The End of Hyper-growth:

Political and Economic Responses to a Slowing China

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Preliminary Draft: Comments and Suggestions Welcome.

China's growth slowdown has attracted a great deal of attention during 2012. With the rest of the global economy weak, China's dynamic economy has been widely seen as the best hope for an engine to drive global growth. China's growth rate has drifted continuously down through 2012, with an unexpectedly sharp deceleration in April followed by stabilization but continuing slower growth. A particularly striking facet of China's deceleration has been that many external observers, especially investment banks and advisory firms, have expected China to respond with a fairly vigorous stimulus effort, which has not been forthcoming. Since China had surprised the world in 2008-2009 with its massive and decisive stimulus program, many expected a similarly vigorous response this time around. The fact that Chinese leaders did *not* resort to a hasty or indiscriminate stimulus response shows how different the situation is this time around (and also that Chinese leaders may know something that investment bank analysts do not).

The main argument of this paper is that China is facing an unusually complex and challenging economic environment, in which a wide variety of forces are all tending to slow China's overall growth rate. These forces can be grouped into three types: long-run structural changes; medium-term institutional challenges; and short-term macroeconomic fluctuations. As the labels imply, each of these forces affects the growth rate on a different time scale. However, they interact, and in ways that we do not necessarily understand well. The first part of this paper provides an overview of these three factors, starting with the long-term structural. Following this discussion, I make four observations. First, the interaction among the three creates unusual unpredictability, and should lead us to raise our estimate of the odds of a sharp correction in China's economic trajectory. Second, the interaction among these effects makes it virtually impossible to use standard Keynesian macroeconomic policies—i.e., stimulus—to maintain the short-run growth rate. A stimulus response would only address the short-term factors, and would make it harder to address the other two (institutional and structural). Third, there is a widespread recognition of these challenges in the Beijing policy community, but no consensus (yet) on what the next steps should be. To a surprising degree, these attitudes seem also to be held among many in the top leadership. The result is a growing conviction that policies need to change; that they will indeed change after the beginning of the Xi Jinping administration; and that nobody—probably including Xi Jinping—really knows what the changes will be. Finally, the interaction among these factors strengthens the argument for a substantial revival of market-oriented reforms. Only fairly bold steps, of the kind that have been absent for several years, are likely to address the requirements of medium and long-term growth. The argument for this position is grounded both in economic logic, and in political logic, based on the incentives of policy-makers. Therefore we should raise our estimate of the odds of a significant revival of reform in China.

Long-term: The End of Hyper-Growth

China's high growth phase has been an epochal event, reshaping global economics and politics. Over the past 35 years, China's economy has grown faster, longer, than any other in world history. Remarkable as China's achievement is, it also echoes the experience of other "growth miracles," particularly those in East Asia. Ever since Japan grew at an average rate of 10.4 percent between 1950 and 1973, we have understood the kind of growth that economies are capable of. The Japanese miracle was followed by a Taiwan miracle and a Korea miracle, and by super-fast growth phases in other economies around the world. These growth phases occur when societies are able to successfully orient themselves to world market, and then invest enough to enable the rapid transfer of underemployed workers from low-productivity agriculture to urban services and industry. The practically inexhaustible absorption capacity of the global market (in the early stages) means there are no limits on the demand side. Structural change tends to be accompanied by a "demographic dividend," that is, a period when populations have an unusually large number of young adults, and few (young or old) dependents. A virtuous cycle of high saving and investment, rapidly increasing education, and rapid occupational change means that economies can change their structure very quickly. With this kind of underlying change, economies can grow at 10 percent or more for 25 years, or even a little longer.

China completely fits into this framework. To be sure, there are at least two additional important factors in the China case, but these complement the basic story of structural change, rather than requiring serious revision. Most fundamentally, China also undertook a program of generally successful economic reform before and during its hyper-growth era. Policy-makers had to get reform policy right, just as policy-makers in Japan, Korea and Taiwan had to craft successful outward-oriented development strategies. The Chinese challenge in this respect was much more difficult, but the essentials of the achievement were no different. Reform had to be done right to liberate the potential for rapid growth. Since the legacy of the old command economic system was much heavier, some of China's extraordinary growth in the 1980s was almost certainly "recovery growth," as productive potential that had been actively suppressed by the Maoist system recovered to rudimentary levels.[1] Second, China arguably entered the global market at an unusually propitious time and place. Just as "globalization" was leading developed country multinationals to unbundle, outsource and relocate their production networks, China's low-cost labor was available to handle low-skilled manufacturing and assembly. Moreover, businesses in the forerunner economies in Hong Kong, Taiwan, and Korea were already plugged into global value chains and quickly grasped the opportunity involved to bring Chinese labor into the system. Thus, China's access to the world market corresponded to a period of accelerated change in the global division of labor, and gave Chinese hyper-growth an additional boost. These are important parts of the China story, and we should keep them in mind when making comparisons, but they do not undermine the common experience that makes comparisons valid.

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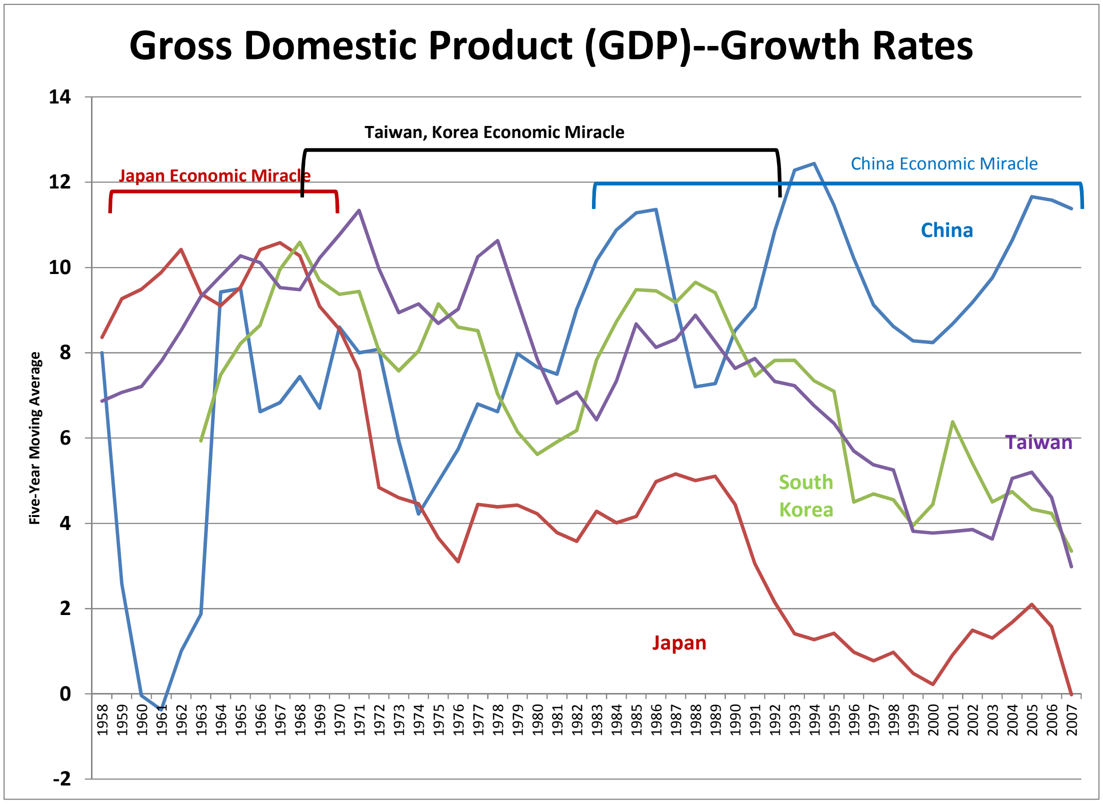
[1] If this "recovery growth" is excluded, then China's hyper-growth appears *less* anomalous in some ways: hyper-growth does not begin at such a low income level, and China's hyper-growth period is no longer unambiguously longer than other countries. However, China's average speed of growth would be even higher (if we take the twenty years from 1992-2012) .

