction of new residential buildings has also fallen (-14%)\(^ {14}\).

A contraction in the property market has direct effects on growth as it reduces investment. Indirectly, it has also a knock-on effect on upstream and downstream industries. In general, the contraction is symptomatic of China’s economic malaise. Characterised by overbuilding and price misalignment, the sector has been fuelled by distortions on both the demand and the supply sides.

In terms of demand, the lack of property taxes in China and households’ limited access to other investment options have underpinned China’s housing demand. In addition, the government introduced an urban ‘social housing programme’ to push the sale of houses at below-market prices and to subsidise rental housing\(^ {15}\). Finally, demand has been fuelled by the prospects of future urbanisation\(^ {16}\) and the importance of replacing existing, low-quality housing stock\(^ {17}\).

On the supply side, because the property market in China is not fully

\(^{12}\) Statistical Communique on China’s 2014 National Economic and Social Development.

\(^{13}\) RBA 2015

\(^{14}\) Statistical Communique on China’s 2014 National Economic and Social Development.

\(^{15}\) In recent years, there were around 5 million social housing units completed per annum in urban areas, and around 7 million ‘commodity’ residential property completions (RBA 2015).

\(^{16}\) although China’s urbanisation rate has risen from 42 per cent to 55 per cent over the past decade and expected to rise to the announced a target of 60 per cent for 2020 (RBA 2015).

\(^{17}\) A survey conducted as part of the 2010 census found that 16 per cent of urban households had no access to toilet facilities, and that 10 per cent lacked a kitchen (RBA 2015).
liberalised, local governments have relied on the sales of land rights to finance their spending (see Figure 6) and have used land as collateral for their borrowing. The need for local governments to access credit and increase revenues has sustained a vicious spiral, in which land has been expropriated from farmers and rapidly converted from rural to urban use\textsuperscript{18}. This practice has contributed to the country’s rapid urbanisation and overbuilding\textsuperscript{19}.

The contraction in real estate caused by these distortions have been a concern for Beijing, which has taken a number of steps to revive the property market. In March, the central bank lowered the minimum down payment required for second-home purchases to 40 %; it had been 50-60 % in most cities and 70 % in Beijing and Shanghai. In addition, the finance ministry expanded a capital-gains tax exemption to include sellers who have owned their home for as little as two years, rather than the previous five-year minimum.

These policies have already improved the state of the market. In the three months proceeding May 2015, sales of finished apartments rose by almost one quarter from the same period one year ago, with developers selling more pre-construction units\textsuperscript{20}. Prices have started to rise again.

\textbf{Figure 6:} 
Local government revenues

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure6.png}
\caption{Local government revenues}
\end{figure}

\textsuperscript{18} In China as land is owned by the State and clearly marked either as for rural or urban use, the local governments - especially those in the poorest and most remote areas of the countries - have financed their financial gaps by speculating on the conversion of the land from rural into urban. By doing this they fuelled inefficient growth of the cities and incentivized real estate developers to build housing without any matching with the actual population growth. On top of this inefficiency, the land conversion process has been criticized as often inappropriate or no compensation was given to farmers for their expropriated land, this having unintended drawbacks on the rise of inequalities and vulnerability of poorest segments of the population.

\textsuperscript{19} Further details on this mechanism can be found in Henry Sanderson and Michael Forsythe, \textit{China’s Superbank: Debt, Oil and Influence - How China Development Bank is Rewriting the Rules of Finance}, 2013.

\textsuperscript{20} In China, 80% of new apartments are sold on the basis of the developers plan, often well before construction is started.
Along with urbanisation, the government has cumulated growing debt, mostly generated by local governments' off-budget borrowing to sustain spending in local infrastructure. Following the 1994 budget reform, local governments were not entitled to run deficits or sell bonds. In order to borrow off-budget from state-banks, the governments instead established 'local government financing vehicles' (LGFVs)²¹.

With the launch of the government’s fiscal stimulus programme to counteract the 2008 global crisis, LGFVs came to play a growing role in financing urban infrastructure investments²². Many local government institutions, such as hospitals, universities and even schools, have borrowed as well. The result is that China’s debt has almost quadrupled since the start of the 2008 financial crisis, reaching 282 % of GDP in 2014. The country’s non-financial corporate sector, which includes the LGFVs, owns the largest share of this debt (see Figure 7).

