

CHINA

Changes in development model?

China has unveiled an ambitious five-year plan. How likely is it to succeed? What might derail it?

Angélica Wiederhecker, Beijing, China

When Jeff Immelt, chairman of General Electric, the world's largest manufacturing company, rose to speak at a dinner in Rome last year, he captured the growing disillusionment of some companies about China. Previously, corporate America had been a staunch defender of closer ties with Beijing but, Mr. Immelt told his audience, "I am not sure that they want any of us to succeed."

India, too, has had tense commercial disputes with China recently, even banning (temporarily) Chinese producers of telecoms equipment from operating in India. And where once only Washington made an issue of the Chinese currency, other countries have begun to express concerns that the yuan is significantly undervalued. Dilma Rousseff has signaled that the Chinese exchange rate has risen on Brazil's economic agenda. As the global economy still limps along, there is omnipresent potential for battles between China and many of its economic partners over exchange rates and other economic policies.



Photo: Roberto Stuckert Filho/PR

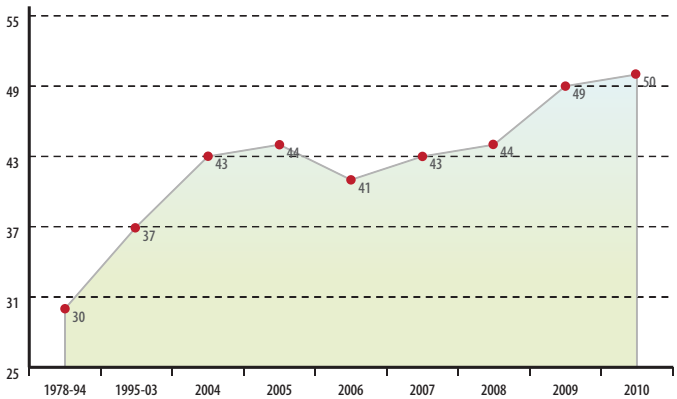
Chinese President Hu Jintao meets President Dilma Rousseff.

The good news

Beijing is aware of the dangers. Its leaders have talked for several years about the need to alter the country's growth model to reduce reliance on exports and boost domestic consumption, which will also stimulate demand globally. In its new five-year plan, for 2012–2016, Beijing has detailed a road-map to restructure the economy that will, Chinese leaders

While the global economy still limps along, the potential for battles between China and many of its main economic partners over exchange rates and other economic policies is omnipresent.

CHINA: INVESTMENTS (% OF GDP)



Sources: World Bank and Pivot Capital.

In recent years, it has become clear that China was relying too much on a growth in exports that could not be continued without political backlash.

hope, create more sustainable growth and deliver more of the fruits of that growth to ordinary people. Their goal is to profoundly rebalance the Chinese economy not only in relation to the rest of the world but also internally, between manufacturing and services and urban and rural areas. If they are successful it will go a long way to relieve international economic tensions, regardless of what happens to the exchange rate.

The bad news

The plan will be extremely hard to implement. China's leaders have been working for years on similar proposals, with limited results. To engineer a significant shift in the pattern of growth, the top leaders in Beijing will need to rein in deeply vested interests, from provincial governments to state-owned companies.

"The document sends a direct and unambiguous message to provincial governments that they should shift from a focus purely on growth to broader economic and social considerations," says Eswar Prasad, a former IMF official now at Cornell University in the US. "But it is not clear that incentives facing provincial governments can be shifted easily."

The context

To make the case that China needs a new growth model might seem surprising given the country's recent success. The economy has grown at double-digit rates for over 30 years, even at a time when the global financial crisis had pushed most OECD economies into a deep slump. But in recent years it has become clear that China has been relying too much on a growth in exports that could not be continued without political backlash. It also depends too heavily on investment rates, which are becoming dangerously high. During its capital-intensive high-growth period in the 1960s

and 1970s, Japan was investing about 40% of GDP; in China in recent years investment has been closer to 50%. China's growth model, Premier Wen Jiabao himself has said several times, is "unbalanced, uncoordinated and unsustainable."

