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China's Reforms: Time to Walk the Talk

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Introduction

China is facing a growth slowdown driven by structural factors (with a rapid ageing of the population; with the supply of labour from rural areas diminishing fast; with capital contributing less to growth than in the past in order to rebalance the economy; with catching-up close to completion in a number of sectors; and last but not least, with an urgent need to factor in environmental and social costs). In order to avoid getting stuck in the middle-income trap the country is in the process of changing its growth model.

This brief assesses the progress made in the transition to a more consumption-driven and environmentally-friendly growth model and concludes that many of the critical factors have been addressed in the new Chinese leadership's 'blueprint for reform' adopted by the Third Plenum of the Communist Party of China (CPC). Some of this political guidance has already been transformed into concrete policy action, with implementation well under way. However, progress appears mixed so far across different areas of reforms.

Looking forward, the brief argues that the Chinese leadership is at a crossroads: while continued 'gradualism' in implementing the necessary reform has its advantages, it also presents risks, some of which are of systemic nature; an 'accelerated transition', where more emphasis is put on the quality of growth and its inclusiveness/sustainability, would be a preferable option both in terms of potential gains and lower system risks (although at the possible cost of higher short-term volatility). Against this background, this brief highlights the importance of pressing ahead with far-reaching reforms in the areas of social safety nets; quality of investment; wage growth; services- and the financial sector.

Summary

The transformation of Chinese economy in the last decade has been impressive and credit has to be given to the Chinese authorities for engineering it. However, the transition to a more sustainable, inclusive and environment-friendly growth model is far from completed and many obstacles still lay ahead. While significant progress has been made in tackling corruption, cutting red tape and advancing interconnectivity, in other areas such as State Owned Enterprises reform, reduction of pollution; and aligning the spending responsibilities with revenues for central and local government, substantial concrete measures have still to be taken. In all these areas, the Chinese authorities should "walk the talk".

Still, more may be needed. This brief argues that to complete the transition, additional measures should be introduced in a number of areas, namely (1) social safety nets, (2) the quality of investment, (3) wages; (4) services, and (5) the financial sector. The acceleration of reforms in these five areas would allow China settling faster into a new normal. In this way, China would also find itself much better equipped for the daunting challenges that still lie ahead in order to avoid falling in the middle-income trap.

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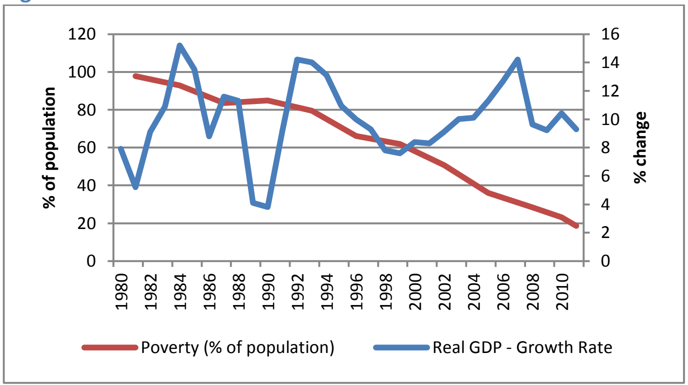
Economic and Financial Affairs

China's medium-term path to strong, sustainable and balanced growth (and the stumbling blocks on this path)

China is at a crossroads in its development path. After a formidable economic performance since the 'reform and opening up' process started in 1978[1] (see figure 1), many of the input factors that spurred growth in the past are set to change (World Bank and the Development and Research Center (DRC), 2013). Most notably, the catching-up process is close to completion in a number of sectors, with the technological frontier not far away. In addition, the rapid aging of China's population caused by the one-child policy now implies a shrinking labour force and an old-age dependency ratio that is set to double in the next two decades.[2]

