3. China's Economic Growth. Heading to a "New Normal"*

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* This Chapter is included in ISPI Report [***Xi's Policy Gambles: The Bumpy Road Ahead***], Alessia Amighini, Axel Berkofsky (Eds.), 2015.

As downward pressures on the Chinese economy are intensifying, President Xi Jinping said the nation needs to adapt to a "New Normal" in the pace of economic growth, with the aim of shifting focus from the speed to the quality of growth. The Chinese economy can no longer postpone facing and solving a series of structural imbalances. Rebalancing the drivers of growth to change the structure of the economy will require deep economic and institutional reforms.

Introducing a "New Normal" for China's growth

At the opening of the annual National People's Congress (NPC), Chinese premier Li Keqiang officially announced that the growth target for China in 2015 will be of "approximately 7 per cent", considerably lower than in the past. The announcement came as no surprise as it had been anticipated in a speech by Mr Li in Davos in February stating that the country had "entered the stage of the new normal, shifting from high speed to medium-to-high speed".

The new growth target set by Beijing is now lower than last year's 7.5 per cent, and more than 2 percentage points lower than in the past two decades. The government's ambitions therefore align with the recent slowdown experienced by the Chinese economy since the beginning of the financial crisis in 2008.

After the first two years of Xi Jinping's term, the Chinese economy grew by 7.4 per cent 'only' in 2014 – the lowest rate since 1990 – low enough to convince Chinese policy makers to shift to a new policy stance, as they realize previous growth targets are no longer sustainable. The shift to a lower but more sustainable growth target came soon after the International Monetary Fund (IMF) warned last year that a series of danger signs suggested that China would probably face a hard landing in the absence of crucial reforms. More specifically, the IMF said that without change, the risk of depressed annual growth of just 2.5 per cent for a 'protracted period' of time was 'medium' to 'likely' before 2030.

Mr Li said that China is likely to face even more serious difficulties in the year ahead, as "downward pressures on China's economy are building" up quickly and the country is facing "deep-seated problems in development" that can no longer be postponed. Mr Li assured that the new normal will not be inconsistent with the government's goal "of finishing building a moderately prosperous society". In fact, he said "this target is both aligned with our goal in all respects and is appropriate in terms of the need to grow and upgrade our economy". "A growth rate of approximately 7 per cent will ensure ample employment", and the government still aims to create 10 million jobs per year to keep the urban unemployment rate at 4.5 per cent or below.

The official announcement has been welcomed by the more dynamic business community. According to Xinhua, the official news agency, Jack Ma, the founder of Alibaba, described growth in China as being "like a man's height: it can't grow higher forever".

Why did the Chinese government decide to shift to a new growth model at Xi Jinping's mid-term? What are the roots of China's growth decline? Which structural policies should be put in place to rebalance the Chinese economy?

In fact, the process of rebalancing the economy had already started in China in mid-2005, precisely on 21 July, with introduction of a new exchange rate rule (anchoring the yuan to a basket of currencies). The new exchange rate regime has progressively reduced the profitability of exporting compared to producing for the domestic market, and therefore has reduced the incentive to invest in the export sector, especially in manufacturing exports[1]. Since then, investment has started increasing in services sectors and more recently in construction and infrastructure building. A substantial part of these new investment programmes were financed by local governments (through local banks, which are in turn state-owned). Therefore, the first attempts to rebalance the Chinese economy led to a number of further imbalances, namely excessive investment in the real estate sector and rising public debt both at the central and local levels of government. As that growth model has become visibly unsustainable, the Chinese government eventually opted for a new regime, which has been called the 'New Normal'.

Understanding China's growth decline

After more than two decades of double-digit growth rates, China is preparing to mark a significant slowdown in 2015, with GDP (Gross Domestic Product) growth estimated at 7 per cent, a further decline from the already unsatisfactory 7.4 per cent in 2014. Industrial production limps and with it investment, which in the final quarter of 2014 reached the lowest rate in 13 years.

In an attempt to limit the damage, the central bank cut rates in November for the first time in two years, further accelerated credit and reduced mortgage rates to stimulate demand. And it is ready to reduce the required reserve ratio of banks to loosen the constraints, which are already low, on credit supply.

