China's Elusive New Normal?

By Wu Jinglian, Researcher at the Development Research Centre of the State Department & CEIBS Baosteel Chair Professor of Economics

"This is the current economic situation: the 'Old Normal' cannot last, but the 'New Normal' does not yet exist. To establish the type of New Normal that we expect, the key is to bravely push ahead with reforms while keeping the general economy stable, optimise the economic structure and improve efficiency. To put it simply, we need to complete the transformation of the economic growth model.

AN OLD NORMAL THAT CANNOT LAST

The so-called Old Normal status of the Chinese economy refers to the long-standing economic growth model that involves high-speed development driven by vast investments and huge export surpluses. The Old Normal cannot last, that is now an undeniable fact. With the strong stimulus of the RMB4 trillion investment and RMB10 trillion of loans in 2009, China's GDP saw two quarters of growth above 10%, and then took a downward turn which has lasted till now. From 2011 to 2014, China's GDP registered annual growth of 9.2%, 7.8%, 7.7% and 7.4% consecutively, and in the first quarter of this year the percentage of growth lowered further to 7.0%.

Why is it impossible for the Old Normal to last? There are two views.

The first makes use of the insufficient impact of the troika's [a universally accepted term for three organisations which have the most economic power in a country] explanation for the downward turn in China's economic growth. The "troika" analysis is essentially a new version of the Keynesian short-term analysis framework. According to Keynes' theory, total supply is decided by total demand. When there is not sufficient demand and there is a period of economic recession, fiscal and monetary policies should be used to increase demand and maintain growth. Remember that Keynesian theories and their resulting policies are proposed to solve short-term economic problems. But Keynes, never one to avoid tough questions, had an answer to the criticism levied by new liberalism: in the long run we are all dead. Meaning that, in the long run, a market economy will automatically recover its equilibrium after periods of economic fluctuation. However, if there were no intervention, the losses would be too great in the short term; just as measures such as building dams and fighting floods would still need to be taken (even though the waters would eventually ebb without action) or people would die during a flood.

Now there is a popular argument that says China's long-term economic problems are to be analysed by the Keynesian short-term analysis framework. The "troika" decides the growth rate of the economy, and we have already seen this technique being used in the long-term. Consequently, the remedy for slowing growth is to provide stimulus with expansive macro-economic policies, which results in the over-issuing of currency, and huge debt for enterprises and governments, which presents the potential systematic risk of "national balance sheet recession". In my opinion, it's a misuse of the Keynesian theory to use it for analyses of long-term economic problems – even if it's 100% right.

To give a forecast of China's economy, I think we should look at it from the perspective of supply, rather than that of demand. In the past, people generally accepted that production is decided by the two factors of labour and capital. Robert Solow pointed out in his 1956 paper that, apart from those two drivers for growth, there is a remaining figure (Solow's Residue A). His research used data from the first 49 years of 20th century America. He defined this residue as technological advance: the improvement of total factor productivity (TFP). Solow's production function shows that economic growth is driven by three factors: new labour, added capital (investment) and improved efficiency (greater TFP).

The root of China's current economic problem lies in the defect in the country's growth model, which is mainly supported by investment. Overly high investment means a low consumption rate, and ultimately insufficient demand. To make up for such defects, Japan made export-oriented policies after WWII, encouraging exports and discouraging imports by devaluing domestic currency and other methods, thus increasing net

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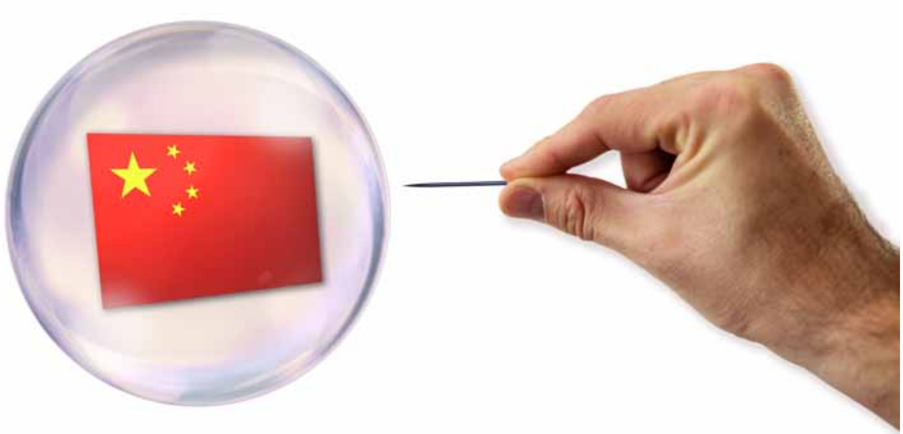
exports. China took the same approach, particularly after foreign currency reform, when export surplus surged and supported the rapid increase of production. However, the experience of Japan and East Asian countries shows that long-term use of export-oriented economic policies has considerable side effects, or even dire consequences. In the 21st century, and particularly after the 2008 global financial crisis, it has become necessary for China to change its export-oriented policies.