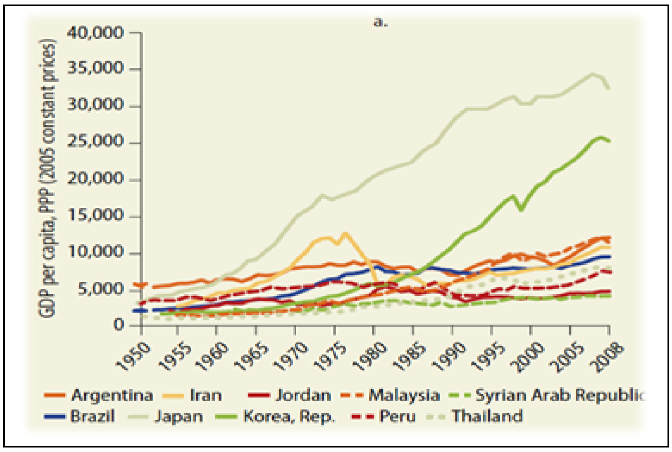
Figure 1. China's remarkable achievement so far



Source: IMF, Word Bank

Although investment can be expected to remain an important source of growth to foster China's urbanisation process and the ambition to 'go green', because of the already very high share of investment in GDP, capital will contribute less to growth in the future. Last but not least, China is coming closer to the so-called Lewis turning point[3] where productivity growth is no longer boosted by an endless transfer of labour from agriculture to more productive sectors. A gradual Chinese 'growth slowdown' driven by structural factors would be far from unique. Both theoretical and empirical research suggests that the rapid growth many emerging economies experience on the back of low-cost labour and easy technology adaptation are seldom sustainable. According to the World Bank, of the 101 countries that had obtained middle-income status by 1960, only 13 became high-income economies by 2008 (World Bank and DRC, 2013). Most of the remaining countries have found themselves stuck in the middle-income trap and unable to graduate to the status of advanced economies (see figure 2).

Figure 2. The Middle Income Trap



Source: China 2030 Building a Modern, Harmonious, and Creative Society by the World Bank and the Development Research Center of the State Council, (2013)

Looking at different 'growth slowdowns' across countries, Eichengreen et al (2013) note how they are typically positively associated with high growth in earlier periods; unfavourable demographics; very high investment ratios and undervalued exchange rates. They find that growth slowdowns are most likely when per capita GDP reaches USD 15,000 (at 2005 constant prices), but that there already seems to be a threshold at USD 11,000 – whilst noting that per capita GDP surpassed USD 5,000 in China in 2014.[4] However, the probability of a growth slowdown appeared

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[1] Real GDP growth has averaged close to 10% per year since the start of the 'reform and opening up' process (or by 9.9% on average between 1980 and 2014), which in turn has been crucial in lifting more than 500 million people out of poverty.

[2] The one-child policy that was introduced in the 1970's to put a brake on population growth has been gradually eased in the most recent years. The take-up of the recently introduced opportunity of having a second child has been rather muted, so far, and the impact on demographic trends over the coming two decades is expected to be limited. On current trends, the labour force that started to shrink already in 2011 while population is expected to peak in 2030 and decline by 40% over the rest of the century according to UN projections.

[3] Wages could be expected to increase more rapidly as the economy approaches the Lewis turning point. First, the initial labour surplus has been largely absorbed in a "two-sector economy", i.e. from the agriculture to the industrial sector in the case of China, and second, where the gap in marginal productivity between the two sectors is about to close.

[4] The estimate is based on China's 2014 GDP growth rate in GDP per capita terms. It amounted to about USD 4,900 in 2013 in China according to World Bank data (in 2005 constant prices).

less likely in countries with a high level of secondary and tertiary education and with a relatively large share of high-tech in exports. Using an alternative approach, Aiyar et al (2013) confirm that middle-income countries are disproportionately likely to experience growth slowdowns compared to low- or high-income countries.[5] In a recent paper, Pritchett and Summers (2014) question the use of the level of income as the best predictor for 'growth slowdowns' (and thereby the existence of a middle-income trap). They argue that the 'current growth rate' has a substantial and statistically significant impact on the likelihood of a slowdown that is largely explained by the statistical principle 'regression to the mean'. Against this background, they consider that there is a "significant risk of a major growth slowdown in China at some point over the next decade" and highlight the need to allow for 'creative destruction' in the economic system to sustain rapid growth. While new investments / industries / profits may be an easy sell, the sought-after transformation may also require a reallocation of resources away from some sectors and regions where the exits of firm are a necessary part of the adjustment process.