A significant portion of local authorities' off-budget debt has been financed by the shadow banking sector – i.e. by trust companies, securities houses and insurance companies entitled to operate under less-regulated terms than banks²³. In October 2014, the government introduced some measures to reform local government debt, including by allowing some debts to be converted into local bonds.

Figure 7: China’s debt as % of GDP

Source: Economist.com

²¹ Companies set up in order to provide local administrations with the necessary funds to complete infrastructure projects.

²² It was estimated that the LGFVs financed by the China Development bank during the 2009-2011 period received loans and lines of credit for RMB 928.6 billion. This amount represents almost a quarter of the whole RMB 4 trillion envisaged by China as fiscal stimulus to counteract the effects of the global crisis. The central government only provided RMB 1.18 trillion, while the rest came from state banks (for further details see Sanderson and Forsythe 2013).

²³ Such institutions were able to avoid regulations on rates of interest; on the sectors to which they could lend; requirements for capital adequacy; loan-deposit ratios and reserve ratio requirements.
2.2. Financial markets

Repressive financial policies have fuelled imbalances across economic agents and sectors.

While much of the Chinese economy has been progressively opened, its financial sector is still characterised by strong state intervention. The government has created a complex system to control the interest rates, exchange rates, capital allocation and capital mobility. China is one of the world’s most tightly controlled countries in terms of finance.

Beijing’s financial policies have de facto privileged the corporate sector over households, and state-owned enterprises (SOEs) over small private firms. Controls over interest rates have created a de facto tax on households. Borrowers who have benefited from very low interest rates – essentially ‘subsidised’ lending rates – are state-owned enterprises (SOEs), while banks are generally reluctant to lend to riskier, small private firms.

Before 2005, tight controls over the exchange rate maintained the value of the renminbi artificially low, thereby fuelling unbalanced development based on the high-growth of exports and manufacturing. In 2005, the People’s Bank of China (PBOC) switched to a managed floating exchange rate system, under which the exchange rate was not determined by the USD alone, but on a basket of currencies. In 2014, the PBOC doubled the daily trading band within which the renminbi was allowed to fluctuate, and over the last year, the renminbi finally appreciated substantially. Since the policy changed in 2005, the real effective exchange rate of the renminbi has risen by nearly 60%24. This sustained movement resulted in the IMF declaring that the renminbi is no longer undervalued. The Fund even envisaged including the currency in its Special Drawing Rights (SDR) basket.

2.3. Regional and rural-urban disparities

Disparities between regions and between urban and rural areas constrain consumption and exacerbate financial pressure.

Sharp economic and social disparities have grown along with China’s rapid economic expansion of the last three decades. Gains from economic growth did not reach the whole country’s population, with households’ location a determinant of social and economic well-being.

Coastal areas have achieved per capita income levels largely above those in inland, and notably areas in the west. Income disparities are even more significant between urban and rural populations (see Figure 8): the annual income of urban households is on average three times that of rural families. The OECD has argued that the relative gap seems to have shrunk in recent years25, following the abolition of regressive agricultural taxes and the rapid growth of off-farm earnings (migrants’ remittances)26.

24 Bank for international settlements http://www.bis.org/statistics/eer/
26 OECD findings have to be taken with care as the (i) income is measured in nominal terms, (ii) the ratio takes no account of differential levels or rates of change in urban and
The rural-urban division is further complicated by the emergence of a new population class: urban residents with rural ‘hukous’ (residence permits). These ‘migrants’ live and work in cities without the access to the public services and social participation enjoyed by residents with urban hukous. It is estimated that four in ten urban residents suffer this discrimination. This dual system has generally impeded the growth of China’s middle class and created major social tension.