China has put boosting consumption at the center of the 2012–2016 plan. The growth target has been lowered to 7% a year, a stentorian statement that the authorities want to slow the pace of expansion. The plan also calls for household incomes to expand more quickly than growth. "We must make improving the peoples' lives a pivot that links reform, development, and stability," Wen Jiabao told this year's National People's Congress, where the new plan was first aired.

The plan calls for expansion of the services sector from the current 43% of GDP to 50% by 2015. Officials say they also want to raise basic prices of land, energy, labor, and capital, whose low cost is the reason for high investment. A main idea is accelerated urbanization: by integrating ever-larger numbers of rural migrants into city life, planners hope to boost consumption while making sure the real estate and infrastructure sectors do not collapse.

The chances for success?

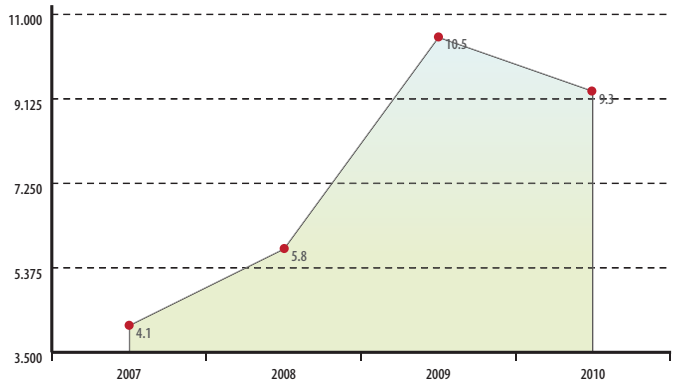
Despite the detail of the 5-year plan and the size of the planning bureaucracy that produced it, China is no longer a planned economy. In areas like energy, different arms of the state do control investment, so the targets for nuclear power and energy efficiency may be realizable. But economic planners do not have the tools to simply switch on more consumer demand and stop relying on public investment. That will require a much more complicated set of policies—one that will challenge some of the Chinese Communist Party's biggest vested interests.

A major battleground will be the financial system. Chinese households have $4 trillion in bank deposits, which currently earn negative real returns and at the best of times have enjoyed only very modest returns. The effect has been to repress household spending while providing an enormous incentive for investment-heavy economic growth. A real interest rate just 1 or 2 percentage points higher than its long-run average would be a highly effective way to increase the incomes of hundreds of millions of Chinese families.

Unfortunately, for the past two years Chinese state-owned companies and local governments have been on a borrowing spree to finance post-crisis stimulus spending, which came largely in the form of bank credit rather than fiscal spending. New bank loans doubled in 2009 and almost did so again in 2010. Considerably higher interest rates would put enormous pressure on

For all the detail of the 5-year plan and the large planning bureaucracy that produced the document, China is no longer a planned economy.

CHINA: NEW BANKING LOANS (Yuan trillions)



Source: Fitch.

Even though state-owned companies recorded substantial headline profits between 2001 and 2008, they would have operated at a loss if it had not been for subsidized credit and low-cost land.

many lenders and could provoke a financial crisis for many local governments. As for state-owned companies, a recent study by the Unirule Institute of Economics, a Chinese think tank, found that even though they recorded substantial headline profits between 2001 and 2008 they would have operated at a loss but for subsidized credit and low-cost land. While annual financing costs for private companies were 5.5%, state-owned companies paid only 1.6%. Arthur Kroeber, head of the Dragonomics consultancy in Beijing, says, "If the authorities cannot create a system that allocates capital more efficiently, it will be difficult to maintain high rates of growth."

The Chinese central bank has been pushing for years for more liberal interest rates on savings accounts, which are currently set by the authorities, so that depositors can get higher returns. It has been forcefully opposed by the large state-owned banks, which would lose the 3 percentage point spread they currently enjoy between deposit and lending rates—and possibly lose their profitability.