This would be supported by theories that argue that it is markedly more difficult to 'sustain' than to kick off or 'ignite' growth (Rodrik, 2008). The former require a much better institutional underpinning[6]. Distinguishing between 'extractive' and 'inclusive' institutions, Acemoglu and Robinson (2012, p151) argue that China is "*unlikely to generate sustained growth unless it undergoes a fundamental political transformation toward inclusive political institutions*". While agreeing that China's institutions suffer from serious shortcomings if measured against traditional theories, Xu Chenggang (2011) stresses that China's 'regionally decentralized authoritarian system', in which regions compete and use policy experimentalisms, has to a certain extent created de-facto institutions that are essential for a well-functioning market. Given the importance of regional decentralisation for running the economy, it will be critical to adapt the incentive structure for subnational governments so as to ensure their support for and implementation of the needed reforms.

[5] When comparing determinants of growth slowdowns for different Asian economies, the empirical results in the Aiyar et al (2013) suggest that China could face a relatively larger risk of a slowdown stemming from 'institutions'.

[6] Rodrik argues that to 'sustain' growth, institutions are needed that "*maintain productive productive dynamism and endow the economy with resilience to shocks over the longer term*".

Despite their different theoretical approach, the "middle-income trap", the "regression to the mean" and the "need for reform-conducive institutions" explanations all converge on the fact that China's former growth model had become unsustainable. The transition to a new one presents important risks that may bring economic instability and lead to a much lower growth path (well below the current growth target of 'around 7%').

In addition, there are increasing social and environmental costs that have to be factored in, as the current growth model has caused: (i) a sharp increase in income inequalities (Naughton, 2007 and ILO, 2015[7]) and (ii) generated vast environmental damage[8]. Therefore, there are demands coming from large groups of the Chinese society to put in place measures to rapidly reduce these costs, even if this come at the expense of higher growth, since a better quality of life and a fairer society are increasingly weighed against higher incomes.

Indeed, to address all these challenges, the previous leadership had already revised the growth strategy in the 12th five-year plan to make the growth model more economically resilient; socially inclusive and environmentally sustainable. This would require a reduction of the dependency on external demand and investments. GDP growth would instead be driven increasingly by domestic consumption and by the services sector. However, these objectives were even then not entirely new and the impact of the financial crisis and ensuing global recession can only partly explain why progress has been mixed so far. Moreover, the way in which the leadership addressed the global crisis contributed to the build-up of further economic imbalances in the Chinese economy[9], making the transition towards a new growth model more challenging.

[7] For example, the Gini index rose from 32.4 in 1990 to 42.6 in 2002 and has remained basically unchanged thereafter, while the share of total income held by the top 10% increased from 25.3% to 30% according to ILO data.

[8] China became the largest CO_2 emitter in 2006 and is also the largest coal producer and consumer; contributing to soaring air, land and water pollution (where UNEP estimates that 75% of river water is unsuitable for drinking or fishing, while about 40% of the population lives in regions facing water scarcity (West J., Schandl H., Heyenga S. and Chen S. (2013), "Resource Efficiency: Economics and Outlook for China", UNEP).

[9] IMF's 2014 article IV report for China lists the importance of the property sector for growth (and in need of a correction); the rapid increase of debt in the corporate sector as well as among local governments; and vulnerabilities within the banking system incl. shadow banking as domestic vulnerabilities. While they are considered manageable, the IMF points to the risk of a disorderly adjustment as the vulnerabilities are, at least in part, interconnected and could

Was the Third Party Plenum a watershed in the transition process?

The new Chinese leadership came into power in November 2012 and has from the beginning advocated broader and more far-reaching reforms. In particular, the new leadership sent a strong signal when it called for "comprehensively deepening reforms" at its 'Third Plenary session of the 18th CPC Central Committee' in November 2013. While the key role of State-Owned Enterprises (SOEs) was not called into question, the Plenum stated that the market is set to play a "decisive" role ahead, suggesting a better pricing and allocation of resources. This was a sea-change compared to the "basic role" to which the market was confined thus far. A wide range of financial, fiscal and land reforms seems also to be in the cards.