In a nutshell, the slowdown is partly the expected result of the phasing out of the impact of an enormous stimulus programme introduced after the financial crisis of 2008 (see Chapter 2). The emergency measures, designed to prevent an excessive drop in production and employment, are likely to further undermine the

[1] O. Blanchard, F. Giavazzi, "Rebalancing Growth in China: A Three-Handed Approach", *China & World Economy*, Institute of World Economics and Politics, Chinese Academy of Social Sciences, vol. 14, no. 4, 2006, pp. 1-20.

economy's ability to reposition itself on a path of sustainable growth. Chinese expansion over the last three decades in fact relied on a set of imbalances. First, macroeconomic imbalances: the excess of investment and credit made the economy vulnerable in being full of low-profit investment projects, which can lead to an increasing amount of bad loans for banks. Today, further accelerating credit to avoid a sharp slowdown has the bitter scent of oil on fire... The excessive role of investment – compared to household consumption – is accompanied by another excess, in foreign demand (exports) compared to domestic demand. This makes the Chinese economy highly dependent on the rest of the world, which adds further fragility.

The other imbalances that Beijing can no longer ignore are the demographic one – with a workforce that is going to shrink, and the demographic dividend now exploited – and the regional divide – with many provinces highly specialized in few sectors producing capital and instrumental goods.

Declining investment

To face the negative impact of the global financial crisis, China launched a major investment programme in the second half of 2008 and 2009, which saw credit expansion and large-scale investment in real estate and infrastructure. Each of those two sectors have since then accounted for one third of China's total investment. Fuelled by massive credit facilities, the housing boom and infrastructure projects kept investment at extremely high growth rates, sustaining the whole economy. But once overcapacity had been reached, the decline in investment projects has dragged the whole economy into a substantial slowdown. As the Chinese economy relies heavily on investment for growth, the decline in investment growth has been a major driver of the current slowdown.

To be blamed now is a stagnant housing market compared to the boom of the last decade, which now – as the history of real estate bubbles teaches – is about to burst, threatening to drag much of the economy with it. The end of the real estate boom has an impact on many other manufacturing sectors (from materials to furniture) with dramatic consequences on employment.

The national government began to respond to falling growth in the final quarter of 2014, when the National Development and Reform Commission (NDRC) approved infrastructure projects worth more than Rmb693bn ($112.7 bn). Although the government has substantially redefined its GDP targets, other targets, such as those for rail construction or hydropower installation, remain in place. Further investment in construction and infrastructure will be spurred by the launch of the 'one belt, one road' initiative, which combines the concepts of the Maritime Silk Road and the Silk Road Economic Belt[2]. However, investment projects might be increasingly difficult to realise because of rising constraints on the main sources of revenues for local governments, i.e. land sales, which are contracting as demand for residential and commercial space is on the decline.

Rising public debt

China has accumulated very high debt, close to 210 per cent of GDP. This and other data disclosed in these days refer not only to the debt held by the central government but to the total debt accumulated by all operators resident in China, including local government, businesses and households. If we consider only public debt – that is, the debt of the central government – the percentage of GDP falls below 45per cent. In this sense, China is far from risking a debt crisis, unlike countries with higher debt/GDP ratio (in descending order: Japan 245, Greece 174, Italy 136, Portugal 131 and the United States 105).

What are the other components of China's debt? If we look at the composition of China's public debt, we see that much of it is made up of bank loans (130 per cent of GDP), given of which 40 per cent to medium and large enterprises, 25 per cent to local government, that is, the provinces, 17 per cent to small companies and another 17 per cent to households. This amount of credit is the

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[2] See Chapter 6.

result of major structural imbalances in the Chinese economy: the high rates of investment that Chinese companies, many of which are state-owned, have been able to sustain were financed by easy credit obtained from banks, which are also state-owned. As long as things go well, no one complains. Since 2009, this mechanism has worked well, because credit has increased from 58 per cent of GDP to current levels. Today it is evident that many of those loans are or will be non-performing, because many of the financed investments, especially in real estate, are not profitable. It is estimated that the amount of non-performing loans reached $125 million at the end of 2014.