Figure 8:
Urban-to-rural disposable income ratio

Unbalanced development across the country has systemic consequences for public finances. Local governments’ accumulation of debt has occurred on a larger scale in those areas where revenues could not support government spending for education, health or infrastructure. The financing gap has been larger for the western and central provinces than for the coastal provinces. The central government has tried to meet this gap through transfers from its budget, with the result that transfers are strongly redistributive, rising sharply as GDP per capita falls. A number of low-income counties in the west of the country receive transfers worth more than 150% of their GDP.

Figure 9:
Relationship between transfers as a share of local GDP and the level of GDP per capita

The government’s fiscal transfers to counties are strongly redistributive.

rural prices, (iii) the definitions of disposable income differ between rural and urban households (see China’s Statistical Yearbook for complete definitions).
Levels of human development are lowest in rural western areas.

**Figure 10:**
Urban-to-rural Human Development Index (HDI) ratio (2010)

Regional and rural-urban disparities are not only economic. Looking at human development aspects, which include education and health, the 2010 urban-to-rural gap was the largest in the west, followed by the central regions and north-east and coastal provinces (see Figure 10). The gaps offer further proof that China offers large, untapped potential for more inclusive growth.

The Hukou – China’s ‘Household Registration System’ – has been in place since 1958, playing a primary role in the allocation and re-allocation of China’s population in rural and urban areas. The system creates a differentiated regime for rural and urban residents, making registration compulsory and restricting mobility to urban areas.

As a consequence of economic reforms, the system underwent substantial transformations from the 1980s until 2006, when mobility restrictions were largely eliminated. This, in turn, has generated a ‘surplus’ workforce of about 275 million people who have moved from rural parts of China to major cities.

These rural residents are currently de facto ‘second-class urban citizens’; they earn lower wages than the urban registered workers on average and have limited access to social services. The situation has placed social stability under pressure, especially in the urban centres and mega cities of the eastern region, such as Beijing and Shanghai, where most migrants

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27 The human Development Index was calculated using data from the 2000 and 2010 population census, complemented by national statistical yearbooks for the construction of the dimensions education and per capita income. The HDI dataset included rural and urban areas of 31 Chinese provinces/regions (excluding Hong Kong and Macau Special Administrative Regions and Taiwan Province).

28 OECD 2015, p.12.
move in search for better opportunities, away from the poor conditions of rural life.

NOTE:
(i) Population in each province is reported in brackets.
(ii) The figures displayed in the graph refer to the percentage of migrants residing in urban areas.

Source: data compiled from China’s Sixth National Population Census

2.4. Urbanisation, quality of life and social unrest

Over the last 35 years, urbanisation has proceeded on an unprecedented scale and speed, and China’s urban population has nearly quadrupled. In 2010, China has become a predominantly urban country, with over 50% of its population residing in the cities.

The country’s urban development is seen as unsustainable, as the process has failed to price fairly the factors of production employed (i.e. labour and land) or the environmental effects of export-led and industry-led growth.
Problems related to urbanisation have fuelled social unrest across the country.

The mismanagement of these factors has led to the current situation, in which (i) the human and economic costs of environmental degradation are high, (ii) populations are inefficiently allocated across cities\(^{29}\), (iii) the urban labour market includes more than 275 million migrant workers with rural status and diminished social rights (see above), and (iv) land conversion and its use as collateral\(^{30}\) have negative effects on public finances.

Land disputes, environmental concerns and labour conflicts: these three major aspects of China’s urbanisation have been identified among the top causes for growing social unrest across the country\(^{31}\). In the third Plenum, the new leadership of the Communist Party responded to this unrest – a challenge to the Party’s legitimacy – by putting forward a new concept of development that is people-centred and focused on improving citizens’ quality of life. With growing consumption and increasing purchasing power, Chinese citizens are also more and more sensitive to issues related to food safety and consumer protection\(^{32}\) (see below).

In March 2014 the Chinese government launched the ‘National new-type urbanisation plan’ for 2014-2020, which aims to generate quality growth and increased welfare for its urban residents. The framework foresees further support for industries and technologies that enhance energy efficiency and environmental protection, as well as new-generation telecommunications and enhanced professional and consumer services. This plan considers regional disparities affecting the country by targeting the development needs of the central and western regions. The implementation of this plan is, however, expected to be a long-term effort with numerous challenges.