The 60 reform areas outlined in the Third Plenum positively surprised many China watchers in terms of its coverage and, if implemented, would address many of the strategic challenges that are deemed essential to allow China to embark on a new 'development path'[10]. The Party Plenum gives overall guidance to the Government for the coming five years. However, this guidance has to be spelled out in greater detail and be implemented by the relevant authorities.[11]

At the annual meeting of China's National People's Congress (NPC) that followed the Third Plenum, Premier Li outlined (i) how the economic model was to be transformed (by increasing the budget for R&D and innovation; reducing overcapacity in industry etc.); (ii) how the role of the Government should be reduced in the economy (by reforming approval systems; reducing the number of items on the 'negative list' for investments etc.); (iii) the importance of further 'opening up' (stressing how FDI can be used more actively; how more services sectors could usefully be opened up; and how the China (Shanghai) Pilot Free-Trade Zone could be used as a testing ground for a more effective governance model and, if successful, used as a 'model to be copied to other FTZs or extended to the whole country); and (iv) the need to strengthen the role played by domestic demand in China's growth. The growth target was kept unchanged 'at around 7½%' for 2014 and investment was seen as "key in maintaining stable economic growth". In a way, the new leadership opted for both growth and reform or, alternatively, for as much reform as possible without jeopardising the targets for growth and job creation.

The focus of the Fourth Party Plenum (autumn 2014) was on "governing the country according to the law". The crucial issue was how to improve implementation of law (not to be understood as 'rule of law', since no separation of powers was foreseen) and advance 'governance by law' by for instance curtailing local power and strengthening professionalism. However, the Party control over the law seems, if anything, strengthened following the fourth Plenum by 'building a Socialist rule of law system with Chinese characteristics'.[12]

At the 2015 NPC meeting, Premier Li struck a more muted tone on the speed of reform, reflecting both a complex global environment, but also difficulties in implementing some of the sought-after reforms (see section below). Although the 2015 'Report on the work of the Government' attaches great importance to moving reform priorities forward, even more emphasis was put on 'maintaining stability'. The ground for such an outcome had been prepared by the Central Economic Work Conference that took place in December 2014, as it put 'stabilising growth' as the top priority for 2015. The growth target was lowered to 'around 7%', whilst keeping the employment target unchanged at 10 million new urban jobs. Among the main reform areas, the NPC stressed, in particular, addressing pollution and moving towards a green economy together with efforts to foster infrastructure investment in the Asian region linked to the effort of 'going global'. Interestingly, emphasis was also put on state support to upgrade the manufacturing capacity and on export of such goods (raising some question marks about the willingness and/or ability to change the growth model).

feed on each other. Still, the authorities are deemed to have enough buffers, to prevent a sharp slowdown in growth in the short term (IMF, 2014).

[10] See for example the policy areas highlighted in the "China 2030 report" by the World Bank and the Development and Research Center (2011). In a nutshell, China was seen as having the potential to become a 'modern, harmonious and creative high-income society' if (1) undertaking structural reforms to strengthen the foundation for a market-based economy; (2) accelerate the pace of innovation and create an open innovation system; (3) seize the opportunity to 'go green'; (4) expand opportunities and promote social security for all; (5) strengthen the fiscal system; and (6) seek mutually beneficial relations with the world.

[11] Recognising difficulties in securing implementation in China, the Third Party Plenum also created a new 'leading small group on comprehensively deepening reforms' to facilitate coordination, navigate vested interests and thereby ensure implementation of the reforms. This group is chaired by President Xi, which should help ensuring that resolute and timely efforts are made to implement new policies.

[12] Ideally, the legal reforms of the Fourth Plenum should have preceded the economic reforms of the Third Plenum as the former typically facilitates the latter.

Implementation is now crucial (but may not be enough so far)

The reform 'talk' has undoubtedly been impressive and would, if fully implemented, go a long way towards securing more inclusiveness, a better allocation of resources, a more even distribution of growth across regions and an improvement of the environmental situation.

However, the actual implementation of the announced decisions varies greatly across areas. To some extent this reflects the targeted time horizon, with the new leadership aiming at achieving substantial results by 2020 and not necessarily before (at least in some fields). As in the past, the preference of the new Chinese leadership seems to be for 'gradualism' and 'experimentalism' when it comes to far-reaching reforms. The upcoming 13th Five-Year Plan (due 2016) is an opportunity for China to show whether it is ready to pursue a more robust reform path.