The historical experience of these growth miracles shows that all such hyper-growth periods must come to an end. At a certain point, the growth payoff that you can get from moving young people into new occupations quickly starts to fade, and growth rates drop. The process occurs differently in each economy. Often it is triggered by some kind of crisis: the Japanese growth miracle ran into the first global energy crisis in 1973, and Japanese growth dropped more than five percentage points. Never again did the Japanese economy grow faster than 6 percent in a single year. The Korean story is different in every particular detail, but similar in the sense that the growth slowdown was associated with an extremely difficult adaptation process, including the traumatic Asian Financial Crisis in 1997–98 (Figure 1). Undoubtedly, China will have to go through a similar long-run slowdown and adaptation in the future.



What are the patterns and regularities that govern the slowdown process? Unfortunately, the rule that emerges from the study of these earlier slowdowns is that there is no rule.[2] In terms of its level of income, China is not necessarily at the turning point yet. According to the

[2] For an accessible version of the results of the most important recent study, see Barry Eichengreen, "Escaping the Middle Income Trap," Federal Reserve Bank of Kansas City, *2011 Economic Policy Symposium*, August 25–27, 2011, accessed at http://www.kc.frb.org/publicat/sympos/2011/2011.Eichengreen.Remarks.pdf. For the full study on which the remarks are based, see Barry Eichengreen, Donghyun Park, and Kwanho Shin (2011), "When Fast Growing Economies Slow Down: International Evidence and Implications for China," *NBER Working Paper* no.16919 (March).

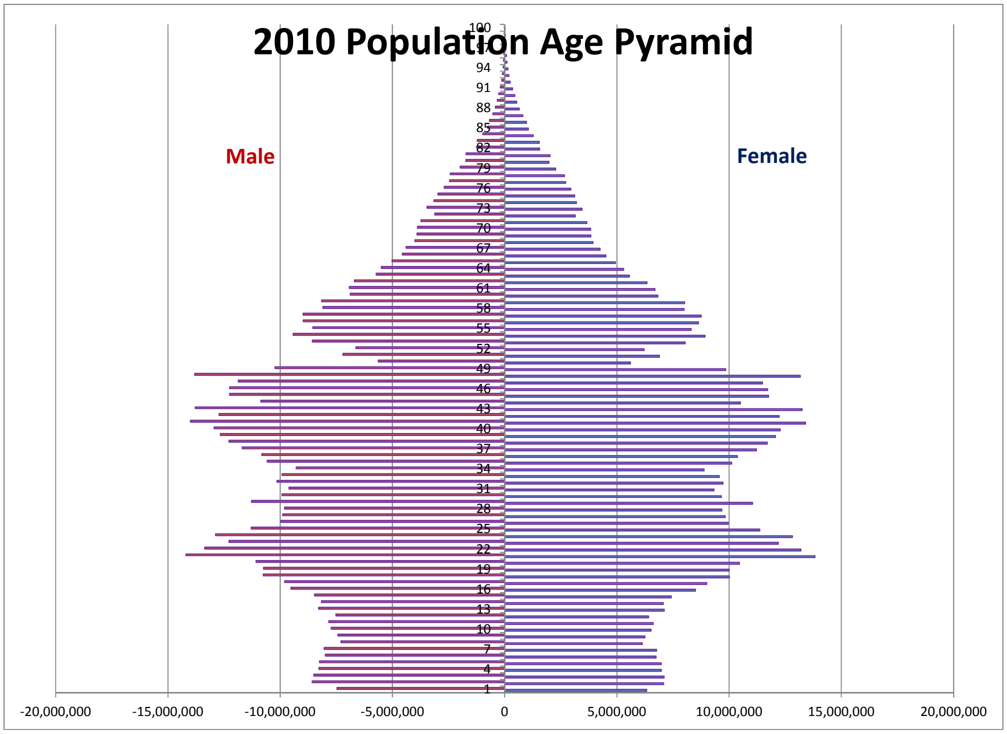
comprehensive study of Eichengreen, Park, and Shin (2011), it is not until about 2015 that China will reach the average income level at which predecessor economies experienced slowdowns. But of course, even here there is some ambiguity. In the first place, 2015 is not that far away. Moreover, the price conversions on which these income level calculations are based are extremely weak and uncertain. Thus, though comparative studies do not tell us that China is inevitably entering a growth slowdown, neither do they provide much reassurance that China is *not* entering that slowdown. While there are reasons to question whether China is already exiting hyper-growth, there is also a very strong reason to believe that China has already begun to enter a period of long-term growth slowdown: China has already entered a period of unusually rapid and dramatic change in labor force growth, with rapid changes in labor characteristics.

The first reason to expect an abrupt slowdown in the long-run rate of Chinese growth is that Chinese labor market conditions are changing extremely rapidly. The changes are complex, because many different things are happening simultaneously. However, all the different changes point in the same direction: China's labor force growth is already slowing very dramatically, and in just a few years the labor force will begin to shrink. Moreover, this transformation of the labor market will occur even more rapidly with respect to the market for relatively unskilled labor. Indeed, it is likely that the supply of unskilled labor has already begun to shrink. The complexity of the changes comes because three different, conceptually distinct, changes in China's labor supply are in fact occurring simultaneously. All of these are predominantly long-run changes, and it is more or less only by accident that each one is occurring rapidly right now. The three changes are an absolute decrease in the number of young people entering the labor force; the exhaustion of the pool of potential young rural-to-urban migrants; and the rapid rise in the number of young potential workers entering the tertiary education system.