So even if China does not risk running a debt crisis, certainly the situation is delicate because it threatens to overwhelm the whole economic system. Part of the problem is represented by so-called shadow banking, which accounts for 23 per cent of total loans. These are loans made outside the banking sector, of which only 10 per cent are loans made by a trust company. These claims are outside the banking supervisory system that requires banks' efficiency criteria to ensure the soundness of the banking system. In the case of China, however, the problem that is often linked to high debt, that is, the difficulties in repaying debt held abroad, will not arise. Less than 10 per cent of China's debt is in foreign hands, or about $1 billion, much less than the foreign reserves in the hands of China, four times larger.

Debt is a big burden for the economy. With an average cost of loans at about 7 per cent, borrowers have to generate much higher revenue growth in order to be profitable, and with an economy growing at 7 per cent, this is no longer possible. To face rising financing difficulties, the government plans in 2015 to run its biggest budget deficit since the global financial crisis and has allowed local governments to issue bonds directly. This will introduce further disparities among provinces, as richer, more populous provinces have larger and richer markets, which will support consumption as a driver of growth.

Provinces have a crucial role in this scenario, because it is precisely the uneven development within China that pushes less advanced provinces to keep up with the more developed coastal provinces. This is partly due to the need to improve internal economic conditions, partly to make them beholden to Beijing. The risk of default is much higher in some provinces, whose growth rates are far below the national average, particularly Liaoning, Yunnan, and Gansu. Some central provinces, Henan, Hubei and Hunan, have better prospects as they grow more than others. Therefore, economic development can be affected in the sense that the most backward and less diversified provinces will have less chance of finding new sources of revenue. This could further worsen divergence among provinces and therefore undermine the efforts by Beijing to overcome the dual model of development, with the coastal provinces far more advanced than others.

The China Banking Regulatory Commission has enabled many provinces to open Asset Management Companies (AMC) since last July. AMC buy distressed assets from banks at discount rates and sell them after they have been securitized, that is, included in a package of securities that have their own dedicated market. It is currently the only action taken with direct effects. These measures, however, treat the effect and not the cause, which remains excessive credit growth. In this sense, the reduction in interest rates and other incentives to stimulate demand for credit in part act in the opposite direction. What we need to look carefully at is the behavior of the individual provinces, declared and implemented, regarding the default of individual cities. Shandong has declared that it will not save the city from bankruptcy. This means that the securities issued by these governments become in fact junk, and that many other provinces will have difficulty in continuing to finance themselves. It seems unlikely that Beijing will allow individual provinces to let local governments go into default, and may take care of the problem. In this case, however, it will exacerbate the origin of the problem, namely the separation of spending decisions from financing capacity at the provincial level.

Demographic transition

China is in the midst of an important demographic transition. This demographic transition is double-sided. Firstly, the age structure of the whole population is changing. The country's working-age ratio (i.e., the number of people between 16 and 65 years old divided by the number of people in non-working age, i.e. children – younger than 16 – and older people – aged over 65) reached its peak of 2:6 in 2010 and has since begun to decline[3]. In fact, the absolute number of working-age people began to decline in 2012. Secondly, the labor force is moving from the countryside to cities. The rapid economic expansion over the last decade, before the start of the financial crisis in 2008, brought about 200 million people out of agriculture. But recently the rate of migration has slowed substantially, although 35 per cent of China's total labor force still works in the countryside (a much higher percentage than the contribution of agriculture to GDP, i.e. around 10 per cent). These two transitions have together contributed to the slowdown of the economy since 2010, because the labor force started shrinking on the one hand, and on the other, because productivity gains due to the movement of workers from less productive agricultural sectors to more productive urban sectors decelerated.

The net loss of labor in China will be partly offset by a substantial improvement in human capital among young people. Because new workers are twice as productive as retiring workers, China will enjoy large educational dividends created by cross-generational substitution in the next 20 years. Moreover, the educational attainment of the young is improving steadily. Currently, 27 per cent of 18 to 22-year-olds have a college education; by 2020, that number will reach 40 per cent.