Among reform areas, the most significant efforts have been made to combat *corruption*, since progress in this field strengthens the Party's legitimacy and can be used to 'prepare the ground' for reform or lower resistance to it among local and/or party officials whose interests may no longer be aligned with the centre. Indeed, Huang (2015) stresses the need to break "*the corruptive relationship between the central players in the dual economy*", thereby separating the roles and responsibilities of the Party; the government; enterprises and banks, to enable China to fulfil its reform blueprint.

Some progress has also been made as regards *the role of the government*, for example by cutting (or delegating to a lower level) the number of approvals needed for doing business. The Shanghai Free Trade Zone (FTZ) has acted as a reform laboratory in this respect: administrative procedures have been simplified (introducing a so-called single window) and shifting away from pre-approval e.g. by introducing a negative list for foreign investments (implying that investments are basically allowed if they are not explicitly prohibited, which is an important theoretical shift, even if the actual list is still so long that the reform has had a very limited effect on foreign investment so far). The FTZ most significant progress so far has been the 'customs trade facilitation'. The FTZ record as regards financial opening has been more mixed, but Shanghai as a financial centre (if not in the FTZ) has also been at the forefront when launching the cooperation between its stock exchange with that of Hong Kong. Drawing on these experiences, the Government announced that three new FTZs are to be opened this year, namely in the Southern Guangdong province; the Eastern Fujian province; and the Northern Tianjin Municipality.[13]

On the *fiscal side*, important measures have been taken to improve the management of local government debts, rollout the gradual replacement of a business tax with VAT across more sectors and to strengthen budget management in general. However, it has proven more difficult to make progress on a property tax, where the two pilots in Chongqing and Shanghai were deemed rather unsuccessful (in addition, there is still a strong resistance across provinces for the set-up of a nationwide register of assets). Last, but not least, the issue of the significant mismatch between expenditure obligations and revenues at the local level still remains to be addressed.

The use of targeted *monetary policies* to support growth (while containing emerging financial risks) has held back progress towards a stronger financial framework and more price-based instruments. Among structural changes, the deposit guarantee scheme will be put in place from May 2015. As such, it should make it easier, especially if combined with a 'resolution' scheme, to allow for bankruptcies, which in turn ought to foster a better assessment of risk and thereby pricing and allocation of capital.

Significant and concrete efforts have been made to allow Chinese firms to *'go global*' and to strengthen China's capacity to foster interconnectivity. The initiatives to set up a "Silk Road Economic Belt" and a "21st Century Maritime Silk Road", backed up by establishing a new multilateral bank: the Asian Infrastructure Investment Bank (AIIB), aims at strengthening connectivity within China (developing its central and western regions) as well as within Asia. In this respect, it is also noteworthy that China saw a net capital outflow in 2014 for the first time ever. Outbound direct investment to non-financial sectors surpassed FDIs if taking profit reinvestments as well as investments via third countries into account.

Notwithstanding recent efforts to strengthen *environmental policies* by improving incentives (e.g. via environmental taxes and emissions trading), the 'war on pollution' that Premier Li announced at the 2014 NPC is far from won. For

[13] It remains to be seen to what extent these FTZs can contribute to a significant market opening. On the back of the limited impact of changes to foreign investments in the Shanghai FTZ so far and the latest update of the 'Foreign Investment Catalogue' from March 2015, which only makes for a modest additional opening up in some areas (and even regress in others), foreign businesses remain very cautious in their outlook.

example, only eight out of 74 monitored cities met the standards for clean air in 2014 according to the Ministry of Environmental Protection. (Better) enforcement of existing and new laws will be critical going forward.

Urbanisation has been another area where announcements seem stronger than actual outcomes, at least so far. The 2014 NPC report spelled out the three tasks: to grant urban residency to 100 million people who have moved to cities from rural areas; to rebuild rundown areas and 'villages within cities' where 100 million people are currently living; and to guide the process of urbanisation for 100 million people in the central and western regions. The report was followed up by a specific urbanisation plan last spring that was, however, scarce in details on new concrete measures and little has been done on e.g. rural land reform (it may, in part, be difficult from a technical point of view with limited recording of owner- or user rights; but a certain 'resistance' towards reform may also be at play).

