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Is China transitioning to a lower growth plateau?

By M. Bertoldi and A. Melander

Summary

China's economy slowed significantly in the first three quarters of 2012 and questions have been raised on a possible hard landing. While recent early indicators have shown signs of improvement in the most recent months, it is essential to understand what is driving this slowdown and how lasting it may be given China's importance as an engine for global growth. Is the Chinese economy experiencing just a "temporary malaise"; is it at the beginning of a sharper and more prolonged downturn; or is it in a transition to lower but still sustained growth rates?

It is generally recognised that the current growth model "with growth at any cost" is no longer a viable option. While it raised hundreds of million people out of poverty it also proved too dependent on external demand and investments, gave rise to economically and social tensions, generated rapidly growing inequalities and vast environmental costs. The 12th five-year plan that was adopted in 2011 makes a good case for reforming the Chinese growth model. That would imply that GDP growth should be increasingly driven by domestic consumption and the services sector. Such a transformation would also provide an important contribution to the rebalancing of global growth. Therefore the real issue in the coming years will be the speed of the transition. Since there is a lot of inertia in the Chinese economic system a too gradual reform process may not succeed in changing the growth model. Decisive policy action is therefore needed to ensure a successful transition.

1. Introduction

China's economy slowed significantly in the first three quarters of 2012. While partly policy induced, the deceleration has proven sharper than authorities' expected. GDP growth has decelerated to less than 7½% year-on-year in the third quarter of 2012. In order to gauge to what extent China can be expected to continue to lead global growth in the coming years, it is essential to understand how much of this slowdown is of a temporary and cyclical nature, and how much of it reflects structural shifts.

With the outlook unusually uncertain, this note is articulated around three possible medium-term (five-year) scenarios: the 'temporary malaise', the 'tip of the iceberg', and the 'lower plateau'. The aim is to review cyclical and structural factors behind the current slowdown and to discuss possible evolutions of the Chinese economy over the medium-term.

- Should the current slowdown be only a "temporary malaise", mostly determined by the sluggish growth in advanced economies and an adjustment in the housing market, by 2013 GDP growth could rebound to levels close to 9% per year.
- Should instead the Chinese growth model be broken and the 2010 and 2011 rebound have been its "last hurrah", then growth may well move rapidly below 7% (the tip of the iceberg scenario).
- Finally, the slowdown could be the result of a combination of some negative external developments and the efforts by Chinese policymakers to move to a different and more sustainable growth model. In such a case (the lower plateau scenario), it could be expected that there would be an effort to stabilise growth around the current levels and China would grow between 7% and 8% in the coming years.

While most China watchers appear optimistic about the country's capacity to adjust and would be arguing either for the temporary malaise or the lower plateau scenario, some of them are also pointing to more substantial risks ahead, which could significantly dent the growth path of the country over the next years.

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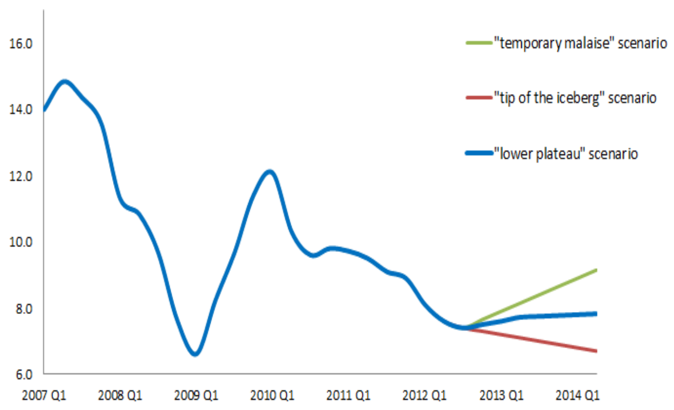
2. Factors driving the 2012 slow-down

The Chinese economy slowed significantly in the last twelve months. Growth in 2011 was still 9.3% (down from 10.4% in 2010), but for 2012 it is expected to have been just above 7½% (see Figure 1).

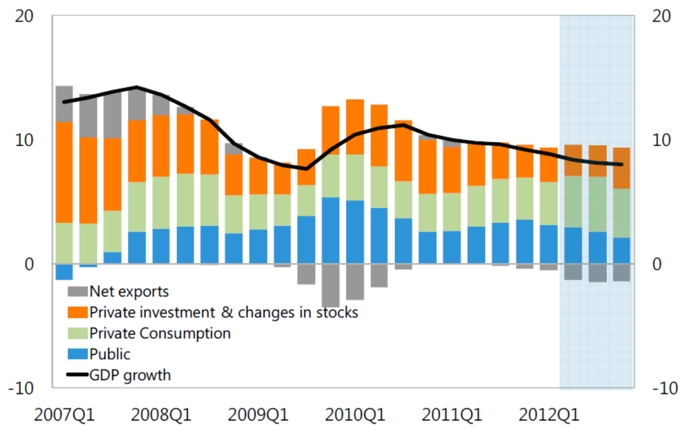
Figure 1: China's GDP growth



Source: National Bureau of Statistics of China.

The quarterly profile shows that the slowdown has been steady and continued over four quarters[1]. Most of it was determined by a tightening of credit conditions until mid-2012 (in response to relatively high inflation and the possible threat from the real-estate bubble) and weak external demand, (see Figure 2), in particular from advanced countries. On the other hand, domestic consumption and investment remained strong. In 2012 real investment is expected to have grown close to 9%, somewhat lower than 2011 (10.5%) mostly due to a weak performance of the housing sector, while consumption growth should have accelerated to 10%, slightly up from 9.7% in 2011. As a result, domestic demand growth was more than 2 percentage points (pps.) higher than real GDP growth. This was already the case in 2011 (by 1 pp.), but is a quite rare event over last thirty years.