First, the decline in the supply of young workers has already begun. According to the 2010 census, there are today 28 million Chinese who were born in 1990. That year was the last peak of births: slightly more Chinese were born in 1990 than in the previous peak "baby boom" years of 1968-70. In the years after 1990, the number of new births declined significantly, before stabilizing somewhat after 1997 at around 13-15 million.[3] The implications of this history for today's labor force are extreme. Those born in 1990 are already in the labor force, or just entering it as they graduate from college. But from now on, the number of young workers entering the overall work force every year will decline, particularly over the next decade. The immediate impact of this change is that overall labor force growth will slow. A further stage will be reached when the number of retirees starts to increase rapidly, several years from now. By 2020, retirees will outnumber new labor market entrants, and the labor force will start to shrink.

[3] The drop may be over-reported if there is undercounting of "hidden children" due to evasion of strict birth control laws. While this can be an important effect, it could not be large enough to eliminate the trends being described here. *China 2010 Census. Summary Volume.* Table 3-1. Population by Age and Gender. Beijing: National Bureau of Statistics, 2012.F

When this happens, problems of population aging will become serious. But more importantly, right now, the growth rate of the labor force has already dropped sharply [Figure 2].



Second, the number of young rural residents ready to move to non-agricultural jobs in distant locations has been declining in recent years as well. This has led to a vigorous discussion about whether China has now exhausted the pool of "surplus labor" in the countryside. That is, has the supply of underemployed young people, who could move to much higher productivity occupations in the city, been drawn down to nearly nothing? If so, that implies that wages for unskilled workers will begin to increase, as employers are increasingly forced to compete for the available supply of workers.[4] These changes imply that growth will slow down in those industries that traditionally rely heavily on unskilled labor. The number of workers will decline, while their wage will increase, raising costs and decreasing competitiveness of those industries.

Third, the increase in the intake into higher education has been extremely rapid. In 2011, 6.8 million students enrolled in universities, colleges, and vocational schools; 6.1 million

[4] There is a rich developing literature in China (and outside as well) over this issue, and whether China has reached the "Lewis turning point" when the supply of unskilled labor is no longer highly elastic, and wages start to rise sharply. For a good collection of academic articles on the subject, see the 2011 special issue of *China Economic Review*, and especially the article by the leading proponents of this view, Cai Fang and Du Yang, "Wage increases, wage convergence, and the Lewis turning point in China," *China Economic Review*, 21: 601–610.

graduated.[5] College education defers labor force entry, but also permanently reduces the number of young people who anticipate taking low-skill jobs. In 2011, about 18 million students turned 17, but 6.8 million of these went to college. This is already a remarkably high intake rate for a country at China's income level. Such a high college intake rate means that labor supply trends are very different for college-educated versus less-skilled workers. In 2011, 6.1 million students graduated from college or junior college, which implies that the supply of college-educated workers is growing at more than 10 percent per year. For less-skilled workers, the total addition to potential supply was 11.2 million in 2011 (18 million minus 6.8 million). This is probably less than the total number of workers leaving the work force as they grow older, as the overall working population is only increasing by 3 million per year. The supply of less-skilled workers is in fact already shrinking [Figure 3].

Figure 3: Growth of Skilled and Unskilled Labor Force

	2000-2010	2010-2020	2020-2030
Total Labor Force Growth	115	20	-15
ow: With College Degrees	33	58	57
Non-College Worker Growth	82	-38	-72

(Net Change in Labor Force, in Millions)

The change in labor force conditions is not a bad thing. Indeed, over the long run is it a good thing for China to have a more highly skilled and slower-growing labor force. However, the speed of these changes will increase the pressure to transform the growth model. Traditional industrial sectors will no longer be able to count on abundant cheap labor, while the economy will be under pressure to provide jobs for the rapidly growing supply of college-educated workers. Already there are numerous anecdotal stories of unemployed college grads, as well as college graduates compelled to take jobs far below their aspirations. The extraordinarily rapid shift in the composition of the labor force puts the Chinese economy under more pressure to adapt rapidly. It also implies that the underlying structural changes that bring the end of the high-growth period are already at play in China. Although China may not have reached the "average" income at which high-growth periods end, it has already begun to experience the demographic and labor force changes that are associated with the transition to slower growth. That leads us to expect an earlier transition to lower growth.

[5] 中国统计摘要 (China Statistical Abstract) 2012, pp. 165–66; 44–45.

Medium Term: The Stagnation of Market-Oriented Reform

Economic policy under the Hu Jintao-Wen Jiabao administration made a sharp turn away from the bold market-oriented reforms of the preceding Zhu Rongji administration. It took quite a while for this turn to be clearly manifest. It was obvious right away that Wen Jiabao had diagnosed the country as suffering from reform fatigue; and was giving priority to rebuilding the social safety net and reducing some forms of social inequity.[6] Moreover, the administration continued to give rhetorical support to reform, most notably in the declaration of the "economic" Third Plenum of the 17th Party Congress in October 2003, passed a programmatic document on continuing and completing economic reforms, but nothing much ever came of it.[7] At the same time, some of the major reforms designed during the Zhu Rongji administration, such as the restructuring and listing of commercial banks, worked through the system in the mid-2000s under Wen Jiabao. But it has gradually become clear that real market-oriented reforms had effectively petered-out by year 3 or 4 of the Wen Jiabao administration. If we define reform in a restrictive manner to mean "measures that enhance equal competition by lowering entry barriers," there have been no major economic reforms conceived since the beginning of the Hu-Wen era.

The absence of forward movement on market-oriented reform inevitably means that there will be movement backwards. In the normal course of events, interest groups are able to influence specific regulatory outcomes and government procurement and allocation decisions that go unnoticed by the broader public. Furthermore, in a political economy such as China's where government policy-makers have enormous discretionary powers, the inevitable mistakes and miscalculations that would create distortions in any economy quickly become entrenched—and are profited from—in the absence of review or effective public pressure. China's economy may be based on the market, but the Chinese market is shaped by multiple cross-cutting government interventions, so that there is no obvious mechanism to expose and eliminate the distortions, which therefore accumulate. We can see many examples of this general process at work in China over the past decade.

Specific features of the Chinese economy in the 2000s strongly reinforced this general process. In the first place, robust growth reduced the urgency of reform. The success of economic reforms in the 1990s created a powerful tailwind for economic growth. Restructuring

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[6] For assessments at different stages in the Wen Jiabao administration, see Barry Naughton, "China's Left Tilt: Pendulum Swing or Mid-course Correction?" in Cheng Li, ed., *China's Changing Political Landscape: Prospects for Democracy*. Washington, DC: Brookings Institution Press, 2008. Pp. 142-58; and Naughton, "China's Economic Policy Today: The New State Activism," *Eurasian Geography and Economics*, Volume 52, Number 3, (May-June 2011). Pp. 313-329.