Last but not least, little progress has also been made as regards *SOE reforms* so far, the exception being the increase of dividends to be paid into the central budget. On the contrary, recent mergers of SOEs with an export orientation (e.g. of train manufacturers) has raised question marks if this aims at fostering national champions rather than enhancing competition and rationalising SOE activity.

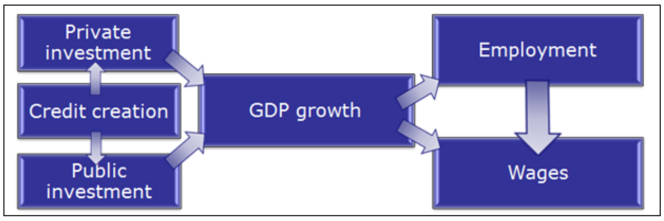
Overall, economic activity slowed to 7.4% in 2014, the lowest growth rate since 1990. The growth target was (just) missed, which is unusual in China where local and provincial officials' promotions used to be linked to their capacity to not only meet but surpass annual growth targets. While authorities have acted to counter the slowdown, speeding up the approval process of different investment projects and undertaking targeted monetary stimulus, employment creation remained healthy and has supported economic activity (allowing the employment target to be met). This reflects continued progress in rebalancing the economy towards the services sector, which tend to be more job rich. In fact, the share of the service sector continued to rise (accounting for 48% of GDP in 2014, up by 1¼ percentage points from 2013); thereby surpassing 'secondary industry' by 5½ percentage points. Progress has also been made in ensuring that consumption provides the largest contribution to growth, while investment was hit by a cooling property market. Against this background, it is clear that China has made progress in the transition towards a new, more sustainable growth model, but the issue of whether the pace adopted is the appropriate one.

Looking ahead: gradualism or acceleration?

The reform process is gradually changing the nature of the Chinese growth regime (Bertoldi and Melander, 2013). Until the global crisis, China's growth was driven mainly by investment and exports (see figure 3). Manufacturing was the leading sector, while services remained relatively underdeveloped. In the immediate aftermath of the crisis, through the stimulus provided both at central and local level, growth became essentially investment-led, with infrastructure investment and construction taking the central stage (see figure 4).

Figure 3. The transformation of the Chinese growth model. Before the crisis: a growth model led by exports and investment.

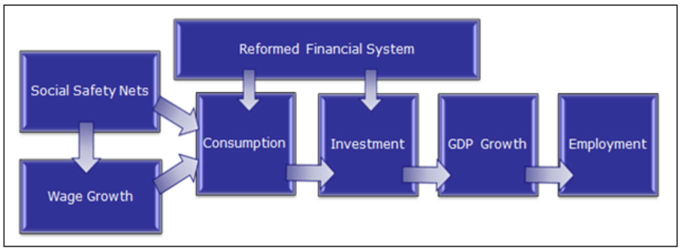
Figure 4. The transformation of the Chinese growth model. In the wake of the crisis: growth model led by public and private investment.



Since the introduction of the 12th five-year plan, growth has become more balanced, led both by investment and consumption. In addition, the service sector has surpassed (slightly) the manufacturing sector. Still, the share of investment on GDP and the size of the manufacturing sector relative to other sectors of the economy remain unusually large if compared to other emerging market economies with the same degree of development or to past stages of development of advanced economies. Furthermore, the special status of SOEs in the Chinese economic system has led to excess capacity and misallocation of (financial) resources. Last but not least, China remains a super-exporter: although its current account surplus has declined from 10% of GDP in 2007 to 2% in 2014, only part of the adjustment is structural. Therefore, it may rise again if and when the global economy gathers momentum (Dorrucci, Pula and Santabarbara, 2013).While this unbalanced situation can allow China to grow faster in the short-term (as productivity growth is traditionally higher in manufacturing than in other sectors and exports can rapidly pick-up in a favourable external environment), in the medium term it presents significant risks for its economic and financial stability (Bertoldi and Melander, 2013, IMF, 2014). In addition, these domestic and external imbalances have generated over time very high social and environmental costs: inequalities remain high, the hukou (household registration) system has created a two-speed citizenship, and pollution has reached levels that are hazardous for people's health, entailing significant current and future health costs (OECD, 2013).