Figure 2: Contributions to China's GDP growth



Source: IMF staff calculations.

If sluggish export growth was one of the main contributors to the weakening in China's economic growth, short-term policy measures also played a key role. Since 2010 China had to confront two related challenges: (1) relatively high inflation, which was well above the 4% safety range (it peaked at 6.5% in July 2011), due mostly to a rise in commodity prices and, in particular, in food prices; and (2) overheating in the real-estate sector. To address them, authorities relied mostly on monetary-policy and administrative measures. The objective was to cool economic growth after the macro-economically effective, but micro-economically more problematic, counter-cyclical stimulus of 2008-2010 (see Box 1). The People's Bank of China (PBoC) raised interest rates three times in 2011 and hiked banks' reserve requirement ratio (RRR). As a result, credit growth slowed significantly from a peak of 29% in early 2010 to 16% in May 2012, and in the same month inflation moved below 3%. The housing market also cooled significantly and by the summer of 2012, both inflation and housing prices had moved back in the authorities' comfort zone.

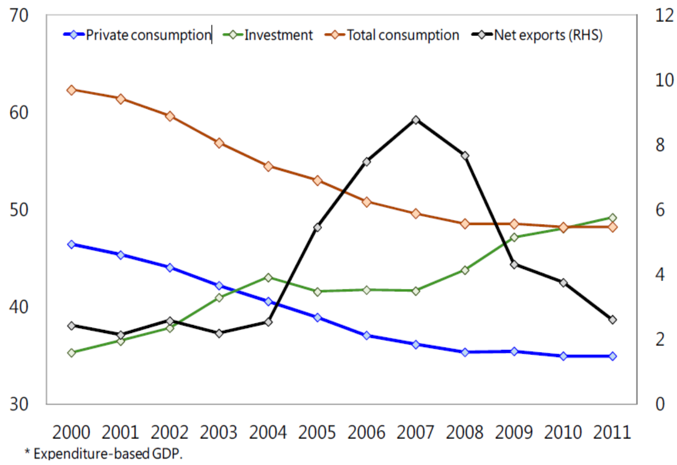
However, by then the impact of monetary tightening had spilled beyond commodity markets and the real-estate sector. China's PMI moved in negative territory already in March/April 2012 and remained negative until October when it edged up to just above the 50-treshold, suggesting a "stabilisation" and a possible improvement of manufacturing activity ahead.

Developments on the consumption side have been moving in the right direction (with consumption making the largest contribution to growth this year), but the pace of rebalancing is still slow. The consumption share on GDP is still well below 40% (see Figure 3) and growing only modestly. Since the extension of safety nets is

[1] Chinese economic data must be interpreted with due caution as time series are not (yet) always long, robust or reliable. The remainder of the note will present data 'unrounded' to mirror what is available in the public, whilst recalling that while they appear precise, they should be interpreted with a pinch of salt.

taking place gradually, precautionary savings are on a moderate downward trend only. The tightening of the labour market is contributing to strong wage dynamics: real-wage growth accelerated in Q3 (up 14.3% y-o-y for rural wages and 10.3% for urban wages in Q3, from 13.6% and 9.3%, respectively, in Q2), which ought to bode well for consumption growth ahead. However, this has so far not been sufficient to fully compensate for the weaker momentum on the investment side and the adverse effects of advanced countries' slowdown on Chinese exports.

Figure 3: Consumption and investment / GDP

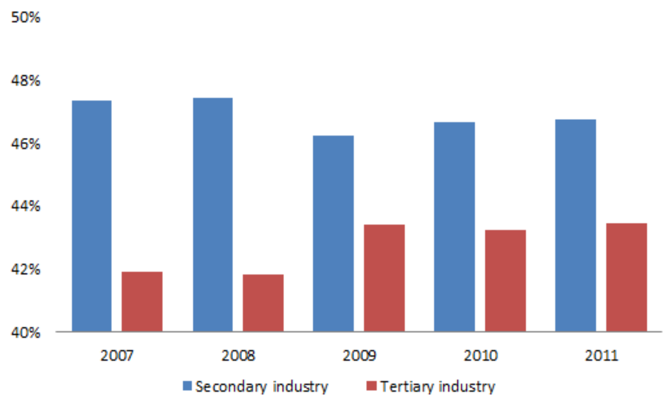


Sources: CEIC; Haver Analytics; WEO; and IMF staff calculations.

China's structural "rebalancing" may also have taken a toll on growth. Looking at the supply side, (i) the shifting to higher value-added productions in the manufacturing sector and (ii) the fostering of the services sector may have slowed activity. Higher value-added productions in the manufacturing sector should in principle support an acceleration in growth, but in the case of China this would not automatically be the case. This is because many of the heavy industries continue to show strong economies of scale. Therefore, if the shift takes place essentially from heavy industries to high-value added productions, the immediate impact may be a deceleration in the growth rate rather than acceleration.

With regard to services, the slow increase in the share of the services sector had already started under the previous five-year plan, but the target was missed by almost 2 pps of GDP (43% instead of 45% of GDP). A faster growth of the service sector, while strengthening the sustainability of the economy, may weigh negatively on headline GDP growth initially, since in emerging economies productivity growth in the services sector is usually lower than in manufacturing. There are now signs that the weight of services has increased in the last five years (see Figure 4) and services have grown faster than manufacturing. As a result, these developments in the service sector, while welcome, may have slightly dragged down the headline growth of the country.