Prior to the reforms, improvements in efficiency contributed little to China's economic growth. With the beginning of the reforms and opening-up, efficiency was greatly improved, mainly from two sources. There was a structural change. For example, in the past the rural and urban areas were completely divided, leaving resources unable to flow freely. After the reforms began, the labour and land markets opened up, and there was a significant improvement in the efficiency with which they were used. The second source was opening-up. There was rapid improvement in productivity with the purchase of foreign equipment and the acquisition of foreign technology. The bonus of having the world's largest population was also an important factor.

Around 2006, the above-mentioned factors for high-speed growth obviously slowed down, and China's potential for growth began to slow down as well. To maintain economic growth, investment had to be relied on more and more heavily, i.e. through borrowing, through pumping more money into the market. By 2010, the problem had become starkly serious, the most serious symptom of which was the surge – since 2009 – in the leverage rate for the national balance sheet, and particularly for those of local governments and enterprises. This increased the risk of systematic crisis.

A NEW NORMAL HAS TO BE ESTABLISHED

The term New Normal was first used by former CEO of Pacific Fund Management Mohamed El-Erian to describe the possibility of a long-term economic recession after the 2008 global financial crisis.



This is definitely not the New Normal we hope to establish. According to authorities on the issue, there are – in general – two aspects to the New Normal for China's economy: first, from high growth to medium-high growth; second, from scale-and-speed-type extensive growth to quality-and-efficiency-type intensive growth. The first aspect is now an established fact, and most people are, to an extent, prepared for it. The second aspect is still just a hope, not actual fact, and can only be achieved with effort. Only by quickening our pace in the second transformation will China be able to conquer the current difficulties and embark on a broad road of sustained development.

As many of the past social problems were "covered" by quantitative growth, there is a risk in letting economic growth fall too quickly. If we cannot make up for quantitative loss with qualitative improvement, many social and economic problems will surface – and even intensify.

With the growth rate remaining worryingly low, in recent months, there have been increasing arguments that "demand is to be expanded and growth sustained", and calls for the central bank to "pump more liquidity" into the market. There are plans for large investments into railways, public facilities and infrastructure. However, I doubt whether these "good old ways" can be effective.

Can expansive monetary policies solve the problem of insufficient demand? Chief economist for Japan's

> *"Poor people face greater dangers when they lose money than the rich, so we have to pay attention to this issue."*

Nomura Research Institute, Dr Richard Koo's analysis of "balance sheet recession" offers some interesting insight. He points out that when there is a crisis of "balance sheet recession" resulting from leverage rates that are too high, monetary policies will be useless. This is because when "cash is preferred", people will be unwilling to make long-term investments. If they have money at hand, people will be more willing to invest in stocks rather than in industry, which has low liquidity and is hard to exit. If monetary policies are overused, there will be bubbles and inflation in the stock market; or the bubble may burst, causing a severe crisis. Currently new investors into China's stock market are generally young, and when such inexperienced youth with little capital and sense of risk open lots of accounts, there is a greater risk that once problems arise, social stability will be shaken. Poor people face greater dangers when they lose money than the rich, so we have to pay attention to this issue.

We should also take a close look at the drivers of investment. In recent years, when it comes to returns on investment the "rule of decrease by degrees" has become increasingly obvious. There were many projects that got under way in the hustle and will yield little, and in the end they will only increase the leverage rates and further add to the risk.

As I said before, the best approach is to focus on pushing forward with the reform and opening up while keeping the general economy stable and making sure that there is no risk of systematic risks. We can only promote the transformation of the economic growth model and the improvement of efficiency with reform and opening up.

The problem is that the transformation of the economic growth model is not a new one. As early as 1995, when the ninth Five-Year plan for 1996-2000 was being drafted, it was proposed that the two "fundamental changes" of turning the extensive type of economic growth into the intensive type, and turning the planned economy into a market economy must be carried out. Now it is 20 years later. The policy making and reform practices during these 20 years all came down to one major debate on "where should China go?" The 18th National Congress of the CPC gave a clear answer to the question: we must stick to the reform principles outlined during the Third Plenary Session (TPS) of the 11th National Congress, "comprehensively push ahead with reforms with greater political courage and wisdom". Then, the TPS of the 18th National Congress made a general blueprint of the effort to comprehensively further the reforms. The Fourth Plenary Session further stipulated the guideline of comprehensively pushing forward the rule of law.

HOW THE GENERAL ECONOMY SHOULD BE STABILISED TO BUY TIME FOR THE REFORM

Leverage rates are now too high in China, with total debt amounting to 250% - 300% of GDP, debt for local governments exceeding RMB16 trillion, and about RMB1.8 to 2 trillion total debt due in 2015. There is considerable financial risk in this. If individual enterprises face financial problems or a

> *Stop pumping blood into zombie companies.*

few people run away, these are not big problems. What is to be guarded against is systematic crisis.