Against this background, there are good reasons to argue that China's transition towards a more inclusive-consumption driven-environment friendly economy needs to proceed at an accelerated pace rather than a gradual one (see figure 5).

Figure 5. The transformation of the Chinese growth model. A more sustainable and consumption-driven growth model for the Chinese economy.



Certainly, a gradual transition has its advantages: it is less economically disruptive makes it easier to deal with vested interests and economic policy authorities can better control economic and financial volatility, while achieving the economic targets set for the year. It would thereby also facilitate an orderly unwinding of existing imbalances in e.g. the property sector. On the other hand, with too gradual an approach, China may not be able to tackle the root causes of some structural weaknesses of its economy, as those negatively affected by the changes can put in place strategies able to limit or even counter the impact of reforms. As a result, China could find itself trapped in the "Achilles and the tortoise paradox". In such a case, the transition to a new stable economic model would take much longer than expected by the authorities. It is, at this stage, unlikely that much further progress is possible through a gradual approach to reform in terms of rapid rebalancing of growth, reduction of inequalities, improvement in the environmental situation, and a reduction of the systemic risks stemming from the financial and real estate sectors. In a nutshell, with a gradual transition it may be easier to address short-term risk factors. However, the objectives of achieving more inclusive growth and reduce systemic risks may prove to be an elusive goal, since the measures undertaken, while steering the economy in the right direction, are not strong and timely enough to set the economy on a stable and sustainable path for the years to come.

Figure 6. Gradualism or acceleration: costs and benefits of two different scenarios

	COSTS	BENEFITS
Gradual Transition	Growing systemic risks; more umbalanced, less inclusive growth	Stronger economic growth in the short term
Accelerated Transition	More economic volatility in the short term	Faster transition to the "new normal"; more sustainable and inclusive growth

Therefore, we see higher benefits from an accelerated transition, where priority is given to the quality of growth and its inclusiveness, even if this may create some short-term volatility and raise tensions with vested interests facing significant losses (see figure 6). Still, faster and bolder reforms have the potential to rapidly bring the economy onto a strong, sustainable (including in environmental terms) and more balanced growth path, significantly reducing medium-term risks and uncertainties that loom over the Chinese economy[14]. In particular, there are five areas where we consider that reforms could be more ambitious and/or their implementation should be accelerated:

(i) Social safety nets. Past experiences in advanced and emerging market economies show that social safety nets are a powerful instrument in the hands of government to reduce precautionary savings, rapidly increase the share of consumption in GDP, and make consumption growth more independent than in the past from investment growth. China's

[14] In its 2014 Article IV report, the IMF makes a strong case for an accelerated pace of reforms by stating that "without a change in the pattern of growth, the likelihood of a shock triggering financial disruption and/or a sharp slowdown will continue to rise. Overreliance on credit and capital accumulation to support growth would further weaken balance sheets and reduce investment efficiency. This would ultimately lead to a slowdown in growth, and put further pressure on corporate profits and the financial system. The more vulnerabilities accumulate, the more likely it is that a shock could trigger a negative feedback loop. Thus, although the near term risk of a hard landing is low, it increases to medium over a medium-term perspective" (p.10).

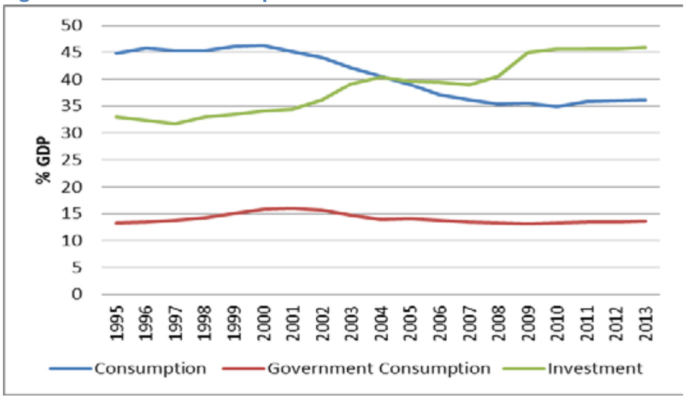
social safety nets are still well below those of the average of middle income countries and this is contributing to excess households' savings (IMF, 2014, World Bank and DRC, 2013 – see table 1). The reform of the hukou system and the integration of migrant workers in universal safety nets would not only eliminate a source of unequal treatment among citizens, but would also lower significantly the need for precautionary savings for tens of millions of workers, who are forced to have very high saving rates to face unforeseen events for them and their families (IMF, 2014; OECD, 2013). A better health care insurance against catastrophic risks would have the same effect (Barnett, Myrvoda and Nabar, 2012), in particular on the urban population, which is more aware of the damages created by the dramatic rise of pollution. Another measure that would have a positive effect on consumption would be the shift to more progressive social contribution rates (which at the moment are very regressive[15]). Finally, the strengthening of social safety nets (together with better public services) is also essential to ensure that in the years to come urbanization will remain a major driver of growth. As pointed out by OECD (2015), "The migration of an additional 100 million rural residents to cities by 2020 … requires that better public services and social security coverage be provided to them".