### Consumer protection

Rising prosperity in Chinese society and the surge of a relatively conspicuous middle-class have boosted consumption in recent years. Unfortunately, the Chinese government’s consumer protection efforts have proven incapable of keeping pace with this rapid development. Strengthening consumer protection has become an extremely sensitive issue in the country, where a growing number of people call for stricter safety standards and more efficient enforcement. In response, the Chinese leadership has turned its attention to consumer policy.

On 15 March 2014, a new consumer law entered into force, marking the biggest reform in this area in 20 years. The law appears to significantly reinforce consumer protection. By introducing the law and reinforcing domestic confidence in Chinese products, Beijing has also aimed to help shift the economy from exports towards consumption-driven growth. Under the new law, retailers are obliged to take back goods sold within

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\(^{29}\) Big cities are over populated and highly congested, while other parts of the countries experience the development of so-called ‘ghost cities’, inhabited urban conglomerates.

\(^{30}\) See discussion above on the issues of land expropriation, land conversion from rural into urban, land sales and land used as collateral for local government borrowing (Par. 2.1).


\(^{32}\) 2014 Survey on Chinese Urban Life Quality.
seven days. In the case of online purchases, consumers can, without offering any reason, demand that retailers accept returns. Consumer data protection from misuse is reinforced, and permission is needed for any commercial use of these data. Class-action lawsuits (extremely rare in China) have been made easier to file – and in some cases even encouraged. Despite the legal innovations of the law, it has not been exempt from criticism from both the business operators and consumers’ associations. It nevertheless represents an important step towards a stricter implementation of consumers’ rights in the PRC.

China’s economy has grown dramatically thanks to exports and foreign trade. The safety of Chinese products is therefore not only a very sensitive domestic issue but is likely to affect consumers worldwide. China’s commercial image has often been damaged by scandals involving dangerous products, such as hazardous small magnets, lead paint on children’s toys and highly inflammable electronic devices originating. The European early warning system for hazardous products – the Rapid Exchange of Information System (RAPEX) – has reported an extremely high number of hazardous goods imported from China. In Europe and elsewhere in the world, this has caused a marked loss of consumer trust in goods marked ‘Made in China’.

After the recent food scandals (e.g. gutter oil in restaurants, the fraudulent labelling of fox and rat meat as beef and pork, the sale of pork from diseased pigs and of milk contaminating with melamine), issues related to public health and food safety have become highly sensitive in China. An extensive survey carried in 2013 demonstrated that a growing number of Chinese consider food safety a ‘very big problem’ – almost on equal footing with other, traditional, worries.

A new food safety law (FSL) is to enter into force on 1 October 2015. The Chinese authorities allowed EU officials to help draft the new legislation, and several EU comments were taken into consideration for the final text.

Speaking about the new law, Premier Li Keqiang stated that there would be no more tolerance of food safety crimes. He committed to monitoring the entire process of food production, logistics and sales via a viable food tracing system. The Commission actively cooperates with China in this regard, and a system to exchange information has been set up via the EU-China Consultation and Cooperation Mechanism. Under an agreement signed on 26 October 2010, three joint working groups have been established for pharmaceuticals, medical devices and cosmetics.
### Figure 11:
Increasing public concerns in China: Percentage of responders who consider a given issue a very big problem