Figure 4: Secondary and tertiary sectors / GDP



Source: National Bureau of Statistics of China

Chinese authorities were taken aback by the strong weakening of growth and have shifted their main policy objective from "fighting inflation" to "steady growth" in 2012. Indeed, uncertainty surrounding growth in the main advanced economies as well as the slowdown in some emerging-market economies increased the risk of policies turning pro-cyclical. This is why in early June 2012 the PBoC reversed monetary policy to the easy side (since then rates have been cut two times, by a cumulative value of 56 basis points), while discussions about a possible targeted stimulus on the fiscal side started as early as spring 2012 (including speeding up the approval process by the NDRC of different types of investments and a certain increase in infrastructure investment later in the year).

While it seems unwarranted to conclude that China's slowdown in the last year was led by a structural shift in the growth model (or by policies that would secure such a shift, even if orientations are clearly in "the right direction"), it is unlikely that only cyclical factors were at play. Looking forward, China cannot continue on the path set in the past recognising that the current growth model with "growth at any cost" is no longer a viable option (see Box 2). The technological frontier is no longer far away and there is a need to move towards a different and more innovative economy, changing the label "made in China" to "designed in China", not least due to rising wage costs[2]. Therefore, looking forward,

[2] The demographic dividend is in fact set to reverse, with labour supply starting to shrink a few years from now, with the excess of "easily employable persons" in the agriculture sector largely absorbed. Moreover, the impact of China's household-registration (or hukou) system, which implies that migrant workers do not have the same rights of urban citizens in edu-

the key issue will be the pace of the reform process. Depending on it, different evolutions are possible for the Chinese economy.

3. Scenarios for the Chinese economy and policy implications

At the crucial moment of the change in China's leadership[3], various factors have been pulling the Chinese economy in different directions. Against this background and when looking ahead, we see the possibility of three different scenarios: (1) the temporary malaise, (2) the tip of the iceberg; and (3) the transition to a lower plateau.

3.1. The temporary malaise scenario

If the slowdown of 2012 was mostly due to cyclical factors, the economy should be able to progressively come back on a relatively strong track (i.e. close to or above 9%). A moderate acceleration in global growth expected for 2013 and the stimulus measures adopted by the Chinese authorities during 2012 should allow for a rebound of the economy.

In such a scenario, the transformation of the growth model would proceed at a relatively slow pace: i.e. the rebalancing between consumption and investment[4] would be a long haul. The export sector, possibly helped by exchange-rate policies with the Yuan deemed "moderately undervalued", would regain some of the ground lost because of weak external demand and the current-account surplus could move from the current 2.5% of GDP to around 4%-4.5% over the medium term (IMF (2012a)). The main objective of the financial sector would remain the financing of investments by the corporate sector and financial-sector reform would proceed slowly.

Against this background, the below 8% growth of the Chinese economy in 2012 would have been only a temporary malaise, promptly addressed by an appropriate policy-mix. The Chinese growth model would continue to evolve towards a different composition, both on the demand and the supply side, but the pace of adjustment would be similar of that of the previous five-year plan (i.e. very gradual). In this seemingly benign growth scenario there would not be a significant break, but a relatively seamless transition to a slightly less imbalanced growth model, which would continue to rely heavily on investment and exports and, as such, be subject to a higher degree of risk and volatility as well as inflationary pressures.

This gradual rebalancing is possible, but far from risk free. The most likely development under the temporary malaise scenario is instead that significant vulnerabilities build up and, in a few years' time (by 2015 or 2016), China "hits the brick wall" (see Box 2). Therefore, over the five-year horizon we are considering, there are non-negligible risks that the recovery from the temporary malaise through a pick-up in investments and exports will not bring the Chinese economic system back to a strong and sustainable growth path. Rather, structural problems will become increasingly intractable and ultimately break down the growth model, triggering a rapid correction of imbalances causing a sudden and sharp slowdown in economic activity.

3.2. The tip of the iceberg scenario

According to some commentators who focus mostly on the structural weaknesses of the Chinese economy, the 2012 slowdown could have just been the tip of the iceberg which sank the Titanic. Against this background and instead of recovering in 2013 and 2014, the Chinese economy would continue to weaken and move to growth rates below 6% (or even much lower, with unforeseeable social and political consequences). Domestic and external headwinds could cause a markedly weaker economic performance. A toxic mix, fuelled by the euro-area sovereign-debt crisis, US fiscal woes, and negative developments in emerging-market economies, would trigger the materialization of domestic risks that are so far under control, bringing the economy on a tailspin.

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cation or heath care, combined with the Government's "going west" policies, make it more interesting for potential migrant workers to stay near their place of origin (and registration). Nevertheless, "urbanisation" is a mega trend that is expected to continue to influence China over many years to come in view of the still sizeable rural-urban income differences.