[7] "CCP Central Committee Decision on Several Issues Relating to the Completion of the Socialist Market Economic System [Zhonggong zhongyang guanyu wanshan shehuizhuyi shichang jingji tizhi ruogan wenti de jueding]," October 22, 2003. Accessed at http://www.gov.cn/test/2008-08/13/content_1071062.htm

of state-owned enterprises cut off many money-losing firms and created a structured competition environment for the remaining central firms. State enterprise profitability soared in response. Membership in WTO at the end of 2001 allowed China to hook into the global economic boom of 2003-2008. Successful economic dynamism strengthened state-linked interest groups while simultaneously leading policy-makers and the general public to doubt that further economic reforms were urgent. If the economy is performing so well, who needs reforms?

Moreover, against the background of reduced reform urgency, Chinese policy-makers between about 2005 and 2009 made a series of momentous decisions: first, to gradually re-affirm the ideological primacy and importance of state-owned enterprises; then, along with the 2006 Medium and Long-term Plan for Science and Technology Development, to legitimize direct government activism to lead the growth of high-technology industries, reviving industrial policy in China after its near-death under Zhu Rongji; and finally to intervene massively in the fall of 2008 to buffer the economy against the shock of the global financial crisis emanating from the United States. During 2009-2011, these strands were increasingly interwoven. Policy support for SOEs was unstinting during the crisis-linked stimulus; technology policy morphed into large-scale industrial policy with the so-called "strategic emerging industries," and money flowed freely to selected firms. Along with investment in housing and infrastructure, these government-directed investments become one of the main supports for continued rapid growth in the face of the global slow-down.

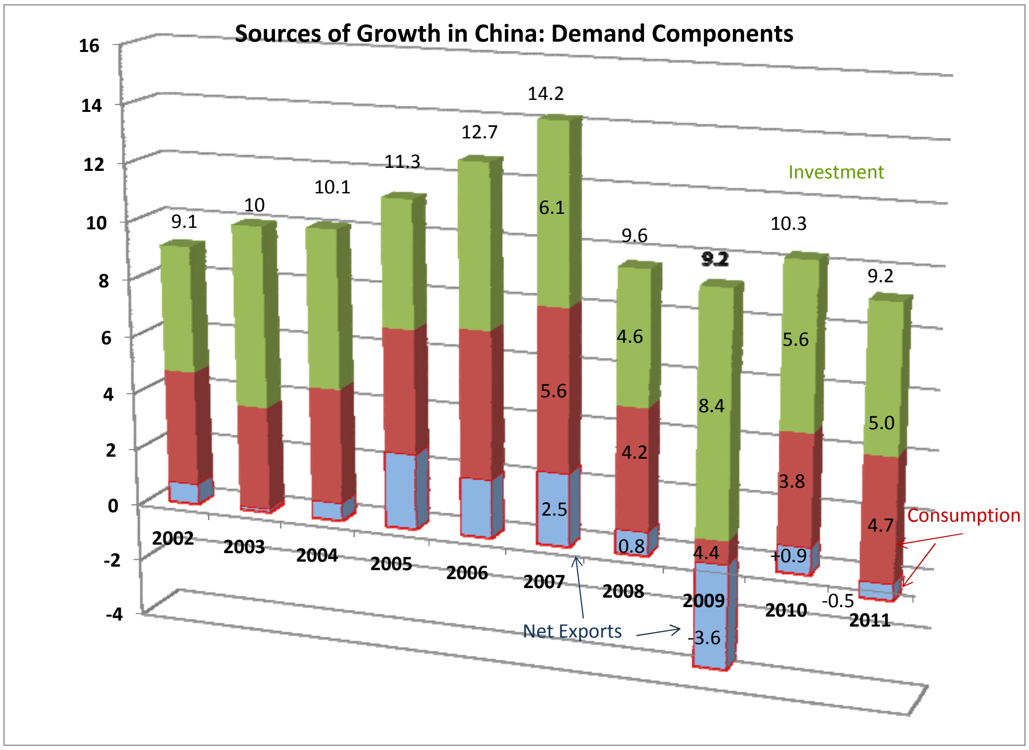
Systemic stagnation and regression is the generalized outcome of a multiplicity of subtle and not-so-subtle changes in economic institutions, rather than a single causal factor. The impacts on the economy are complex and operate through many channels. However, the overall impact can be easily understood by analogy to the effect of protectionist policies in foreign trade. A spate of new protectionist policies initially pushes up profits in the protected sector, and may even boost measured growth (since "higher price" sectors with a larger weight in the economy experience acceleration). But protectionism gradually undermines growth, by keeping resources in low-productivity uses and discouraging innovation. The long-term impact of trade protectionism has been experienced by so many different economies that—no matter what you think of the "Washington consensus"—hardly anybody today advocates, and few countries practice, development policies systematically based on industrial protection and import substitution. Yet China in the past decade has drifted towards uncoordinated micro-protectionism, in which thousands of sub-sectors, crucially including the high-tech, sophisticated and innovative sectors, are sheltered behind mini-protectionist barriers. It would be extremely difficult to quantify this effect, since it co-exists with market opening in other sectors and rapid capability building and learning across the board. But we are on firm ground in asserting one thing: the apparent benefits of protectionism show up quickly, but the costs only gradually accumulate and become obvious over a longer time frame. The costs of protectionism can be significantly mitigated if a government strictly limits the length and degree of protectionism, opening new sectors to competition promptly after brief nurturance, thereby preventing these costs from accumulating. Most governments have trouble mobilizing that kind of will, however, and China over the past decade has given little evidence that it has any particular solutions to this universal dilemma.

Over the next few years, then, we can expect China to experience a kind of systemic "drag" that will reduce growth. The tough choices made during the Zhu Rongji era led to a productivity dividend during the 2000s, but this dividend has now been used up (and largely spent). Instead, going forward, the distortionary policies of the past few years will erode efficiency and exert a downward influence on growth. These effects are diffused through the economy, so they are difficult to quantify, or even to prove. But qualitative and anecdotal evidence is there in virtually every individual sector, and in many aspects of daily life.

Short Term: Macroeconomic Slowing

China under-went a huge surge in credit and investment spending in 2009, which nicely offset the potentially catastrophic impact of the global financial crisis. Normally—in the absence of further aggressive Keynesian counter-cyclical policy—we would expect this investment surge to be followed by a period of slower growth, or a shake-out period, as competitive forces purged the worst of the crisis-supported projects from the economy. Moreover, weak demand in Europe in particular has slowed demand for China's exports, removing a crucial driver of growth. Short-term macroeconomic conditions then clearly point to a growth slowdown.