Today many Chinese politicians might be even more reluctant to reform a banking system that seems to have served them well during the crisis. The government's ability to instruct banks to ramp up lending as the crisis hit made it possible for China to ride out the storm. Reformers argue that direct government control of financing is not suitable in less turbulent times and that gradual liberalization would improve the efficiency of bank lending, but the crisis has made such arguments a much harder sell in Beijing.

The same vested interests have spoken out loudly in the debate over corporate dividends. Until recently state-owned companies did not actually pay dividends even though some of them

– such as the Industrial and Commercial Bank of China, China Mobile, and PetroChina – are among the largest companies in the world. Reformers have long argued that these companies should pay dividends so that, among other reasons, the funds could be channeled into increased social spending. "If state-owned companies do not pay dividends, it is essentially creating unfair competition for private companies. They can pay higher salaries and reinforce their dominant position in the market," says Tang Min, secretary-general of the China Development Research Foundation in Beijing. After a long political battle, state-owned groups finally began to pay dividends two years ago and the rate has risen this year. However, most of the money goes to the government body that manages state-owned assets for investment in other such groups rather than to social spending. Thus the dividends do not actually leave the state's coffers.

Where to find efficiency?

Although boosting services is a central part of the blueprint for changing the pattern of growth, most service industries are dominated by powerful state-owned companies. However, logistics is one area with huge potential efficiency improvements. At present, the logistics system in China is dominated by regional monopolies. By gradually breaking up those monopolies, the cost of moving goods by road could drop sharply, which would also open the way for big investments in new logistics operations. Government officials also see considerable potential for expansion in tourism.

But the telecoms industry is controlled by three huge companies that will fight fiercely against any threats to their domination. Financial services are also dominated by bloated state-owned firms with enormous political influence. China has a large informal banking sector, which is especially active in the east coast provinces. Reformers have lobbied for over a decade that such underground banks be legalized – a vital step toward expanding access to cheaper and more reliable bank credit. All such moves so far have been blocked. Media is another sector where growth could be rapid if restrictions were lifted. There is huge untapped demand for new television programs, magazines, and films. But tight control of the media is key to the Communist Party's monopoly on political power.

Promoting internal migration

Perhaps the most politically sensitive part of the 5-year plan is a commitment to reform the hukou, the household registration system that divides rural and urban residents. One of the defining features of modern China, because of the hukou tens of

Perhaps the most politically sensitive part of the 5-year plan is the commitment to reform the hukou, the household registration system that divides rural and urban residents.

The most powerful reason for skepticism about the plan is that all its priorities —boosting household income and consumption, reducing inequality, rebalancing the economy away from exports — were central themes of the previous 5-year plan, yet for most of them, performance was actually worse.

millions of migrant workers who have moved from villages to work in factories or construction sites are not treated as permanent city residents and have no access to urban schools and other social benefits. Because these migrants have little stake in the cities where they live, they save their salaries to send home. Phasing out the system as planned would transform these workers into permanent residents who buy houses and bring their families to the city. It would provide a great impetus behind the urbanization drive at the heart of the 5-year plan.

But reform of the hukou system requires a huge reform in core political arrangements related to local governments and land. The reason migrant workers are not entitled to many services is that local governments cannot afford to provide them. Local governments in China must rely on direct funding from the government in Beijing and revenues from one-off sales of land to property developers. Although Shanghai and Chongqing, a city in central China, have begun to tax property modestly for the first time, Beijing has backed off plans to introduce bigger property taxes across the country for fear that would depress the housing market. Creating a sustainable source for financing local governments will be one of the thorniest political issues over the next decade.