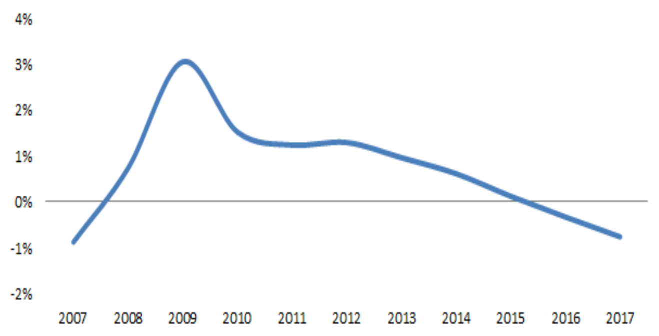
[3] The change in leadership, which since the early 1990s takes place every ten years, involves all top echelons of the Party, Army and Government. The 18th Party Congress in November 2012 appointed, as expected, Xi Jinping as the new Secretary General of the Communist Party of China (CPC) as well as head of the Central Military Commission; at the same time, the party selected a new Politburo of 25 persons and its important Standing Committee (down to 7 from 9 persons) being the key decision-making body at party level. The leadership transition for the Government will instead take place only later this year, as the new country's leaders have to be appointed by the plenary session of the National People's Congress, scheduled in March 2013. At that occasion, Xi and Li will replace Hu and Wen as President and Premier of China, respectively.

[4] Such a rebound of investments could for instance be driven by the government's wish to further foster developments in the inland / western regions of the country, where income levels are significantly lower than in the coastal / urban areas (whilst noting that the marginal efficiency of some of the (local) investments have been called into question). In addition, local governments have recently resumed investments in infrastructure after a clampdown in 2011 and the start of 2012. Finally, SOEs have increased investments in response to rate cuts by the PBOC.

This could happen through a banking crisis that, starting at local level, would spread to the entire banking sector. The lending binge of the 2008 stimulus package undoubtedly caused a sharp increase in debt levels. As some of these projects are of a medium-term nature, the loans are currently being rolled over (a common feature in China, where the local authorities basically can not issue bonds, but have to use short-term bank loans also for infrastructure projects etc.). When assessing how 'viable' these projects are, there are some predictions that the share of non-performing loans (NPL) could go up sharply, in particular in presence of a marked slowdown in growth (although the systemic risk is still deemed "under control" and the NPL ratio remains at a low level according to the head of China's banking regulator)[5] . While in a comparative perspective China's debt level is still relatively low[6] , if contingent liabilities are included and unsubsidised rates of return are taken into account, some analysts consider that the total amount of debt exceeds the value created by the debt if credit quality deteriorates and this could trigger a systemic crisis.

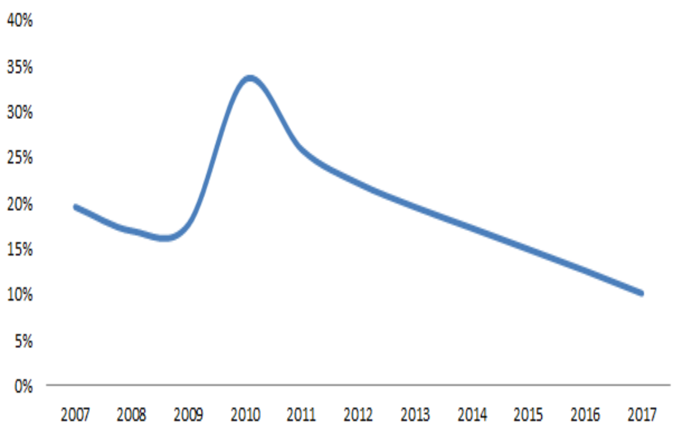
Political constraints in "managing change", as well as policy mistakes, could also play a key role in the tip of the iceberg scenario. The Chinese authorities currently have ample room for manoeuvre both on the fiscal and the monetary side to counter systemic risks, should they arise[7]. However, powerful interest groups and broken local governments could steer policies in the wrong direction, creating a boom-boost cycle that would make things worse and bring the economy to a standstill. Peking-University Professor Pettis (who is among if not the most pessimistic China watcher), argues that a rebalancing of the Chinese economy may well happen, but in a "quick, catastrophic way". His baseline scenario foresees a sudden correction when imbalances become unsustainable (which could be quite soon). In such a case they would be set to reverse their course and would follow a dramatically different path, pointing to a growth rate of closer to 3% per year going forward. In such a case, China would become another emerging-market economy stuck in the "middle-income trap"[8] .

Figure 5: General government deficit as % of GDP



Source: IMF - World Economic Outlook.

Figure 6: General government debt as % of GDP



Source: IMF - World Economic Outlook.

[5] At the 18th National Congress of the CCP, the Chairman of China Banking Regulatory Commission, Mr. Shang Fulin said that "the banking system's risk is under control and the NPL ratio remains at a low level". Moreover, bank lending is not concentrated on any high-risk investment projects, and most of the loans have mortgage guarantees. Anecdotal evidence would suggest, however, that the NPL ratio may be much higher than the reported 1%, but still low in an international comparison.

[6] According to Standard Chartered, China is still leveraging with total debt level expected to rise to 206% of GDP by the end of 2012 (up from 191% end 2011), but still well below the average debt ratio of 315% in developed countries. Standard Chartered estimates based on a public debt of 58% of GDP, consumer debt of 19% and a corporate debt of 128% of GDP. While the upturn in credit growth may have been essential to the recent turnaround noted in activity, the increased leverage does carry some risks – should there be a deterioration in credit quality; problems associated with local government's investment vehicles or a too rapid expansion of the shadow banking system – in combination with a more pronounced economic downturn.

[7] Inflation at the end of 2012 was below 2% and, in response to this development; interest rates sets by the PBoC have been lowered. In addition, China has more than 3 trillion US$ in currency reserves that, should it become necessary, can be used to bail-out the banking sector. On the fiscal side the deficit is low (about 1% of GDP) and the debt on GDP ratio (22%) is also quite low compared to other emerging market economies (see Figure 5 and 6).