Yet over the past decade or more, China has seemed almost immune from these apparent cyclical processes. The essence of Keynesian macroeconomics is simply the idea that growth is driven by aggregate demand, and that governments can (and must) play a role in sustaining



healthy aggregate demand. From one standpoint, then, China has done a superb job of Keynesian macro-management: government policies on investment (especially) and trade have maintained robust demand that has driven growth. As Figure 4 shows, Chinese growth has been driven by investment, pushing growth to remarkable heights in 2006-2007, and then maintaining rapid growth despite a net negative contribution from net exports in 2009 and 2011. As is widely recognized, this has also meant

that China's economy is overwhelmingly dependent on investment, with fixed capital formation accounting for an astonishing 46% of GDP in 2011, compared with only 35% for household consumption.[8]

Why does this apparently exemplary Keynesian outcome foretell a slow-down today? In practice, the government has been able to increase investment when needed in three concrete areas: infrastructure, housing, and high technology. In the case of infrastructure, central and local governments spend directly, financing the outlays through land sales, bank loans, and budgetary expenditures. In the case of housing, manipulation of credit policy combines with huge pent-up demand for investment among households, to create strong housing demand. Finally, for high technology industry, the combination of central government policy direction, generous credit policy, and local government political entrepreneurship has fostered a substantial flow of investment into high technology, and particularly into "strategic emerging industries." The details are different in each of the three cases, but in each of these areas there has been over expansion. One might say—since the word has no precise definition—that there is a "bubble" in all three sectors. In the case of infrastructure, the "bubble" is manifest as a shortage of attractive investments; in housing, as the fear that prices are already so high as to price middle-class and lower-income families out of the market; and in high-technology industries, through a combination of over-investment in risky technologies, and over-supply of output in simpler technologies (such as solar panels). In each of these sectors, then, there is likely to be a shake-out, of different degrees of severity.

To be sure, there is still plenty of scope for investment in infrastructure, housing and emerging industries. But the *expansion* of investment in these areas is very unlikely to be as robust as it has been in recent years. Therefore, all else held constant, growth will slow. In principle, the Chinese government could continuously develop new areas of worthy investment—more hospitals and other kinds of social infrastructure, perhaps pollution control—and maintain investment-driven growth for another few years. However, it is difficult to visualize a scenario in in which these new areas become large enough to compensate for slowing investment in previous core areas. As the rate of growth of investment slows, demand for

[8] *China Statistical Abstract 2012*, p. 36. The remainder of demand-side GDP is government consumption (13%); inventory accumulation (3%); and net exports (less than 3%).

investment goods (produced primarily by private manufacturing firms) will also slow, creating an accelerator effect.

An investment bubble leads to the build-up of bad quality assets in the financial system. Inevitably, the quality of decision-making declines when projects are rushed into construction with shortened deadlines and minimal review. As a result of this effect, some argue that China's GDP growth is hollow, and the financial system in danger of collapse. These critiques fundamentally misinterpret the problem. China's economic growth is real, and even if the build-up of bad assets in the financial system over the past five years ultimately adds up to ten or twenty percent of GDP, China has the ability to write off the bad assets, and pay for it from fiscal revenues. The problem is not the dead-weight cost of writing-off the assets—in fact, the assets are already bad, so their negative affect on growth is already in the past. Instead, the problem is that the way that bad assets are disposed of effects incentives in the system for decades to come. If the government simply takes over non-performing loans, it signals the state-run banks that they bear no risks from politically approved lending, and therefore permanently re-instates the "soft budget constraint" that was one of the root causes of systemic inefficiency under the socialist system. In addition, new credit resources are injected into the system, increasing inflationary pressures. Conversely, if the government makes the banks truly responsible for their own lending decisions, the banks will quickly shut down lending to a broad range of projects in the sectors described above. Individually rational action by banks would aggregate into an economy-wide down-turn that would make the problems more difficult to solve in the short-run. If there were a way for the government to move decisively to help banks write down bad assets, but also credibly commit to never again do so in the future, that would work, but under current conditions that is impossible. Given the backsliding on economic reform, nobody would believe such a commitment.[9]

Most critically, we are currently in between the two poles sketched in the previous paragraph, with a great deal of uncertainty about the direction in which policy will go. Consider this choice: you are a local branch of a state-owned commercial bank. During 2009, you were strongly encouraged to lend to a local government funding platform that invested in urban infrastructure. That funding vehicle is now in financial difficulty, and comes to you for additional lending. What do your superiors say? If they urge you to support the local government, you are happy, because you can make loans and also expect that the government will pick up the tab for the bad old loans. If they tell you to make your own decisions, you are unhappy, but at least you have some promise of being a true banker. You must make some tough decisions about liquidating assets. If you are in between those poles, though, you can't really

[9] At the end of the 1990s and beginning of the 2000s, the Chinese government was able to do a reasonably good job of this, because they could treat bad loans incurred through 1996 as qualitatively different from loans incurred afterwards. The former were from the old system, and so could be written off, while the latter were from the new regime and were the banks' responsibility. This approach certainly had many problems, but it had enough plausibility for serve its purpose.

make the tough decisions, and you're not happy either. You have to roll over loans, extend terms, and try to reduce your exposure. You don't want to classify loans as non-performing, because then you have to deal with them. Despite the fact that credit supply appears to be abundant, much of it is tied up in existing projects, some of which are terrible.

This is China's current macroeconomic situation. There is an enormous volume of resources tied up in incomplete investment projects: the total budgeted value of projects under construction at year-end 2011 was 134% of GDP. In a sense, policy-makers could easily "stimulate" the economy by signaling to banks that they may finance the construction and completion of these projects without risk, even if the financial status of the recipient is shaky. But doing so signals to the banks that they would be held harmless for bad lending decisions, and therefore that they have soft budget constraints. The stagnation and regression of systemic reform described in the previous section has already eroded the hardness of the banks' budget constraints. Further steps in this direction would be quite dangerous. Under these circumstances, the "natural" cyclical dynamic of the economy is reinstated; it is impossible for completely counter-cyclical policies to be instituted. Since we are on the downhill side of three large investment bubbles, the short-run macroeconomic forces are tending to slow growth.

Interaction among the Forces

The interaction among these three forces creates unpredictability and uncertainty. It cannot be excluded that the interaction among them will create a sharp economic downturn. There are strong forces acting in the other direction. Increased education, rapid capability-building including wholesale transplantation of business models (and sometimes technologies) developed over decades in the rest of the world, and numerous other factors mean that there are also strongly positive trends in productivity growth. China is still an incredibly efficient and low-cost place to get many different kinds of goods made and services provided, although for most things, the differential is not as great as it was ten years ago. Expectations of the future among the broad Chinese population—if not necessarily among the business elite—are still highly optimistic. The average Chinese doesn't remember ever experiencing a recession, and doesn't appreciate it as a realistic possibility. (The last real recession in China was twenty-two years ago, in 1990; the median age is 35). These things give enormous momentum to China's growth. However, they also imply that dramatic changes in behavior could occur if people are suddenly confronted with the need to revise their expectations.