<table>
<thead>
<tr>
<th>Issue</th>
<th>2008</th>
<th>2012</th>
<th>2013</th>
<th>% change 2008-2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Safety of Food</td>
<td>12</td>
<td>41</td>
<td>38</td>
<td>+26</td>
</tr>
<tr>
<td>Quality of manufactured goods</td>
<td>13</td>
<td>33</td>
<td>31</td>
<td>18</td>
</tr>
<tr>
<td>Safety of medicine</td>
<td>9</td>
<td>28</td>
<td>27</td>
<td>18</td>
</tr>
<tr>
<td>Old age insurance</td>
<td>13</td>
<td>28</td>
<td>30</td>
<td>17</td>
</tr>
<tr>
<td>Air pollution</td>
<td>31</td>
<td>36</td>
<td>47</td>
<td>16</td>
</tr>
<tr>
<td>Corrupt officials</td>
<td>39</td>
<td>50</td>
<td>53</td>
<td>14</td>
</tr>
<tr>
<td>Education</td>
<td>11</td>
<td>23</td>
<td>24</td>
<td>13</td>
</tr>
<tr>
<td>Water pollution</td>
<td>28</td>
<td>33</td>
<td>40</td>
<td>12</td>
</tr>
<tr>
<td>Rich-poor gap</td>
<td>41</td>
<td>48</td>
<td>52</td>
<td>11</td>
</tr>
<tr>
<td>Health care</td>
<td>12</td>
<td>26</td>
<td>23</td>
<td>11</td>
</tr>
<tr>
<td>Worker conditions</td>
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<td>23</td>
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<tr>
<td>Traffic</td>
<td>9</td>
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<td>Crime</td>
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<td>24</td>
<td>7</td>
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<tr>
<td>Corrupt business people</td>
<td>21</td>
<td>32</td>
<td>27</td>
<td>6</td>
</tr>
<tr>
<td>Unemployment</td>
<td>22</td>
<td>24</td>
<td>27</td>
<td>5</td>
</tr>
<tr>
<td>Electricity shortages</td>
<td>4</td>
<td>8</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>Rising prices</td>
<td>72</td>
<td>60</td>
<td>59</td>
<td>-13</td>
</tr>
</tbody>
</table>

Source: PEW Research Center

### 3. China’s development strategy

In 2007, well before China’s economic slowdown, Premier Wen Jiabao described China’s growth model as ‘unbalanced, uncoordinated and unsustainable’. Time proved him right, leading China to a crossroads, where factors that contributed to growth for many years have nearly – if not completely – exhausted their potential. In an attempt to address its domestic economic challenges, Beijing has embarked on a new development strategy to ‘rebalance’ the economy and reinforce the country’s integration into global markets.

The government’s programme, first announced during the third Plenum in 2013, has included financial liberalisation, fiscal reform, structural reforms and global pursuits.

#### 3.1. Financial liberalisation

Financial liberalisation and easier access to credit have fuelled a stock market bubble in the last eight months.

In ‘Decision on Major Issues Concerning Comprehensive and Far-Reaching Reform’, Beijing outlined a reform agenda for the financial sector to promote the progressive integration of the country into the world’s financial markets. Major steps foreseen included the establishment of private financial institutions, the development of capital markets, the
liberalisation of interest rates and the promotion of capital account convertibility.

With the launch of the ‘Hong Kong-Shanghai Connect’ initiative in November 2014, capital markets were significantly opened. The programme made it easier for foreigners to access China’s domestic stock markets. In April 2015, financial controls were further relaxed, and domestic financial institutions were allowed to freely access Hong Kong’s stocks.

In response to these financial measures, financial flows between China and Hong Kong spiked after November 2014. The Shanghai stock market surged by more than 150% in 12 months (June 2014-June 2015) because funding had become more abundant and because many firms had offered shares to households for the first time. Investors were encouraged to buy by the falling borrowing costs – the result of the looser monetary policy of the People’s Bank of China (PBOC) and of recent measures easing small businesses’ access to credit. In an effort to rebalance the economy, the Chinese government had also actively supported investors’ asset diversification, to spur investment in equities rather than property.

In June 2015, the Shanghai Composite Index (SCI) began to fall sharply, eventually plunging to March 2015 levels. It is still not clear whether the drop will continue, or what the risks of contagion are. However, it is apparent that the increase in equity values was at odds with declining trends in the real economy. Additionally, what was billed as a shift from the government’s strong economic intervention to a more free market stance remains far from the reality in China; in recent weeks, the government has intervened with an emergency package of measures to counteract the fall in the stock market and prevent further losses.

The future of the Shanghai stock market – like the possibility of sectoral and global contagion – remains debatable. Whatever the outcome, recent volatility underscores China’s struggle to restructure its economy.

Figure: 12
Shanghai Stock Exchange Composite Index

Source: Bloomberg Business 2015

34 ‘The Shanghai Stock Exchange Composite Index is a capitalization-weighted index. The index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. The Index was developed on December 19, 1990 with a base value of 100. Index trade volume on Q is scaled down by a factor of 1000’ (Bloomberg Business 2015).
3.2. Fiscal reform

Core issues for fiscal reform are the central-local government fiscal relationship, local government debt and transparency.