[8] The Asia 2050 report by the Asian Development Bank (ADB) outlined two scenarios. One of them, the "middle-income trap" scenario, illustrates a close to perfect storm in which bad policies, lax supervision, natural disasters, conflicts and weak governance would lead to a major setback for Asian growth. In such a scenario, countries like China would not be able to make a timely transition from a resource-driven growth (based on low cost input factors) to a productivity-driven growth. By 2050, China's share of global GDP would be a mere 11%; half of the potential 22% China could obtain under the favourable "Asian century" scenario. In the "middle-income trap" scenario China would no longer be leading, but lagging global growth.

3.3. The transition to a lower plateau

The transition to a lower growth plateau that would keep Chinese growth between 7% and 8% over the coming five years could happen for two reasons: (1) the transformation of the growth model, and structural problems, as well as developments concerning the accumulation of capital and the dynamics of the labour force would not allow China to return on the growth path of the last thirty years; or (2) while it would be possible to return to the previous growth model (at least in the short-term), Chinese policymakers choose deliberately not to do so, in order to accelerate the transition to a more sustainable one.

3.3.1. A transition driven by structural factors

In recent years there have been important structural changes related to the reorientation of the growth model towards consumption and a lower reliance to investment and exports. In addition, some structural problems have deepened and there are signs that the growth potential may be slowly declining. If the trends that we have seen in 2010 and 2011 rapidly strengthen in the years to come, with consumption significantly exceeding GDP growth and consumption as a share of GDP becoming larger than investment in only a few years, China cannot continue to grow close or above double-digit levels.

Progress in the reorientation of the Chinese growth model towards consumption through, for instance, the strengthening of social-safety nets, is taking place and should not be underestimated. The establishment of a comprehensive coverage of the pension system launched in 2009 and to be completed by 2020, and the development in recent years of a basic health insurance scheme (that according to the OECD now covers 95% of the population) are major achievements, which should reduce future precautionary savings if entitlements are improved. These developments would also reorient part of government resources towards the needs of the population rather than those of the (state-owned) companies.

Structural problems and bottlenecks should not be underestimated either. The pre-crisis Chinese growth model has reached its limits in terms of environmental costs and intensive exploitation of natural resources. In addition, more inclusive growth is needed to deal with rising inequalities, especially between coastal and inland (or rural / urban) growth. The strong dynamics of investment has given rise to over-capacity and the capacity utilization rate has fallen to very low levels (60% in mid-2012 compared to 80% in 2007, see IMF (2012a)). State-Owned Enterprises (SOEs) continue to be at the forefront of investment, although some of it is not based on economically sound decisions but rather follow from distorted incentives that push these firms to overinvest (see Box 1). The rapid increase in lending, which was part of the 2008-2009 stimulus, has increased the risks to bank-asset quality. Last but not least, the real-estate sector is both an opportunity and a major risk to China's model of development. All these factors are presenting a threat to economic and social stability, and might ultimately spill-over to political instability[9].

There are however several problems with this narrative of the transition a lower plateau: (1) China has not reached yet the Lewis turning point [10] (although it may not be far from it); (2) despite very high investment rates, China per-capita capital stock is still low, and therefore there may be room for a sustained investment dynamic for a while; (3) because of the high level of investment in the aftermath of the global crisis there is a significant output gap; and (4) data seem to confirm that the main drivers of growth slowdown in 2012 were weak external demand and short-term measures to deal with inflationary pressures and the real-estate sector.

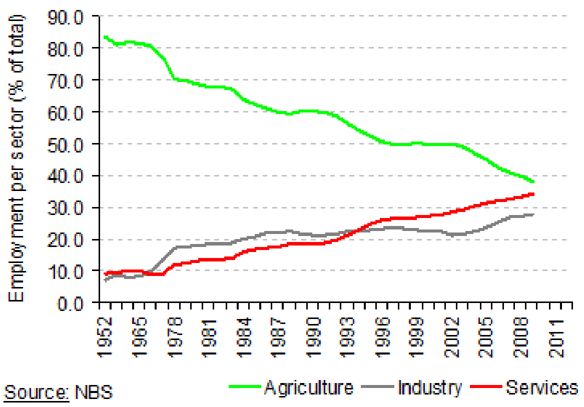
On (1), according to the IMF (2012a) or Deutsche bank (2012), China will continue to benefit from excess supply of labour through 2020. Its excess of labour is currently estimated at around 150 million units and will decline progressively. Therefore, the Lewis turning point will be reached only between 2020 and 2025. However, other studies point to the adverse impact of the hukou system on mobility combined with the declining labour-force participation among older workers (World Bank-DRC, Cai et al., Garnaut) would suggest that the "endless supply of cheap labour" is in fact

[9] According to Yu Yongding (2012) "China has un unsustainable growth pattern. It will have to pay a cost in the form of slower growth. This cost will have to be paid and sacrifices will have to be made. I hope that the Chinese government holds its nerve and continues with its current approach despite the slowdown. Certainly, in responding to changes in the economic situation, it can and should make some policy adjustment to ensure a necessary pace of growth, but if it launches another stimulus package at the expense of readjustment, we will be in big trouble in three to five years' time. China may now have entered a longer-term adjustment period of five years, during which the economy may struggle with relatively slow growth at an average rate of 7 percent, just as we planned in the Five Year Plan … However, I have no doubt that, if the government succeeds in this adjustment, China will have another decade or two of growth beyond 8 percent." (p.44)

[10] The "Lewis turning point" describes a particular stage in the economic development of emerging / developing countries: when excess labour in the agriculture sector is (close to) fully absorbed in the industry further capital accumulation begins to cause a more sustained and rapid increase in wages. This model has recently gained wide circulation in the context of economic development in China.

dwindling more rapidly. Such developments could indicate that the turning point is much closer, since a large share of the population still in agriculture is quite old and lacks the skills to convert to manufacturing activities. In the horizon period we have implicitly adopted of about five years, it is likely that the transfer of active population from agriculture to manufacturing and services will continue to support growth, although the contribution will rapidly decline and it is unlikely that it will be able to curb the significant positive wage momentum that has surfaced since 2011.