Another factor that will further compensate for a declining labor force will be a rise in the retirement age. It is widely accepted in China that the current retirement ages should be

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[3] Yang Yao, *A New Normal, but with Robust Growth: China's Growth Prospects in the Next 10 Years*, 2015, http://www.brookings.edu/~/media/Research/Files/Interactives/2014/thinktank20/chapters/tt20%20china%20growth%20prospects%20yao.pdf.

raised. Currently, China's retirement age is very low by any standard. Female workers can now retire at the age of 50, and male workers at the age of 55. By the age of 52, half of the women are no longer working; by the age of 58, half of the men. As a result, the labor force participation rate is barely above 60 per cent in the whole population. Even if the retirement age were to be raised by half a year each year over the next 10 years, the reduction in the working-age population, now standing at 2.5 million a year, would be more than compensated.

Regional disparities

Since the beginning of 2014, when the central government announced plans to change the growth model, it also explicitly considered the incentives to offer individual provinces to grow rapidly and be particularly beholden to Beijing. Among the criteria for the promotion of local public managers, more weight is now given to indicators of well-being, innovation, and reducing pollution. Because social stability is still a priority objective of the central and local government, the attraction of big business in the territory will always be a priority. In some provinces, the effects are already visible. Heilongjiang has announced a two-year package of stimulus measures to finance infrastructure projects. Shanxi is moving towards the development of technologies to reduce the use of coal.

Regional disparities within the country are also still substantially large. Although every province recorded lower growth rates than in 2013 – reflecting the national-level slowdown from 7.7 to 7.4 per cent – growth slowdown has not been equally distributed across provinces, but instead has been highly uneven across the country; it mostly occurs in the coastal provinces that produce more than 85 per cent of China's output and exports. Inland provinces have continued to grow at relatively high rates, and this has contributed to increasing convergence within the country. As a result, the rebalancing of China's growth has somehow helped to improve income distribution (the national Gini coefficient[4] of personal income declined from 0.481 in 2010 to 0.473 in 2013, according to Yao[5]). Only 5 (out of 31) provinces did not experience a stagnation of GDP in the second half of 2014, four of them (Tibet, Chongqing, Guizhou and Xinjiang) in the western regions, and, in some cases, mainly thanks to central government outlays to ethnic minorities. Other provinces, that are more resistant and stable, are also more diversified by sector, and more devoted to the production of consumer goods, i.e. the coastal provinces. The slowdown of the real estate sector had a negative impact on some western provinces rich in natural resources and based on heavy industries. The most affected by the slowdown, however, are provinces rich in natural resources (such as Shanxi and Hebei). The latest figures also show growing income disparities expected to worsen over the next year. Compared to an average growth of disposable income in urban areas of 9.3 per cent in 2014, some provinces are lagging behind (Chongqing grew by 3 per cent and Hainan by 6 per cent). By contrast, some provinces whose growth rates were already comparatively low in 2013, at around 8 per cent – Shanghai, Beijing and Zhejiang – had much lower declines in growth. This is also due to the fact that their economies are also more diversified, with stronger services sectors and more numerous retail centers, which compensated for the impact of falling investment.

Beijing has indicated that the new growth model must contemplate a move to more modest but more sustainable growth, pledging to reduce the debt of local governments and the overcapacity of many sectors and provinces. But inequality and the growing inter-provincial differences will test the government's ability to cope with the growing socio-economic imbalances: consumption expenditure grew by 12.4 per cent in Jiangsu and 14.2 per cent in Zhejiang, but only 2.8 per cent in Chongqing.

Moreover, richer provinces have more developed and diversified economies, and will be more likely to be able to secure

4 See Chapter 2.
5 Yang Yao (2015).

funding for their projects. They are also more active in putting in place policies of their own, aimed at sustaining growth. In this spirit, parts of Guangdong, Fujian and Tianjin will launch their own free-trade zones similar to that set up in Shanghai in 2013. Unlike western parts of the country, coastal provinces can benefit from stronger pools of labour force, which can fuel the growth of higher-value-added industries and services.