To reform the hukou system, Beijing also needs to look at the other end of the process, the land that migrant workers hold in their home villages. Under China's complicated land system, individuals can have legal title to property in cities but not in the country. Families in rural areas, almost all of which have a small holding as a result of land reforms in the 1950s, can lease the land to other farmers but not sell it or use it as collateral. This is another obstacle to permanent urbanization.

State ownership of farm land is another hugely sensitive political issue that goes to the heart of Communist Party orthodoxy. At a party congress in 2008 Hu Jintao appeared to have won support for a proposal to allow farmers to sell their land, but he was inexplicably forced to backtrack. "If we are to end the apartheid that is the hukou system and create better-quality urbanization,

The BRICS: Uneasy partnership

Because the BRICS group of developing economies has been accused of lacking a purpose, the Chinese hosts of this year's meeting tried to inject some geopolitical substance into the proceedings. (The group, then consisting of Brazil, Russia, India and China, was named by a Goldman Sachs economist. It has now added South Africa.)

Beijing had seemed somewhat aloof from the previous two annual BRIC summits. Yet before the April summit in Hainan island, off the south coast of China, Beijing officials worked hard to boost its status. Some even talked of establishing a permanent BRICS secretariat, the first stage in institutionalizing the grouping.

"In the past, the emerging powers acted individually and were often unable to effectively meet the challenges from the West. Now they can coordinate their policies and movements more efficiently," said Yang Jiemian, head of the Shanghai Institutes for International Studies and a leading supporter of a more foreceful BRICS platform. At China's behest, the summit criticized the military campaign in Libya—an attempt to clip the wings of the UK, France, and the US.

Beijing sees the other BRICS countries as useful allies to deflect pressure from western nations, as became clear during the Copenhagen climate change summit. With the US seeking allies for its campaign to lobby China to strengthen its currency, Beijing is even keener to create a closer bond with the other BRICS countries.

Brazil also used the summit to score geopolitical points, lobbying for a statement in favor of expanding the United Nations Security Council. The summit was also a chance for the other countries to press Beijing on bilateral economic issues. India pushed for greater access to the Chinese market for its pharmaceuticals and IT companies. Brazil warned Beijing about mounting complaints from trade unions and industrial groups that have led Brasilia to introduce a large number of anti-dumping measures this year against Chinese goods.

Brazilian officials also lobbied on behalf of Embraer, the aircraft manufacturer whose request to build its E-190 jet at its joint venture plant in China was recently rejected by Beijing. The Chinese argued that the E-190 would compete with their own plans to build regional jets. For China, the call for a stronger BRICS voice only goes so far.

we need a package of policies that addresses both local government finances and land reform," says Tao Ran, a land issues expert at Renmin University in Beijing. "But there has been little progress during the Hu-Wen administration."

Speed zone ahead

The next 5-year plan will be introduced just as a new generation of leaders takes office. The general assumption is that during 2012 and 2013 Xi Jinping will replace Hu Jintao as head of the Communist Party and president of the country and Li Keqiang will succeed Wen Jiabao as premier, in charge of day-to-day government business. Lacking any formal power base, the new leaders will need first to build up their own support within the party and the bureau-

cracy, which could make them overly cautious for the first few years. Caution is not inevitable; Hu and Wen were able to use the SARS outbreak in 2003, just before they took office, to stamp their authority on the party apparatus. But at the start it will not be easy for the new leaders to make politically difficult decisions.

The most powerful reason for skepticism about the plan, however, is that all its priorities —boosting household income and consumption, reducing inequality, rebalancing the economy away from exports — were central themes of the previous 5-year plan, yet on most of them, performance has actually been worse. And while the central government targets annual growth of 7%, the plans of Chinese provinces forecast a collective growth rate of 11%. Local governments, it seems, are betting that the public investment spree will continue. "Maybe the government this time round will force through the necessary rebalancing," says Paul Cavey, economist with Macquarie Research in Beijing. "But the experience of the last few years suggests we cannot be sure these aims will be fulfilled."



Photo: Antônio Milena/ABr

Beijing.