

China’s Central Development Challenge

**By
Vikram Nehru¹**

Recent evidence of a growth slowdown in the Chinese economy has triggered speculation by some in the West that the Chinese growth model has reached its limits. This premature announcement of the demise of the Chinese growth model is unfortunate, unwarranted, and unjustified. The entire global economy is facing difficult headwinds. All emerging economies face sharp slowdown. The United States and Europe continue to face unusually large uncertainties. And the latest round of quantitative easing by the world’s major central banks is unprecedented and vastly complicates macroeconomic management everywhere. Given China’s economic integration with the rest of the world, it should come as little surprise that it is not immune to these global forces. What is more, the global slowdown has reinforced cyclical factors within China — especially the end of the 2009-10 fiscal stimulus and conservative monetary management over the last couple of years to lower inflation and remove some of the froth from the country’s overheated real estate market. In fact, the macroeconomic evidence so far suggests that China appears to be successfully engineering a “soft landing” toward a more sustainable rate of growth consistent with global conditions and internal factors.

While short-term alarmism may be unwarranted, there is every reason to be concerned about China’s development model over the medium term. Chinese leaders have been making this point for some time, and the 11th and 12th Five Year Plans reflect some of this new thinking. But none of these add up to a consistent and clear medium term development vision that prepares the country not just for the challenges of today but also the challenges that are likely to appear in coming decades.

¹ Senior Associate and Bakrie Chair in Southeast Asian Studies at the Carnegie Endowment for International Peace; previously the World Bank’s Chief Economist for East Asia and the Pacific, Director for Poverty Reduction, Economic Management, and Private and Financial Sector Development; and leader of the World Bank team that, together with China’s Development Research Center of the State Council, prepared the recently published report “[China 2030: Building a Modern, Harmonious, and Creative High Income Society](#)” in March 2012. The logic and arguments in this paper are partly drawn from this report.

This paper argues that the very factors that helped China grow so fast so quickly are also the source of its deep structural challenges. These challenges cover a broad spectrum —macroeconomic, social, environmental, and global— and they threaten China’s ability to maintain rapid and sustainable increases in living standards. But there is one common thread that runs through all these challenges and could arguably constitute China’s central development challenge. That common thread is the need to change —not expand or contract, but change — the role of government in the economy. On the one hand, rather than direct involvement in markets, production, distribution, and resource allocation, the government needs to manage economic activity indirectly through fiscal incentives and a regulatory framework that encourage consistency between private and social objectives. On the other, it needs to boost its direct role in delivering more and better public goods and services through a stronger and better organized fiscal system. Crystallizing China’s myriad challenges into one — that of “pivoting” the role of government — not only helps to sharpen the focus of policy thinking but also serves to remind why it is so difficult to do, especially given deeply entrenched vested interests in the current economic structure that will prove difficult to overcome.

Rapid progress but still middle income

Over the last three decades, China’s two historic transformations from a rural, agricultural society to an urban, industrial one, and from a command economy to a market based one, have combined to yield spectacular results. Growth averaged 10 percent a year, the poverty rate fell from 65 percent to 10 percent, all the MDGs have been reached or are within reach, and China is now the world’s largest exporter and manufacturer and its second largest economy. Indeed, by some accounts, China is already the world’s largest economy (based on GDP in PPP terms).

This economic growth has been accompanied by rapid progress in urbanization, human development, gender equality, banking, infrastructure, R&D, and the application of new technologies (including in space and renewable energy sources). If China continues to grow for another decade and a half as rapidly as it did in the past, it will become a high-income economy — and will have transformed itself from low- to high-income within a generation and a half, an achievement unsurpassed by any nation, let alone one the size of China.

China's heft in the global economy comes largely from the size of its population, not the level of its per capita income. In fact, this is the first time in recent history that the world's largest economy is also not among its richest. China is a middle income country today. Compared to the United States, its per capita income is around a sixth (in PPP terms) and its capital-worker ratio is slightly less than a twelfth. Of 180 countries for which average per capita income data (in PPP terms) is available, China ranks 94th — just below the global median. Indeed, in 2010, China had around 170 million people living on less than \$2 a day (in 2005 PPP terms).² Even if China were to become a high-income economy by 2030, its per capita income would still be well short of today's advanced economies.