More broadly, the benefits to short-run stimulus policies right now are unusually small, and the costs and risks unusually high. We have discussed this in the previous section from the standpoint of a bank deciding on credit to a shaky local-government investment vehicle. From the standpoint of policy-makers, making financing more easily available for investments would simply make the institutional problems more difficult to solve. They have already begun trying to segregate local government financing vehicles into different grades, as a preparatory step to driving some into bankruptcy, recapitalizing others, and passing still others through a series of stress tests. To simply open the spigot on financing now would profoundly undermine this effort and make it even more difficult to achieve in the future.

This attitude is widely shared, within the financial sector, within academic circles, and among economic policy-makers. An interesting official expression of it came in the *People's Daily*, which gave its imprimatur to a June 15 article entitled, "We absolutely cannot do another 4 trillion [stimulus package]." The article quoted He Keng, the vice-head of the Finance and Economic Committee of the National People's Congress, as follows:

> Under current conditions, the most important thing is not to act hastily. Theoretical workers have said that we absolutely should not do another 4 trillion investment [stimulus], and everyone's understanding on this is united to an unprecedented extent. This is really good. . . . We should carry out structural tax reductions to give enterprises more profit; lead and supervise the banks to better serve the real economy; transform the growth model and not just look at GDP growth; and put the people's livelihood at the center of everything.[10]

The fact that the statement above comes from the NPC Finance and Economics Committee is also significant. The NPC is definitely *not* a policy-making institution, but it is supposed to sign off on major changes to government policy, such as making mid-term supplementary budgets, or adding major items to the economic plan. In addition to He Keng, one of the other vice-heads of the Finance and Economic Committee of the NPC is Wu Xiaoling, a retired banking system official who is a well-known budgetary and monetary-policy hawk.[11] He, Wu and others at the NPC have made it clear they will not rubber-stamp any substantial stimulus actions. At the same time, officials in the banking system have also made it clear that while they support an accommodative credit policy, they are not willing to see any kind of resumption of the stimulus excess in 2009. The consensus against pro-active stimulus is not just an academic consensus, it is strongly represented among practical policy-implementation organs. As a result, it has become ingrained in official policy.

Premier Wen Jiabao expressed that policy most clearly in early July (on a visit to Jiangsu accompanied by Ma Kai, Secretary-General of the State Council, who is an economist). Wen emphasized "stabilizing investment" as the key to a policy that would maintain growth.[12]

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[10] "We absolutely cannot do another 4 trillion [stimulus package]; Tax policy should release some water to allow fish to grow" (绝对不能再搞四万亿 税收要放水养鱼), *People's Daily* 人民日报, June 15, 2012, accessed at http://news.xinhuanet.com/fortune/2012-06/15/c_123286565.htm.

[11] Wu Xiaoling was one of the first to speak out about the excessive credit expansion in 2009, having been on record by June of that year on the damage done and risks created.

[12] "Wen Jiabao in Jiangsu inspection [says]; stabilizing investment is the key to steady growth based on increased domestic demand" (温家宝在江苏调研:稳定投资是扩内需稳增长的关键), *China.com*, July 9, 2012. Accessed at http://www.china.com.cn/policy/txt/2012-07/09/content_25852438.htm.

"Stabilizing investment" is a key concept: it means that steps can be taken to prevent investment from dropping rapidly (if investors' expectations of the future deteriorate), but that government investment would not be automatically increased to offset weaker export demand, or sluggish domestic demand. Other policies to increase consumption are instead to be developed, but these will certainly have effects only after a significant lag. This provides leeway to speed up the approval of some investment projects, and ease restrictions on some kinds of financing, but it rules out a large-scale stimulus program.

In fact, there have been periodic press reports of various measures taken to increase government investment. These are real, but also strictly limited. For example, investment in high-speed rail projects had been virtually halted during 2011 after the fatal crash near Wenzhou. Now, the suspension has been lifted and money is again flowing to high speed rail projects, but at a rate substantially below the high tide of 2008-2010.[13] Virtually all the other announcements of "stimulus" have consisted of the National Development and Reform Commission (NDRC) speeding up project approvals, but typically without funding (since the NDRC only rarely disposes of funding for specific investments).[14] Local governments—which pursue a different set of interests and are outside the general consensus against large-scale stimulus—continue to occasionally announce massive investment programs. However, these are invariably multi-year investment programs that may be little more than wish-lists. A few cities that are exceptionally favored by current national policies—such as Tianjin, Wuhan, Changsha—may announce bold programs that actually have some financial backing. In general, though, the crucial issue is whether projects have funding, and very few of the splashy programs being announced have funding. A widely-reported, but non-existent, "1 trillion RMB stimulus program" in early September fully fits this description.[15]

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[13] Eric Min, "China to increase railway investment," *21st Century Business Hearld Online*, July 31, 2012, accessed at http://www.morningwhistle.com/html/2012/Company_Industry_0731/213308.html.

[14] On May 24, one of NDRC's most questionable judgments generated one of the year's most memorable news photos, in which the mayor of Zhanjiang City, Wang Zhongbing, is seen kissing the NDRC approval document that will enable him to finally start construction on a large integrated steel mill, after waiting for 34 years. "The mayor of Zhanjiang City in Guangdong kisses the document because the project was approved" (广东湛江市长因项目获批亲吻文件), *Zhanjiang Daily* 湛江日报, May 28, 2012, accessed at http://news.sina.com.cn/c/p/2012-05-28/223724493737.shtml. This steel mill was initially proposed in 1978, as a companion project to the then-new Baoshan Steel Mill, but then suspended. Steel prices in China today are extremely low, and China's steel industry as a whole was in the read in the first half of 2012.