To avoid systematic crises, strong measures need to be taken to control and avoid risks:

1) Properly deal with local government debt. The Treasury has provided RMB1 trillion of local government debt limits for the clearing of existing debts, and there may need to be complementary measures;
2) Stop investments that bring little or no return;
3) Stop pumping blood into zombie companies;
4) Stop bail-outs;
5) Use state-owned assets to pay the government's contingent liabilities. Our most important contingent liability now is the gap in social security funds; it's immense in number, and a potential danger. The TPS of the 18th National Congress of the CPC made the decision to put aside state-owned assets as a subsidy for social security funds, but up to now there has been no action taken;
6) For insolvent companies, let them go bankrupt and reshuffle under bankruptcy protection, minimise the potential risks and turn big problems into small ones;
7) Effectively use the existing dead assets resulting from extensive growth. Like the wasted developmental zones lying out there, sunbathing across the country.

Second, with the help of proper fiscal and monetary policies, we need to keep the fundamental stability of the general economy to prevent systematic risks.

The Central Meeting on the Economy called in December 2014 proposed "properly elastic monetary policy, and stronger fiscal policy." These two points are both highly relevant. More active fiscal policies mean an increase in the deficit, which is now still some distance away from the generally-agreed warning line. There are two ways to increase the deficit: one is to increase expenditure, and the other is to reduce revenue. Now we need to make wide ranging tax cuts to address the major problem of enterprises' lack of initiative; and we must try everything we can to boost their confidence by improving the business environment. With regards to monetary policy, we should use a combination of deleveraging and the provision of the necessary liquidity.

CURRENT FOCUS: CARRY OUT REFORMS

The most effective way to deal with the current situation and to establish the New Normal is to push forward with reforms. The TPS' Decisions gives clear definitions of the objectives of the economic reform, i.e. to develop a "unified open market system with ordered competition". In fact, this objective was proposed as early as the TPS of the 14th National Congress. At the time the expression was, "the fundamental function of the market in the configuration of resources must be fully played out, and market systems must be developed… to be a unified, open, large market with competition." Twenty years on, this systematic objective is reiterated and around it there are hundreds of specific reform tasks assigned. Now we must sum up and measure the progress of various reform measures since the 18th National Congress against the standard of this "unified, open, market system with ordered competition" and decide on our next step.

Even before the convening of the 18th National Congress, there had been some pilot reforms towards a competitive market system, like the simplification of company registration and operations tax turned into value-added tax, etc. These reforms have obvious effects. Over the years our leaders have been calling for faster development of the service industry, but with little progress. Recently, with the advancement of the above-mentioned reforms, the service industry has made good progress, which keeps our employment numbers at decent levels despite falling economic growth. This shows us how important it is to quicken the pace of reform.

We can see that the reforms in government functions and simplification of government procedures have borne fruit. What requires our attention now is: first, prevent backlash against the reforms; second, carry out the reforms deeply and widely, make negative lists of market entry for enterprises and positive lists of government functions, and make official regulations for clear government-enterprise relations.

There has been the expected amount of progress in the financial reform – with the marketization of interest rates and exchange rates as key issues – and in the fiscal reforms with its focus on the shaping of proper central-local governmental relations. Now we must figure out a way to solve more deeply entrenched problems.

In recent years, despite a certain reduction in the state-owned sector's share of the national economy, SOEs are still in possession of huge key resources, and are dominant in many industries, so the status of the state-owned sector is crucial to the overall efficiency of the national economy. To change the status quo of low efficiency in SOEs, the TPS of the 18th National Congress of the CPC made a number of important decisions concerning SOE reform. Now there is an urgent need to quicken the implementation of these reform measures.

The China (Shanghai) Pilot Free Trade Zone is a historic experiment. Just as [Chinese] President Xi [Jinping] said, the experimental free trade zone is an attempt to "create a business environment that is marketised, internationalised, and conforms to the rule of law", and an effort to adapt to the general trend of making trade and investment convenient. Now the model used by the Shanghai FTZ is being expanded to other areas, which means the comprehensive unfolding of a new opening up initiative. Local governments must contribute to the creation of this new opening up initiative with a view of facilitating convenience in trade and investment.

Private enterprises are the main driver for the transformation of the economic growth model. We should be concerned that some entrepreneurs do not have adequate confidence and enough initiative. I suggest that the measures taken in 1998 to deal with the Asian financial crisis to aid the development of SMEs be taken up again. In-depth studies should be done to try to come up with realistic, comprehensive solution packages.

The effective operation of the modern market economy would not be possible without the government creating a convenient business environment and providing public service. With the anti-corruption campaign raging on, the chaos in officials' conduct has been checked to a certain extent, but malfeasance has occurred and has begun to spread. Secretary of CPC Central Committee for Discipline Inspection Wang Qishan is right in pointing out that we should first cure the symptoms and then go on to cure the illness, and buy time for curing the illness by curing the symptoms. I think we should increase our efforts with the regulatory anti-corruption campaign, to put power in its proper cage. Also the government should adhere to the principle that "nothing can be done without the express license of the law" as pointed out by Premier Li Keqiang. We should make a list of the "license of the law", a list of the powers of the government, making clear the rights and responsibilities of the government, and everything should be done according to the rules.

This article is based on a speech by CEIBS Baosteel Chair Professor of Economics Wu Jinglian at the 7th Shanghai Financiers' Salon and the 75th CEIBS Lujiazui Financiers' Salon in April 2015.