Key objective: Rapid growth in sustainable living standards

As China's leaders have stated, and as the 11th and 12th Five Year Plans indicate, China's objective is no longer just growth in per capita GDP but growth in sustainable living standards. The difference is important. GDP measures current output but does not include other, intangible and non-pecuniary aspects of well-being — such as a sense of security, community, a clean living environment, and so on. It also takes no account of sustainability and the welfare of future generations who inherit this

² Estimate using 2005 PPP based data from the World Bank's Povcalnet (<http://iresearch.worldbank.org/PovcalNet/index.htm>).

generation's legacy stock of human, natural, physical, or social capital. To be sustainable, not only should rising incomes be accompanied by a constant or (better still) rising stock of (human, natural, physical, or social) capital, it should also not come at the expense of a reduction in the per capita income of future generations.

Using this broader concept of improvements in well-being and sustainability, the pattern of growth over the past three decades cannot be considered sustainable. While the stock of physical and human capital has definitely climbed (spectacularly!), the same cannot be said of natural and social capital. The cost of environmental degradation and resource depletion is near 10 percent of GDP, health costs from air pollution are high and rising, some 300 million Chinese use contaminated water, a fifth of the farmland contains toxic levels of heavy metals, and a third of the waterways are below the government's own safety standards.

Similarly, social capital is arguably being eroded as a result of rising inequalities in income, wealth, housing, and access to quality health and education services. Corruption is rampant, eroding confidence in public officials and institutions. The Bo Xilai case, and its accompanying revelations of corrupt and debauched behavior at the highest levels of the Party, may have damaged the reputation of the leadership itself.

Moreover, unfunded contingent liabilities accumulating in the economy (such as pension legacy costs, uncovered bad debts in the financial system, environmental degradation, and the economic costs of climate change) could possibly become the actual liabilities of future generations. It is difficult to estimate these costs, but they could potentially be large. For example, pension legacy costs alone are estimated to be between 80 and 130 percent of 2008 GDP. And as the world has discovered over the

past few years, the costs of financial crises can manifest themselves in wealth reduction, risk aversion, and slow growth in incomes over prolonged periods.

Growth drivers, growth inhibitors, and growth risks

Fortunately, China has the resources and potent growth drivers it could usefully apply to maintain rapid productivity growth. These growth drivers include: increased specialization and scale economies further integration with the regional and global economy (especially in the services sector); continued rapid urbanization (at a projected pace of 14 million new urbanites a year); considerable distance from the technology frontier in a range of industries and subsectors to permit swift technological catch-up, increased research and development (especially in such sunrise industries as renewable energy sources); a substantial improvement in educational standards together with a large projected increase in graduates from tertiary educational institutions (expected to be 200 million between now and 2030); a growing middle class commanding increased spending power and demanding better quality products and services (including government services); and large potential shale and natural gas reserves — by some estimates the largest in the world — that are now accessible and financially viable to exploit thanks to new technologies developed in the United States.

Although China's growth drivers appear strong, there are headwinds that are likely to exert a strong, possibly increasing, drag on growth. Most notable among these is the aging population, the impending decline in the size of the labor force, and the rising old-age dependency ratio. Of course, growth in the labor force has contributed little to the overall growth rate in the last three decades (most of the growth came from rising capital-labor ratios and total factor productivity growth), so the question could well be asked why a shrinking labor force should be of concern. Indeed, in one sense it may not be — rising

labor productivity could easily accommodate the projected decline in the labor force. But in another sense it could be of major concern — the rising dependency ratio could negatively impact savings and correspondingly on the pace of capital accumulation. But even this impact is arguably overstated for three reasons: first, a decline in the savings rate, if it does occur, will help lower the external surplus and could potentially have little, if any, impact on domestic investment; second, there is little evidence that the dependency ratio will lower the savings rate significantly in part because corporate savings represent a large share of domestic savings but also because there is little evidence that the old save any less than the young or the middle-aged in China (given uncertainties regarding the adequate availability of government-financed old-age social security arrangements such as health insurance and pension payments, especially in rural areas).³