Figure 7. Employment per sector in China



With regard to (2), per-capita capital stock is still lower than that of countries that experienced strong growth at a similar stage of development (Japan, Taiwan, Korea, etc.). The growth inflexion point came only at higher levels of per-capita capital stock. [11]

In relation to (3), IMF, using a structural modelling approach, estimates that China's output gap was around 5 percent below potential at the end of 2011. Therefore, there should still be room for the resumption of strong non-inflationary growth, although the composition of growth is crucial in this respect (recalling the soaring inflation witnessed in the first half of 2011). Finally, with regard to (4), a decomposition of the Chinese slowdown in its various components seems to indicate that the main explanatory factors are either of cyclical nature or related to government short-term policy actions to bring inflation down and fighting the potential impact of real-estate bubbles[12].

3.3.2. A politically driven transition

If structural factors do not represent a hard constraint in the short -term[13], transitioning to a lower growth plateau may ultimately become a political choice by the Chinese leadership, even if in itself the 2012 slowdown could have been only a temporary malaise. If a growth rate between 7% and 8% can still ensure low unemployment, reduce risks of overheating, inflationary bursts and real-estate bubbles, contribute to the reduction of environmental risks and avoid the resurgence of embarrassing large external imbalances, the Chinese policymakers may perceive clear political and economic advantages in stabilising growth rates at current levels. In recent months policymakers have laid down the ground and prepared both external observers and the general public to still sustained but lower growth. Outgoing President Hu at the 18th Congress Party called for a doubling of Chinese GDP by 2020, which implies an average annual growth of about 7%, thus in line with the objective of 7% GDP growth on average included in the 12th five-year plan.

While the level of 7% GDP growth is becoming "the new 8%", i.e. the level set in the first decade of this century below which growth should not move over the medium term[14], 8% can become rather rapidly (even if not immediately) the new speed-limit for the Chinese economy. It is important to stress that simply slowing down growth without reforming in-depth the growth model

[11] As former World Bank's Chief Economist Justin Yifu Lin points out "Maddison's estimates show that China's current status relative to the US is similar to that of Japan of 1951, Singapore in 1967, Taiwan in 1975, and South Korea in 1977. GDP grew by 9.2 percent in Japan between 1951 and 1971, by 8.6 percent in Singapore between 1967 and 1987, by 8.3 percent in Taiwan between 1975 and 1995, and by 7.6 percent in South Korea between 1977 and 1997. Mainland China's development strategy after the reform in 1979 is similar to that of Japan, Singapore, South Korea and Taiwan. So, it has the potential to achieve another 20 years of 8 percent growth" (Justin Yifu Lin (2012), p.52).

[12] Point (3) and (4) may appear contradictory, but they are not. China's inflation was driven largely by food prices and the real-estate sector. The aim of monetary authorities in 2011 and early 2012 was to cool down the housing market and avoid second-round effects of the price surge in food prices. The presence of a high output gap can allow for stronger non-inflationary growth in the future, since the rise in food prices was mostly due to bad harvesting mirroring the weather conditions.

[13] It has to be stressed that over the medium term structural factors and widening internal and external imbalances will increasingly destabilise the current growth model, raising the risk of systemic failures.

[14] 8% was the growth rate floor under which a strong policy response could have been expected by the Chinese authorities in the first decade of this century. As pointed out by Shen, Ding and Cheng (2012), "It's becoming clear that China no longer needs above-8% growth. The go-slow policy this year has confirmed that the Chinese authorities are willing to accept slower growth and the challenges associated with it. While views are still divided, the majority of experts and officials agree that China's potential GDP growth rate will fall into the 7%-9% range in the next five years. Though the bottom line of growth will be determined only by the unemployment rate, it seems that government officials are not ready to think about sub-7% growth in the near-term. The policy conservativeness is positive to China's longer term growth, as it leaves more room for policy reform or structural rebalancing" (p.3).

along the lines indicated in for example the "China 2030 report" by the World Bank and the DRC [15] may not be enough (see Box 2). In fact, the key challenge in such a scenario will be how to ensure that an investment slowdown will not translate in lower consumption. In China, investment and consumption are more strongly correlated than generally perceived (with the investment-led growth model being the main driver of employment and wages for years). Therefore, if the lower plateau is obtained by simply putting a break on investment growth, China could again be at risk of hitting the ice berg, albeit at a slower speed than in scenario 1.

3.4. Which scenario will prevail in the short term?

Recent Chinese data seem to indicate that economic activity is strengthening and the weakening of growth that lasted for several quarters would not continue. This makes for the time being the tip of the iceberg a very low probability scenario. Only a perfect storm affecting most Chinese major trading partners could generate feedback loops strong enough to bring the Chinese economy into a tailspin. In addition to that, Chinese authorities would also need to badly mismanage their policy response, since they appear to have both monetary and fiscal space currently (see Figure 5 and 6) to counter a major slowdown.