[15] E.g., Josephine Moulds, "Chinese Market Goes Wild After 1 Trillion Yuan Stimulus Plan," September 7, 2012. The Guardian. Accessed at http://www.businessinsider.com/chinese-market-goes-wild-after-1-trillion-yuan-stimulus-plan-2012-9#ixzz28zgPTJMp Moulds writes "Crucially, these new projects have been signed off by the central planning agency, meaning they are likely to proceed….Once projects have Beijing's approval, however, funding is seen as a formality." This is incorrect. There were many inaccurate reports after this announcement, so it is obvious that the misconceptions are widespread. They also reflect a misunderstanding of what happened in 2008-9: the "4 trillion RMB stimulus" was not the essence of what happened. The essence was a top-down policy

This description may make it sound like there is a jousting match going on between the NDRC and local governments, on one side, and the NPC Finance and Economics Committee and the banking system, on the other side, but that is not really true. The central government has to be prepared in case economic conditions deteriorate sharply. The NDRC's job is to make sure there are projects in the pipeline in case of need. The local government's "job" is to jostle to the front of the line in case the pipelines is opened. But neither of these has their hands on the spigot. Rather, central government officials are trying a balancing act, being ready with tools if needed, but not signaling too much relaxation of credit policy. In that sense, there is a general consensus that the last stimulus program, despite its benefits, was also very costly:

> The last stimulus program left us with excess capacity in 21 industrial sectors; a build-up of stockpiles; a reduction in investment efficiency; increased environmental costs; worse inflation; a build-up of local government debt; plus an asset bubble. For the past two years we've been trying to deal with these problems, so I completely agree that we can't use massive investment to stimulate the economy. That would just be like taking drugs, or worse, drinking poison to quench our thirst.[16]

Although this statement, by the very market-oriented Cheng Siwei may be more vehement that many, it does reflect an assessment of the past stimulus that is more generally held. This rejection of across-the-board stimulus also generally rules out a thorough relaxation of the housing control policies, which in addition are closely associated personally with Wen Jiabao. The need to maintain those policies has been repeatedly stated by Wen and other central government officials. A Politburo meeting on July 31, 2012, maintained the policy and reiterated previous statements.[17]

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mobilization that led to unrestricted bank lending. See Barry Naughton, "Understanding the Chinese Stimulus Package," *China Leadership Monitor*, Issue 28, Spring 2009. Accessed at http://www.hoover.org/publications/clm/issues

[16] Cheng Siwei 成思危, "Using massive investment to stimulate the economy is like drinking poison to quench thirst" (用大量投资刺激经济是饮鸩止渴), July 10, 2012, CCTV, accessed at http://news.163.com/12/0710/02/86147IO60001124J_all.html.

[17] Wang Lei (汪蕾), ed., "Central Politburo reaffirms stable growth, real estate control policies will not waver" (中央政治局定调稳增长 地产调控不动摇), *Duowei News* (多维), August 1, 2012, accessed at http://economics.dwnews.com/news/2012-08-01/58794619.html.

Broad Consensus over Growth Slowdown

There is a general consensus in the central government that growth will slow down. Moreover, the transformation of the growth model that Hu Jintao and Wen Jiabao have been advocating for more than five years is inextricably linked to the need to manage a transition to a new era of slower growth. Consider this quote from Liu Shijin, the vice-head of the State Council Development Research Center:

> From the Party Center down to the individual scholar, a consensus has already formed that a growth slowdown following a transformation in the economic development model is definitely not a bad thing. To transition from high-speed growth to medium-speed growth is to shift from one stage in which growth was driven by cheap production factors to a new stage in which innovation is the driver.[18]

Of course, it would be naïve to believe that there is a consensus in Beijing just because someone claims there is a consensus, and the official press reports it. In fact, Liu Shjin represents a government agency—the State Council Development Research Center—that is relatively more strongly associated with the few that a long-run growth slowdown has already begun. (This agency was also the counterpart with the World Bank on the China 2030 Report that first brought these issues widespread publicity in China). Another group of academic economists providing intellectual leadership on this issue are those writing about labor market changes and Lewis turning points, led by Cai Fang (see footnote 4 above). These groups advocate strongly that the task for government policy-makers is thus to adapt to slower growth and craft workable policies to facilitate a smooth transition.

To be sure, not all economists place the same emphasis on adapting to slower growth. Justin Yifu Lin, for example, who has just completed his term as chief economist at the World Bank, believes that China can continue to grow at 8 percent per year for another 20 years. His argument, however, is based largely on an argument about China's relative position compared to the economy at the frontier (the US), rather than a structural analysis of China's economy.[19]

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[18] Quoted in Dong Shanfeng and Chen Heng (董山峰 陈 恒), "Prospects for the New Year: Indigenous innovation in the 12th Five-Year Plan" (新年展望：看"十二五"自主创新), *Guangming Ribao* (光明日报), January 5, 2012. Accessed at http://www.mlr.gov.cn/wskt/hgjj/201201/t20120105_1055098.htm.

[19] Lin's argument is based on a straightforward, but perhaps overly simple, comparison. China's per capita GDP today is about 21 percent that of the United States', measured at purchasing power parities. This is the same relative position, compared to the U.S., that was held by Japan in 1951, by Korea in 1977, and by Taiwan in 1975. In the subsequent 20 years, those economies grew at 9.2 percent, 7.6 percent, and 8.3 percent, respectively. Therefore, China can as well. This is an important cautionary argument, but relies heavily on a single set of calculations using purchasing power parity data that are inherently weak, and especially imprecise with respect to China. Most analyses consider the structure of the domestic economy (rural vs. urban); demographic conditions (labor force growth and dependency); and investment rates to be more important, but these do not figure in Lin's argument. See

Other optimists include Hu Angang at Tsinghua University and Zhang Jun at Fudan University. Zhang Jun, for example, argues that China's size may allow it to successfully pass low-skill production sectors on to the inland and Western areas, facilitated by the massive improvement in transportation infrastructure that has taken place over the past decade. Meanwhile, coastal provinces may slow down modestly as they make the transition to middle-income, more skill-intensive production, but overall national growth rates can stay high. These economists argue that the main challenge right now is to craft policies that return China to a fast growth path.

On closer inspection, however, much of the divergence is simply a difference in emphasis. Most serious observers agree that China is facing rapid changes in cost conditions, market opportunities, and factor supplies. Simply put, the old way of doing things is not likely to work in the future. The second group chooses to put a more positive spin on the situation, stressing that with good policies, China can continue to develop rapidly. The first group chooses to stress the fact that without good policies, China's situation will deteriorate, and that with good policies an adaptation to slower growth can be made. Moreover, moderately slower growth is not a bad thing. As we will discuss later, there is also a group that emphasizes that without decisive shift in policy orientation now, conditions could get much worse in a short time.

What this quick review shows is that there is a broad consensus about three things: there have been dramatic changes in China's overall economic environment; that under current policy settings these changes will produce substantially slower growth or, worse, some more fundamental interruption of growth momentum; and that a comprehensive reorientation of growth policy is needed. That is a remarkably wide-ranging consensus to form around dissatisfaction with the current economic agenda. Moreover, as argued above, it is a consensus that seems to be widely shared not just in academic circles, but in policy-making circles as well.