Other factors that are also likely to exert a drag on growth include China's already high penetration of export markets, especially in advanced countries. China's current penetration ratio of advanced country markets is near 10 percent, about where Japan was at its peak in the mid-1980s, when it saw a number of protectionist measures in the advanced countries and was forced to introduce "voluntary export restraints" to assuage advanced country policy makers. The increase in China's market penetration ratio shows no sign of slowing, more so now when growth in the advanced countries has slowed markedly. The rising number of WTO-related retaliatory actions against China brought by a wide range of countries has been climbing rapidly. And this is not restricted to advanced countries alone. China accounts for over one-third of all anti-dumping actions by developing countries initiated under WTO. Other growth-inhibiting factors would also include further environmental degradation, which could manifest itself in rising costs of clean water for industrial and domestic purposes and clean, increasingly scarcity of arable

³ While it is true that the government is increasingly putting in place such health and pension arrangements, the bulk of the costs for illness and old age would still need to be covered by individuals and households, and in any case, savings behavior is unlikely to be changed until government financed arrangements are seen as being reliable and have the confidence of the old age population.

land for agricultural production, not to mention the rising health costs associated with air, water, and land pollution.

While growth-inhibiting factors may slow China's growth gradually over time, one should always be mindful of possible risks that growth could suddenly be disrupted. While a sudden and unanticipated growth slowdown in itself may not be considered a threat, it could expose large contingent liabilities in banks, state enterprises, and local governments and trigger a fiscal or financial sector crisis that may have longer lasting repercussions. Although unlikely, this could be triggered in the short term if, for example, there is a crisis of confidence in the real estate sector or the shadow banking system (or both simultaneously, since they are connected), causing asset prices to crash and nominal wealth stocks to shrink. After all, China's high savings, representing one-third of global net wealth accumulation, are accumulating within China's borders owing to controls on capital outflows. These savings, mostly channeled through state banks and state enterprises (and to some unknown extent through the shadow banking system) in search of positive real returns, are increasingly financing high-risk activities with rates of return dependent heavily upon continued high growth. Maintaining rapid growth is therefore imperative not just to maintain social stability, as many commentators have noted, but also maintain financial stability in the state bank and state enterprise system.

A growth slowdown could also occur for non-economic reasons, such as internal political crises or unexpected civil disturbances, or even an environmental catastrophe — again relatively low (but nonetheless fat-tailed) risks, but which could nonetheless affect confidence and disrupt investment. The consequences of slower growth on economic stability are aggravated by high and rising inequality in incomes and wealth — now approaching Latin American levels. Although growth in incomes at all levels of the income distribution are rising rapidly, growing disparities between rural and urban areas, and the

social and economic disparities within urban areas between urban residents and migrant labor, are raising questions about the social justice inherent in the current pattern of growth. In addition, the swelling ranks of the middle class, now numbering in the hundreds of millions, are likely to be less tolerant of policy responses that hurt their economic prospects or their sense of social justice, adding a further dimension of risks facing the economy.

Finally, external risks are likely to remain elevated in the short and the medium term. Economic uncertainties in Europe, the United States, and Japan, and the instability in the Middle East threaten China's key export markets and its energy supplies. China's deteriorating international relations with its neighbors — mainly Japan, Korea, Vietnam, and the Philippines — over disputed territories in the East and South China Seas could threaten the stability of the region and affect freedom of navigation of the high seas on which China's trade so heavily depends. Other possible externally related risks are new and disruptive technologies, volatile capital and commodity markets, climate change, and threats to food and energy security.

China's central challenge – “pivoting” the role of government

So how can China nurture and strengthen its growth drivers, eliminate factors that are likely to inhibit growth, and manage risks that could arise from within or outside its borders — so it can change its pattern of production, investment, and consumption and maintain rapid growth in sustainable living standards? To achieve this, it will need to slow growth measured in GDP terms while at the same time build its stocks of social, environmental, human, and physical capital. This will mean maintaining high levels of investment, but shifting the pattern of investment so that it is not exclusively in physical and (to a lesser extent) human capital, but rather social and natural capital are given increased emphasis.

Initially, investment in natural capital will initially need to slow and eventually eliminate further deterioration in the environment from current and future production levels, but then efforts will need to be made to restore the stock of natural level to earlier levels. Similarly, investment in social capital, to erase inequality of opportunity in several dimensions (health, education, jobs, finance), strengthen social justice, and improve participatory institutions will be key to maintain social stability in the future.