There is a relatively high probability that the economy rebounds strongly since, in the short term, there are no hard structural constraints for the Chinese economy to return to grow above 8% and even above 9%. It could even continue on its élan into 2014, in particular if monetary and fiscal policies continue to be supportive. In the short term, the political transition, with its focus on the need to ensure support to the new leadership in the party and among the population including through stronger growth, may favour policy continuity over more decisive measures to transform the Chinese growth model at a speedier pace [16]. If the new Chinese leadership opts for short-term consensus and for relative inaction in terms of structural reforms, the conditions are set for a mechanical rebound. Whether the growth rate will be above 8% or above 9% will depend on the international economic situation, since the Chinese growth model would then move back to a stronger dependence on the external sector (with the side effect of higher external imbalances).

The rapid transition to a lower growth plateau can happen, but it must be a deliberate choice upfront by the new leadership. While it would be in line with the stated objectives of the 12th five-year plan (as well as the official declarations at the 18th Communist Party of China (CCP) Congress) and may well ensure economic and social stability over the medium-term, to be successful it requires bold choices and the implementation of a reform agenda that would conflict already in the sort term with powerful established interests within the country (in primis SOEs and exporting industries). Therefore, on balance, while the probability of such a scenario materializing is not small, at this stage, there are no clear indications that the new leadership is ready to embark on this more ambitious, but also riskier and more confrontational policy reform path.

4. Conclusions

Where China is heading to in the next couple of years remains an open question. In the short-term, if the new leadership opts for a slow pace of reform and the global economy is sufficiently supportive, there are no major short-term obstacles for China to return to a growth path close or above 9%, still mostly driven by investment and exports. From an international perspective, in the immediate future this may not be an unwelcome development, given the sluggishness of economic growth in advanced economies and the challenges that emerging market economies are facing. China could continue to be the major engine of global growth for some years, with the hope that, at a later stage, other economies would take up the baton. Still, such a development would further widen China's domestic and external imbalances, with potential destabilising effects and the risk that sooner or later the economy would slow abruptly and in a disorderly fashion. By continuing on the old growth path, it is increasingly likely that the Chinese economy will sooner or later hit the iceberg with damaging effects on the global economy.

If the new leadership opts for a faster pace of reform and a more rapid reduction of internal imbalances, growth is likely to stabilise around the current levels (7-8%). If the reforms are radical enough to partly decouple consumption from investment, consumption could become the main driver of economic expansion, the share of consumption and investment in GDP would rapidly converge and later intersect. The weight of manufacturing would decline and that of services increase. Environmental and social concerns would both improve the quality of growth and limit its headline GDP

[15] The DRC, or Development Research Centre, is a think-tank depending from the State Council in China.
[16] As Shen et al. (2012) point out, "New leaders in China will be particularly stretched between reform and stability, and are more likely to put stability ahead of reform – at least for the near term" (p.3). Moreover, the change of leaderships has led to a "transition effect" in the past with a temporary surge in investments.

figure. All in all, this looks like a first-best scenario for China to continue to build a "moderately prosperous society in all aspects".

However, the political economy of China is increasingly complex and the transition to a lower growth plateau implies that the new leadership has to address a number of major challenges successfully. Powerful interest groups may be resisting a rapid transformation of China's growth model, stressing that the current one has so far assured prosperity and stability. In addition, despite some recently introduced changes aimed at strengthening social and environmental aspects, the promotion incentives inside the CCP so far favour maximisation of growth against other variables.

More fundamentally, the new growth model, while more sustainable and more balanced, will have to also become more and more decentralised, less reliant on political guidance, and more dependent on the preferences of a growing and better informed middle class. Such a development may not be fully compatible with the objective of political control of the economy. As a result, this could prove a significant obstacle for the implementation of the ambitious reform programme that is needed to change China's growth model.

Box 1. What went wrong with the 2008 stimulus package?

To counter the global financial crisis, in autumn 2008 the Chinese government approved a stimulus package of 4 trillion Yuan (about 16% of GDP). The programme started immediately with the goal of spending 100 bn Yuan in the 4th quarter 2008, and the remaining part in the following two calendar years. The stimulus, which was supported by aggressive monetary easing and a rapid growth in bank lending, was mostly used to finance infrastructural projects. In addition, to boost demand, tax subsidies to consumption expenditures and public expenditures for health and education, the environment and technological innovation were also part of the package.

In macroeconomic terms the stimulus was quite successful (Diao and alii (2010), Hur and alii (2010)). The economy bottomed out in 4Q08 (with an annualized growth rate of +4.3%) and, as the stimulus started to take hold, growth accelerated to 9.5% and 11.4% respectively in the first and second half of 2009. In the end, the Chinese economy suffered only a moderate slowdown in 2009 (9.2% growth) and by 2010 growth was back at double digit levels (10.4%). As Nicholas Lardy pointed out, "The results of China's stimulus package were impressive; making China the first globally significant economy to begin to recover from the global economic recession … China's growth in 2009-2011 was impressive compared to the absolute downturns in economic output in the United States, Europe, Japan and many other developed economies. China was the fastest growing emerging-market economy both during and immediately after the global financial and economic crisis" (Lardy (2012), p.11). It is also worth noting that the stimulus did not give rise to a significant deterioration of public finances: the Chinese government deficit levelled off at 2.3% in 2009 and the debt/GDP ratio remained quite low.