China’s fiscal reforms aim to provide a new framework for better regulating budgeting practices and central-local government fiscal relations, serving the final objective of reducing local government debt and increasing transparency and accountability at all levels.

Under the reformed budget law, provincial governments may now issue bonds for the first time, although only after obtaining the approval of the central government. Allowing governments to issue these bonds is a measure intended to improve the current situation, in which local governments have accumulated large debts that are not monitored by the central government. In March 2015, the Ministry of Finance (MOF) also allowed local authorities to convert debts (worth up to RMB 1 trillion) on which they pay high interest rates into lower-yielding municipal bonds. The MOF also suggested future actions for restructuring debt via public-private partnership arrangements.

The implementation of fiscal reforms also shifted the division of responsibilities between the central and local governments in two ways: (i) by giving local governments new taxation powers, and (ii) by allowing local governments to collect a larger proportion of shared-taxes.

3.3. Structural reforms

Social security, land rights, and the hukou system are among the major, sensitive reforms likely to improve people’s life in China.

Beijing has recently adopted a variety of structural reforms to improve Chinese citizens’ quality of life and address certain social and economic unbalances. Working in different ways to address major causes of social discontent, Beijing is advocating a ‘smart’ development model.

For one thing, the government will act on the asymmetric treatment of rural and urban residents by removing some of the limits of the hukou registration system in townships and small cities, relaxing restrictions in medium-sized cities, and setting qualifications for registration in big cities.

The State Council has also granted more rights to migrants in the cities, who are currently the most disadvantaged group (see Section 2.3). The reform has yet to be either completely detailed or implemented.

A second major reform concerns the country’s social security system. Starting from October 2015, many public sector employees (university staff, teachers, nurses and doctors, but not civil servants in the strict sense of the
term) will have to join a pension scheme for business-sector employees – a less favourable programme than the one for civil servants. Concerns have been expressed over the resulting reductions in pensions and salaries, as well as the overall cost of this reform.

The social security ministry has also announced a proposal to raise the retirement age by a few months each year, the first revision of the country's official retirement policy since the 1950s. Chinese men may currently retire at age 60, while women who work in factories may retire as early as age 50. One potential scenario outlined by the minister would involve a two-month increase in the first year, followed by a four-month increase the following year. Some analysts suggest the government may first raise women's retirement age, bringing it level to that of their male counterparts, before making further changes. The final decision is to be taken in 2017, and changes will be spread over a five-year period, with the end result likely to be a retirement age of 65 for men and women.

One of the most sensitive reforms that the government has announced is land reform. A document titled 'Opinion of the State Council Secretariat on Guiding the Healthy Development of Markets for the Transfer and Exchange of Rural Property Rights' contains the first official outline of a reform to strengthen farmers' land-use rights and create rural land markets in which, for the first time, landholders will be allowed sell land to one another or to urban buyers without first selling to local governments. The implementation of this reform appears likely to be rather long and complicated. For the moment, only experimental pilot projects in local areas have been authorised. The more difficult problem, which has yet to be tackled, concerns rural land in urban areas.

Finally, there has been some progress in the reform of state-owned enterprises (SOEs), but mainly at the provincial level. The basic intention was to introduce more private capital into SOEs and lower the extent to which the Chinese Communist Party appoints managers. More than 20 provinces have announced detailed plans for SOE reform, each with distinct goals and initiatives. The government does not intend to privatise SOEs in strategic sectors, such as aviation, power and telecommunications. It would, however, invite investors to buy stakes in non-strategic SOEs. Government ministries are still deciding which industries are and which are not 'strategic'. Little progress has been made in making such decisions at the central level. At the local level, provincial governments are adopting widely different criteria, in line with local political dogma. Shanghai, for example, is taking a restrictive stance, while Guangdong is aiming for

38 When the employee system was established in 1998, business employees experienced large cuts in pension entitlements but the pensions of public sector employees were left untouched.
39 http://www.globaltimes.cn/content/902576.shtml
40 http://blogs.wsj.com/chinarealtimenow/2015/03/10/china-sets-timeline-for-first-change-to-retirement-age-since-1950s/
41 http://www.urbanismith.com/blog/2015/1/23/rgd5t6wbw3v906dvlqahik7k4p4ilz
widespread privatisation.