Innovation, and moving up the value chain, will become essential so that China reaps greater growth benefits from the same level of exports (and export penetration of foreign markets). This will allow exports to continue to be a driver of growth while generating fewer protectionist pressures in external markets while at the same time reducing the share of processing imports and increasing the share of consumer goods imports. Innovation, moreover, is central to continued rapid growth – because as resources are diverted to build the stock of human, social, and natural capital, there will be fewer resources available to invest in physical capital. Maintaining rapid growth with slower growth in physical capital stock per worker — especially at a time when the labor force is shrinking and the pressure to increase labor productivity growth will rise — will mean that total factor productivity growth will need to rise. This will place a premium on increasing efficiency in resource allocation and resource use, absorbing new product and process technologies from abroad, disseminating these technologies more rapidly within China, and creating the incentives to stimulate innovation at home.

In terms of its relations with other countries, China will need to be seen as a country that contributes to global growth as well as one that helps solve global challenges and supports institutions and initiatives that deliver critical global public goods and services — including global trade in goods and services, global financial stability, global capital flows, global climate change, global migration, and so on. Put another way, China needs to build its stock of global (goodwill) capital — a capital stock that, once

accumulated, will increase its global influence and yield returns through the use of “soft power”. To accumulate such capital, it will need to reduce, if not altogether eliminate its current account surplus, provide foreign investment the same safeguards as it would want its own investments to enjoy in other countries, become an active and constructive partner in global institutions, and become a net carbon sink rather than be the world’s largest emitter of greenhouse gases.

These three imperatives — the need to build the stock of physical, human, social, and natural capital; the need for greater (allocative and x-) efficiency and more innovation; and the need to build a stock of global (goodwill) capital through a more active and constructive role in providing global public goods and services and joining other countries in resolving global challenges — are in many respects common to most countries. The question in China is how these priorities will be met.

China’s collective action capabilities are unmatched in the world, so unlike other countries, China will likely be very successful in shifting its priorities toward social, environmental, and global objectives — provided it is convinced that this is the direction it wants to take. Indeed, it is already pursuing some of these objectives (such as developing new energy efficient and renewables technology) with considerable enthusiasm. More difficult for China will be the challenges for increasing greater allocative- and x- efficiency and promoting innovation. This will require giving more space to the private sector, a smaller role for state enterprises, and shifting government emphasis from direct involvement in the economy to more indirect involvement through laws, rules, and regulations that provide a conducive environment for greater efficiency and innovation.

The central challenge for China in ensuring continued rapid improvements in sustainable living standards, then, is to change the economic role of government and its relations to markets, households,

communities, and to the world at large. It needs to “pivot” from its direct involvement in production, distribution, and resource allocation toward a more active role in providing public goods and services — including the legal and regulatory environment for private sector development and the accumulation of stocks of human, physical, natural, and social capital as well as global goodwill.

Implications for the reform agenda

When translated into a possible medium term reform agenda (some of which is already being implemented), the proposed “pivot” in the core economic role of government comprises four dimensions.

The first is the need to genuinely withdraw the important and influential role of state enterprises — including state enterprises owned by local governments that have proliferated in recent years — in agriculture manufacturing, and services (especially real estate, housing, trade, transport, tourism, and telecommunications). Arguably, this presents the biggest political economy challenge confronting the government, in part because of the strong connections between the top leadership of state enterprises and state banks that control financial power in China on the one hand, and leaders in the party who control political power on the other. While there are nevertheless many ways forward to deal with these powerful vested interests, an appealing approach would be to separate the government’s policymaking role for state enterprises and its ownership role. The latter could be transferred to state asset management companies established specially for the purpose, charged with maximizing the returns of state assets and transferring those returns to the budget where they would boost the government’s financial capability to finance the large public goods and services requirements in the economy.

Equally important, competition needs to be encouraged, especially in sectors that have protected monopoly or monopsony rights of state enterprises. The principal ways to achieve this is by easing entry and exit requirements, furthering international trade, especially in services, and vigorously enforcing competition laws and regulations. Competition is also central for innovation, which essentially emerges from a trial-and-error process; the more firms that participate in the process, the greater the chances of achieving technological breakthroughs.