Structural reforms to rebalance the economy

As the "New Normal" growth puts the economy on a more sustainable path after three decades of accelerated growth targets and aims to avoid China's heading for a 'hard landing', Mr Li said slower growth makes "structural reform all the more necessary". In a sense, shifting gears to a more appropriate growth rate will help China to achieve modernization of its economy.

By following a more sustainable development path, China intends to avoid falling into the 'middle income trap'. To do so, structural change – rather than the rapid growth of GDP – is the way to achieve a level of average income equal to that of the advanced economies. The main ingredients of structural change are increasing agricultural productivity through the mechanization of sowing and harvesting, progressive urbanization that allows millions of rural workers to move from agriculture to manufacturing and services and find better-paid jobs in urban areas, investment in infrastructure and the introduction of advanced production technology in manufacturing, also (but not exclusively) by foreign multinationals. Moreover, Li said it is vital for China to go ahead with reforms of state-owned enterprises to improve efficiency and productivity and with liberalizing the banking system and financial markets.

Fiscal and market reforms are particularly high on China's reform agenda. The fight against pollution and corruption has contributed to the slowing economy, as dirty industries have been downsized, and the anti-graft campaign has had a chilling effect on some business activity. Although China's policymakers are currently tackling the short-term emergencies, over the longer run they are seeking to boost consumption to relieve overdependence on export markets and cut wasteful investment. Also, market reforms – implemented in the 'Made in China 2025' strategy – will pursue innovation-driven development, apply smart technology, refocus on green development, tackle overcapacity in polluting heavy industries and move Chinese factories up the global value chain. Li also promised a greater role for private business in the economy, which will be further opened up by halving the number of industries in which foreign investment is restricted.

What to expect next?

As the new normal implies lower growth rates for the Chinese economy, what should we expect in the next decade? Since export growth declined from an average of 29 per cent per annum between 2001 and 2008 to under 10 per cent per annum in recent years, exports as a driver of growth have substantially slowed down. Consequently, the overall contribution of exports to growth has declined from 3 percentage points to about 1 percentage point. As a result, the contribution of net exports has become negligible, at most. At the same time, domestic consumption as a share of GDP began to rise in 2013, after it had stabilized since 2008, due to the comparatively higher rise in investment spending financed by the government's stimulus packages. Retail consumption behaved very differently across provinces; it held steady especially in Guangdong, which is also the country's largest provincial market.

In the first half of 2014, services accounted for more than half of the country's growth. It seems that China has passed the turning point of the inverse U curve of manufacturing widely observed for advanced countries in their earlier days (e.g., the United States in the late 1950s, Japan in the early 1970s). Both employment and output in the manufacturing sector as a share of the national total began to decline in 2013, when manufacturing output was smaller than service output for the first time.

Investment as a share of GDP is likely to decline, but it will probably take a decade for it to drop below 40 per cent, during which time capital stock can still maintain a reasonable growth rate. On top of that, China's innovation capacity is being strengthened. In addition to improvements in human capital, China's spending on research and development (R&D) is accelerating. By 2015, R&D spending will reach 2.2 per cent of GDP, moving close to the ratios prevailing in advanced economies.

A useful contribution to the discussion about what the world should reasonably expect from China's growth has been made by economists and international organizations, both suggesting that China's new normal will entail growth rates in the range of 6 per cent to 7 per cent or even lower in the next 10 years. A useful exercise done by Cai Fang[6] is to use the international experience to predict China's future growth. Fang calculated China's potential growth rates over 1985-2011 and then predicted China's potential growth rates for the 2014-2023 period. The data show that "the Chinese economy outperformed its potential growth rates in two periods, the 1990s before the Asian financial crisis and the years around the global financial crisis. In between, the Chinese economy experienced deflation and its actual growth rates were below its potential growth rates. China's potential growth rates in the next 10 years are predicted to be in the range of 6.9 to 7.6 per cent, with an average of 7.27 per cent. This is indeed much lower than the 9.4 per cent average in the period 1988-2013".

Implications for the rest of the world

Despite the slowdown in recent years, China has led world growth since the beginning of the recent financial crisis. The domino effect will be significant. According to the Organisation for Economic Co-operation and Development (OECD), a reduction in

[6] R. Garnaut, Cai Fang, Ligang Song, *China: A New Model for Growth and Development*, ANU E Press, 2013.

the growth of Chinese demand by 2 percentage points for two years would reduce global GDP by 0.3 percentage points per year. The countries most linked to China as importer will be most damaged, particularly Japan (its main supplier of capital goods), while the United States and Europe will suffer relatively less.