However, if the fiscal stimulus was so successful, why are then the Chinese authorities so reluctant to use it again, at least in the 2008 format, to counter the economic slowdown of late 2011-early 2012? A number of factors have been mentioned to explain this reluctance: (1) it did not help the rebalancing of China's economy and, in the end, perpetuated the old investment-driven growth model. Therefore, while it sheltered the Chinese economy from the global economic downturn, it also drove it in a direction from which the Chinese authorities were trying to move away. In particular, it risked to exacerbate China's dependency on investment and exports; (2) it led to a credit boom to finance investment projects that increased significantly the volume of (potential) non-performing loans in the Chinese banking sector. In addition, in certain industrial sectors it created excessive capacity, while in the real estate sector contributed to the developing of local, but still worrisome, bubbles; in addition, the explicit and hidden liabilities of many local governments grew significantly or, in some cases, to out-of-control levels (3) some of the projects were implemented too fast, disregarding transparency and safety rules. As a result, corruption became more widespread. In addition, and some high profile disasters (e.g. the derailment of a high-speed train in Zhejiang in summer 2011, which led to the imprisonment of the Transport Minister) raised the issue of the quality and safety standards of many infrastructural projects and affected the credibility of the government and the Party; (4) The stimulus enhanced the role of the government at the expense of the private sector, which could be read as a set-back for the long-term reform process. It is not clear the weight these four factors have in the current rejection of a 2008-type fiscal stimulus to counter the slowdown, it is likely that all of them are playing a role. Since the Chinese authorities have been mentioning in official meetings that they are however considering targeted fiscal support to particular sectors or activities (green growth, technological upgrade, etc.), and since at the 18th Party Congress President Hu stressed the importance of economic and political stability, as well as the need of fighting corruption, it is likely that factors (1), (2) and (3) weighed in heavily at political level. On the other hand, factors (2) and (4) may have been more relevant for (and appealing to) the technocrats in charge of ensuring the stability of the Chinese economy and the success of the reform process. In case of a strong(er) economic slowdown, the option of a major 2008-style package remains available. However, it is clear that at this stage the Chinese authorities have a clear preference to explore a different policy mix, more reliant on monetary policy, as well as more targeted fiscal options.

Box 2. Formidable structural challenges ahead calls for a new growth model

China's economic performance has been extraordinary over the past three decades, with GDP growth above 10% per year on average, contributing to the lifting of over 500 mio. people out of poverty. This success can to a large extent be attributed to the ”reform and opening-up process” initiated by Deng Xiaoping in the late 1970s, which has contributed in making China the largest manufacturer and exporter and, since 2011, the second largest economy in the world.

The country now finds itself at a crossroad where several of the factors that were driving growth in the past are about to change. In certain sectors the technological frontier is no longer very far away, with the potential for technological catch-up becoming increasingly limited. China is gradually approaching the Lewis turning point where growth in the industrial sector slows as an ”endless supply of cheap labour” from the agriculture sector is no longer available and where further capital accumulation is expected to result in higher wages (IMF (2012a)). Moreover, while the one-child policy successfully put a brake on population growth, it will cause marked demographic changes ahead, with the labour force starting to shrink by 2015 and the old-age dependency ratio to double in the next two decades. Lastly, even if capital is expected to continue to rise, the already high investment-to-GDP and capital-labour ratios will automatically reduce its contribution to growth.

Growth at ”any cost” (and with investment and exports as main drivers of growth) is no longer a viable option. Already in 2007, Premier Wen described China's growth model as ”unbalanced, uncoordinated and unsustainable”. The issue has been addressed in the 12th five-year plan which aims at ensuring a resilient economic growth model that is at the same time more (i) socially inclusive and (ii) environmentally sound, since inequality and environmental costs have reached unacceptable levels. However, the objectives of having a growth model increasingly driven by domestic consumption and by the services sectors featured also in the 11th five-year plan, where the impact of the Great Recession can only in part explain why progress has been mixed so far. High precautionary savings and a depressed wage share has caused the consumption-to-GDP ratio to fall to less than 40%, well below that of comparable emerging economies. While current policies are aimed at improving education, health care and social-security systems, it is implemented with ”Chinese characteristics”, i.e. done in a gradual (sometime very gradual) manner, thereby potentially reducing its effectiveness.

Incentive structures also play a role where ”the mountain is high and the emperor is far away”. Even if the 12th five-year plan provides a good starting point by focusing on ”quality” rather than ”quantity” of growth, as long as local officials are evaluated (and promoted) on their capacity to generate growth, employment and stability; investments remains an ”easy choice”. As an illustration, it is noteworthy how (almost) all provinces systematically report above-average targeted GDP growth.

China does not have to get stuck in the middle-income trap as so many other countries in Asia and Latin America have done. But this requires a change of the current model before it hits the brick wall. ”China 2030”, a report by the DRC and the World Bank that was presented early 2012 argues that the "middle-income trap" can be avoided. China has reached a turning point in its development path where bold and wide-ranging measures are needed to (i) strengthen the foundations for a market-based economy, notably by redefining the role of the government; (ii) accelerate the pace of innovation; (iii) seize the opportunity to go "green"; (iv) promote social security for all; (v) strengthen the fiscal system; and (vi) seek mutually beneficial relations with the world. On this basis, China has the potential to become a ”modern, harmonious and creative high-income society”. The report is interesting not only by looking at the full range of policy areas, but also by addressing ”how” the necessary reforms can be implemented, pointing to the need of sequencing both within and across policy areas. It will require a decisive leadership to take on strong interest groups and give away a high degree of control. If this happens, the report suggests that China can maintain a growth rate of 6-7% per year on average in the coming two decades.

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