More so than product markets, China's factor markets are in greater need of market reform. The financial sector needs to shed its fiscal burden, be granted greater freedom in resource allocation, and be supervised more rigorously by an autonomous regulatory commission to ensure prudential management. Interest rate liberalization, while important, will need to await these more urgent institutional and corporate governance reforms. Similarly, the "hukou" system inhibiting the flexible functioning of labor markets needs to be phased out gradually while unemployment, health, and pension arrangements need to be made portable nationwide. And rural land markets need to be thoroughly revamped to protect farmer rights, increase the efficiency of land use, and curtail the seemingly limitless power of local governments to acquire and sell rural land to boost their revenues.

The second dimension is the need to advance social objectives – reducing inequality of opportunity and improving environmental protection – through a combination of market reforms and a reordering of public expenditure priorities in the budget. Addressing concerns about rising inequality — especially rural-urban and coastal-interior inequality — requires providing more and higher quality public services (health, education, pension arrangements, and unemployment insurance systems) to relatively deprived communities in rural and interior areas as well as in urban migrant populations, and securing social

safety nets for those who “fall through the cracks”. As far as protecting the environment is concerned, while the bulk of the effort will need to come from the private sector within an appropriate framework of market and regulatory incentives (that would include a carbon cap-and-trade system that is already included in the 12th Five Year Plan), the government will have to step up public investments in a range of areas, including for rebuilding and safeguarding the health of the country’s air, land, water, and ecosystems.

Virtually all the reforms that China needs over the medium term have a fiscal dimension. If the banking system is to be relieved of its fiscal burden, then this burden has to be transferred to the fiscal system. If state enterprises are to be subject to hard budget constraints in the face of increased competition from the private sector, then they may require transitional budget support. If the “hukou” system is to be reformed, then local governments need additional resources to provide migrants the same level of services as those provided urban residents. And the prioritization of social and environmental public investments will also take additional public resources. Indeed, the various elements of a medium term reform strategy for China are heavily dependent on a strong and sustainable fiscal system that mobilizes resources effectively, ensures that resources at each level of government (central, provincial, prefectural, township, and village) are commensurate with its expenditure responsibilities, and that the government’s expenditure priorities are reflected in budget actuals and program and project results. This will require substantial change in the way the current fiscal system is structured and operates.

Finally, the fourth dimension is to change the way the government measures progress, whether this is at the central, provincial, or sub-provincial levels. If the objective is to ensure rapid growth in sustainable living standards, then the measure of progress must extend beyond GDP. The 12th Five Year Plan already includes some twenty indicators of social and environmental progress, and this is definitely a

step forward. The idea should be to define a measure or measures that not only capture progress in living standards, including incomes, quality of life, health, social security, and the environment among others, but also capture progress toward sustainability, namely the stock of physical, human, natural social, and global (goodwill) capital that is passed on to future generations. Such measures are particularly important in guiding the actions of local governments that have competed fiercely with one another solely on the basis of GDP growth — and has been one of the key reasons behind many of China’s successes but also has been the source of many shortcomings in its economic performance. By altering the measure of progress, this inter-local government competition could once again be turned in a healthy direction.

Conclusion

Much of the current debate on China is focused on whether the recent growth slowdown is a sign of imminent failure in its growth model, and discussion of future reform priorities tends to be focused on rebalancing its external current account surplus and its associated savings-investment gap. I find these unduly alarmist and narrow. Nevertheless, an examination of China’s medium-term prospects does indeed reveal concerns about the sustainability of the current growth model over the next few decades. To achieve rapid growth of sustainable living standards in the next several decades, China will need to adopt an altogether different growth model — one with a broad-ranging yet coherent agenda of market reforms to increase efficiency and innovation with substantially increased emphasis in building the stock of human, physical, natural, social, and global (goodwill) capital to ensure greater sustainability for the benefit of future generations. The emphasis in such an approach is a shift in the pattern of investment, not necessarily a reduction in its share of GDP (although that could come about as a result of the ageing of the population and the projected rise in the old-age dependency ratio). A careful examination of the reform agenda that emerges reveals a common thread — the need to change the role of government in

the economy so that it “pivots” away from direct involvement in markets, production, distribution, and exchange, and toward better delivery of public goods and services including the legal, regulatory, and incentives framework for private sector development consistent with long-term sustainability together with a greater emphasis in fiscal policy toward social and environmental (including climate change) priorities.