Because one of the most important drivers of growth worldwide is exports, the decline in China's imports and exports will likely contribute substantially to a global slowdown. In 2014 the value of China's imports rose by just 0.5 per cent, marking a substantial slowdown from the 7.3 per cent rise in 2013 and an even bigger departure from the average annual increases of 22.6 per cent in 2002-2011. The value of merchandise imports will continue to increase, by 9.3 per cent a year on average in 2015-2019, according to *The Economist Intelligence Unit*'s forecasts. The country's move away from its investment-led growth model is already having a big negative impact on the demand for commodities used by the construction sector, therefore imports from many markets have already declined. This trend also extends to other primary commodities, e.g. imports from Brazil, dominated by soya beans and iron ore, dropped by 4.8 per cent last year. Other big suppliers of commodities in Asia and Africa enjoyed much the same experience. Imports from Australia dropped by 1.2 per cent, from South Africa by 7.8 per cent. Unlike the outlook for commodity-exporting countries, the picture is rosy for countries that specialize in selling consumer goods, technology items and equipment. Chinese demand for consumption goods has become more sophisticated and the mechanization of China's manufacturing sector is also spurring an increase in technology-intensive imports, driven partly by a need to increase productivity as wages increase.

According to some recent research[7], the slowdown of global trade since 2012 is not just due to cyclical factors (i.e. declining demand), but also to structural factors, namely to a reduction in the elasticity of trade to world GDP. Among the most important

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[7] C. Constantinescu, A. Dennis, A. Mattoo, M. Ruta, *What Lies Behind the Global Trade Slowdown, Global Economic Prospects*, Washington D.C., World Bank, 2015.

reasons for this is the deceleration of China's trade, which in turn reflects the contraction of global value chains[8]. More specifically, the international fragmentation of production processes has spurred world trade over the 2000s, but the global crisis put a halt to this phenomenon, mainly due to the fact that China's exports are increasingly less intensive in imported parts and components, but instead embed more local inputs.

Compared to China, the rest of Asia as a whole will not grow as much, and despite the possibility that it will become a location attractive to investors, it will never be an equally attractive market. China's GDP in 2015 will grow by $1.2 billion, and will contribute 30 per cent to global GDP growth. The United States will contribute only 22 per cent. Even assuming a significant slowdown, the Chinese economy will remain the engine of global growth in the near future. It is now time for businesses to look at China as a multi-faceted and multi-centered country, with many potential markets in the inland provinces, often with the most promising opportunities in other neighboring countries.

Conclusions

As downward pressures on the Chinese economy are intensifying, and President Xi Jinping announced that the country will have to switch from focussing on the speed to focussing on the quality of growth, the composition of Chinese demand for goods will likely change more rapidly to a more sophisticated consumption model. European producers of both consumption and capital goods will benefit from the new Chinese demand for high-quality goods. However, market access is still cumbersome in a number of sectors due to complex and numerous regulations. Consequently, EU trade policies towards China are likely to benefit from a strategic shift from raising issues of exchange rate misalignments – an argument which is invariably raised by the U.S. – towards

[8] F. Lemoine, D. Ünal, *Mutations du commerce extérieur chinois*, Lettre du CEPII, no. 352, March 2015.

market access concerns. Since the decision by the EU to open negotiations on a bilateral investment treaty (BIT) in 2013, the EU has intensified its efforts to address problems related to market access in China in some sectors such as cosmetics and medical devices, as well as licensing and market access issues in the area of financial and telecommunication services. Moreover, the slowdown of economic growth and the impact of Xi's anti-corruption campaigns will likely have a negative impact on foreign as well as domestic firms, as the slowdown could be accompanied by the adoption of stricter regulations for foreign invested enterprises. Therefore, continued efforts to increase dialogue on investment access and enforcement of intellectual property rights in China will contribute to balance out the impact on European firms investing and operating in the country.