Where the consensus evaporates is over what to do next. What concrete policy recommendations would these economists make? More critically, which policy steps should have the highest priority? To use the vocabulary of the 1980s and 1990s, which policy steps should serve as "break-through" policies that could drive a broader set of changes across the board. The consensus incorporates the desirability of certain broad goals, but these are quite abstract: Future growth should rely more on domestic consumption, and it should be driven by innovation. Just how will the government stimulate consumption? Similarly, fostering innovation is easier said than done. The Chinese government has been pouring billions of RMB into the "strategic emerging industries," in the belief that these are inherently innovative. Yet the result has been over-investment and excess capacity in sectors that have been favored by the government. The most striking example right now is the photovoltaic industry, where the

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Justin Yifu Lin, "China in the World Economy," Public Lecture, Vienna, August 10, 2012, Powerpoint document at http://www.oefse.at/Downloads/publikationen/documentation_china_10_08_2012.pdf leading firms have been bleeding red ink and face serious bankruptcy threats.[20] It is much easier to talk about innovation than it is to actually create an institutional environment that rewards innovators and entrepreneurs who genuinely take risks.

The Opportunity for a Revival of Broad Market-Oriented Reforms

These challenges have created a rich new opportunity for China's frustrated market reformers. Reformers have been sidelined for years, especially since the muscular response of the Chinese government to the global financial crisis in 2008–2009. Now their fortunes have changed. Reformers can now get a hearing, and find outlets for their views. Many reformers today strike a note of doom and gloom: without major reforms, there would be big trouble ahead. This is a common refrain of today's reformers, and it follows directly from the conditions described earlier in this article. Major action is required, but the policies of the past won't work anymore. Qin Xiao, an important reformist voice, argues that the only way to handle the simultaneous transformation of growth strategy and short-run macroeconomic pressures is for the government's visible hand to withdraw from microeconomic coordination, and for a new pro-market consensus to be formed.[21] Guo Shuqing, the new head of the China Securities Regulatory Commission and a dynamic policy-maker with growing influence in the financial sector, made a similar point more subtly in his speech to the Lujiazui Forum this year.[22] Only dramatic changes in the structure of China's financial markets—rapid movement away from bank-dominated financing and toward indirect financing (corporate bonds plus various kinds of investment, private equity and venture capital funds) will provide the flexibility necessitated by the dramatic shifts in the Chinese growth environment. Guo even repeatedly uses the U.S. financial system as a positive role model. He argues that American capital markets were the reason for U.S. success in fostering technological innovation and growing high-technology industries beginning in the 1980s, and that since the global financial crisis, U.S. growth has been healthier than that in Europe, again because of more flexible U.S. capital markets.[23] It was once

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[20] There has been extensive reporting on the troubles of this industry. For one recent example, see Ma Nan, "China Development Bank fell in Suntech's fraud case," *21st Century Business Herald Online*, August 1, 2012, accessed at http://www.morningwhistle.com/html/2012/FinanceMarkets_0801/213316.html.

[21] Qin Xiao 秦晓, " Kick off a new round of economic reforms in China—Problems, objectives and policy tools" (启动中国新一轮的经济改革—问题、目标与政策工具), outline of remarks presented at the *Financial Times*《金融时报》 Qingdao Conference, June 20, 2012.

[22] Guo Shuqing 郭树清, "If China doesn't reform its financial structure, there is no way out" (中国不改金融结构， 没出路). Speech at the Lujiazui Financial Forum, June 29, 2012. Posted on Phoenix Finance (凤凰财经), August 2, 2012, accessed at http://www.xj71.com/2012/0802/684665_2.shtml.

[23] Guo Shuqing 郭树清, *loc. cit.*, pp. 4–5.

common for the U.S. system to be used as a model by Chinese economists, but it has been extremely rare in Chinese official rhetoric since the global financial crisis for the U.S. system to play this role in the argument over China's future.

The logic behind a revival of market-oriented reform is stronger today than it has been for many years. The complacency engendered by China's hyper-growth during the first decade of the 21st century has largely evaporated; a challenging set of short-run financial and macroeconomic problems confront policy-makers with the need to do something, much as the problems of state-owned enterprises focuses the attention of the Zhu Rongji administration on difficult reforms in the 1990s. More broadly, the linkages between short-run challenges and long-run structural and institutional changes are now widely accepted. What bundles of policies could help China's economy adapt more smoothly to dramatic changes in labor force availability? What policies could help China achieve competitiveness with higher-cost, but more highly-skilled labor? How can China arrest the deterioration in institutional and policy quality? How can the necessary restructuring of financial and investment vehicles be carried through? In all these cases, the links between issues are inescapable, and only a thorough and credible commitment to a renewed domestic market-opening initiative is likely to be effective. These economic changes come in the context of a leadership transition.

From the standpoint of economists and policy advisers, they are motivated by the desire to prepare the ground for the new leadership. They wish to short-cut the natural tendency of a new administration to come in and launch a big study of everything that needs to be done. That was what happened in the beginning of the Wen Jiabao administration, a process that culminated (as discussed above) in a decision on continuing reforms in late 2004 that sounded fine, but accomplished nothing. Achieving some momentum today is likely to be essential in convincing the new administration to go forward with important market-oriented reforms.

Moreover, the new administration has incentives to pick up the fallen banner of market reform. Any new administration faces a natural incentive to define itself in opposition to the previous administration. Fatigue with the Hu Jintao/Wen Jiabao administration is set in, and only the most tone-deaf leaders would fail to sense the need to adopt a new theme song. In a more serious sense, though, the Wen Jiabao administration also bequeaths to its successor a very wide spectrum of issues areas in which resources are tied up, but results have not been blazingly obvious. A short list of such issue areas would include: strategic emerging industries; health care reform; public housing provision; fiscal system reform (reliance on ad hoc transfers to under-funded locals); and reform of the land system. In each of these areas, a new leadership is likely to try to shake themselves at least partially free of the policy commitments of the past, in order to regain some initiative and have some resources to address their own policy agenda. That will require defining a new policy orientation which can be used to shake things up, ask people to make some sacrifices, and generally put the stamp of the new leadership on to the current policy environment. Of course, this will happen in a Chinese way: Certainly there will be no repudiation of the past administration; instead, new themes will be sounded; subtle but unmistakable indications of a new regime. That is what happened ten years ago, and it is what we should expect now.

Already, there are signs of this new orientation. Xi Jinping has sent a number of understated but unmistakable signs that he is looking for this new orientation. For example, he dropped by the home of Hu Deping, son of Hu Yaobang and one of the standard-bearers of the reformist camp, during the last month. Various government agencies, even including the stalwart NDRC, are scrambling to put together recommendations for the new administration, recognizing that to maintain influence, they will have to put an attractive and reformist spin on whatever they put forward. All these incidents indicate a welcome opening in economic policy, and a welcome break with the past. But of course, it remains to be seen whether these initiatives can be brought together into a coherent program, and whether a leadership coalition can be assembled that will have the commitment and perseverance to carry out that program.