3.4. Global pursuits

China has a longstanding global strategy that supported its economic development over the years.

China’s overseas financing has strongly supported its domestic exports in various ways.

The country’s ‘One Belt One Road’ initiative is another national development strategy aimed at boosting economic growth and trade.

Since China opened its markets with reforms in 1978, its economic growth has been supported by exports and has benefited greatly from incoming foreign investment, mainly directed to its coastal areas. Over the years, the country’s development strategy has evolved, with greater emphasis on the global aspects of Beijing’s economic measures. In 1999, the country launched its ‘going global’ strategy, in which national ‘policy banks’ backed domestic companies doing business overseas, offering them various forms of financing to mitigate commercial risks and facilitate their export activities.

China’s overseas financing has also taken the form of aid to finance infrastructure development projects in developing countries across the world; this aid ensured that Chinese companies had preferential access by attaching commercial requirements and investment clauses to the grants and loans. China’s global outreach has touched Africa and Latina America and has increased greatly since 2006. In the aftermath of the global financial crisis and the euro crisis, European countries and Eastern Neighbourhood policy countries have also become targets for Chinese investments (see ‘Trade and economic relations with China 2015’, Paragraph 3.3).

Recent economic developments in China – including the country’s economic slowdown and its need to boost exports and find new channels for its overcapacity – and Beijing’s geostrategic interests have amplified China’s international efforts. In 2013, the country launched the ‘One Belt, One Road’ (OBOR) national development strategy. This ambitious framework encompasses two development plans:

- the New Silk Road Economic Belt, running from China to Europe through Central and Western Asia, and
- the Maritime Silk Road, connecting China to Southeast Asia, the Middle East and Europe.

With both, China aims to boost its economic growth through trade, investment and tourism, providing better connectivity and infrastructure.

To drum up support for the initiative in the countries affected, Beijing has mobilised political, economic and diplomatic resources. While details are still vague – and keep changing with time – the financing structure of the OBOR is already well advanced. In less than one year, Beijing has set up a
Chinese-led multilateral financial institution, the Asian Infrastructure Investment Bank (AIIB)\(^43\); this bank will fund various investments in Asia, including the OBOR\(^44\). The OBOR's activities can also be financed through China's Silk Road Fund, which has been slated to receive assets of USD 40 billion.

**Figure 13:**
The new silk road

![The new silk road](source:image)

Source: *Xinhua; The Wall Street Journal* (Nov. 2014)

\(^43\) The AIIB was launched with a Memorandum of Understanding (MOU) signed at the end October, 2014 by 22 Asian countries. In the course of 2015 however China has opened the AIIB's participation to other countries, among which several EU member states. The framework agreement for the operations hasn't yet been signed yet by all participating countries, therefore capital allocations and voting rights still have to be determined.

\(^44\) A forthcoming Policy Department paper will describe the bank in greater detail.
4. Conclusions

What happens in China’s economy is likely to have a major impact across the globe.

Already, the fall in China’s domestic demand has dragged down world commodity prices and trade flows. At the same time, the country’s overcapacity has led Beijing to push Chinese businesses to expand abroad. The increasing presence of Chinese investments in Europe and recently launched trade, investment and development projects – such as the ‘One Belt One Road’ initiative – exemplify Chinese efforts to answer domestic economic challenges with international projects. While China aims to advance economic reforms (those announced in the 2013 third Plenum) to upgrade its status as a global rule maker, many reforms – such as those of its powerful SOEs – have yet to be fully implemented. Beijing’s attempts to liberalise financial markets have further tested the stability of the Chinese economy, ultimately requiring greater government intervention to rescue the stock market.

China’s future prospects for growth – and the outlook for China’s trade and economic partners – will depend on the speed with which the country addresses its domestic challenges and completes its transformation into a market economy.