Table 1. China's welfare spending

Expenditure	OECD	Middle Income: Upper Middle	Middle Income: Lower Middle	China
Total Outlays	41.6	33.1	36.1	25.7
Social Expenditures	26.9	16.2	15.4	9.4
Health	6.3	3.3	3.1	1.0
Education	5.4	3.9	5.4	3.7
Social Protection	15.2	9.0	6.9	4.7
Other	14.7	16.9	20.7	16.3

(ii) Quality of investment. In the years to come, investment will have to grow at a slower pace than GDP to ensure the rebalancing of the economy. It is difficult to conceive a "new normal" where the share of investment on GDP remains close to 50% (see figure 7). In addition, capital efficiency has significantly declined in recent years, although the rate of return on capital remains relatively high (OECD, 2015). Several manufacturing sectors (which often are also among the most polluting ones) have significant overcapacity and need downsizing. Furthermore, the ageing capital stock needs to be replaced by environment friendly machineries, even if this implies a raise in the cost of capital. In the case of China, the rise in the cost of capital would be a welcome development, since, despite some improvement, policy distortions still in place and the price of capital is lower than it should be[16] (IMF, 2014, OECD, 2015). Costlier capital, but incorporating more technological progress (as it is often the case of green investment), not only would help in the rebalancing from investment to consumption and from manufacturing to services. It would also contribute to the modernization of the Chinese economy and its move to higher value added and more technologically advanced production (given its environmental needs, with the right incentives, China could rapidly become one of the world leaders in the production of green technology and provide an essential contribution to the fight against climate change). Last but not least, further progress towards a more flexible exchange rate would help make market mechanisms work better and contribute to reduce excessive capacity and favour the shift towards a more consumption and services based economy, less reliant on manufacturing and a distorted price of capital.

Figure 7. Share of Consumption and Investment in China's GDP



Source: National Bureau of Statistics, China

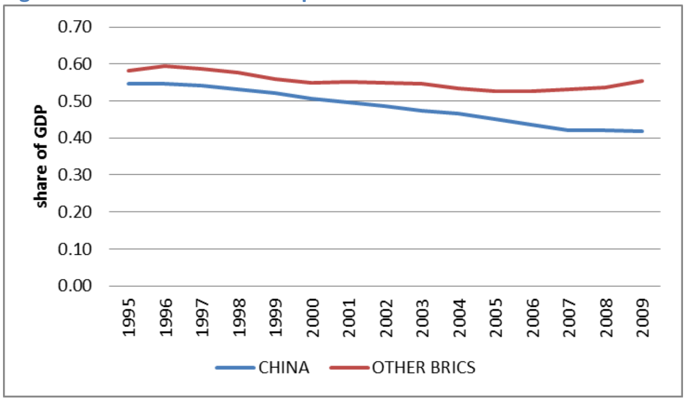
(iii) Wage growth. In China the share of wages as a percentage of GDP is quite low (Hardy and Burst, 2013 – see figure 8) and labour costs have been running below productivity growth for most of the last 30 years. Even if in recent

[15] As noted by IMF (2014), "the combined income tax and social contribution system is fairly regressive. Currently, social contributions raise nearly five times more revenue than the personal income tax, suggesting scope to rebalance toward PIT and make the combined system more progressive" (p.13). On this topic, see also Dorrucci, Pula and Santabarbara (2013), and Lardy and Borst (2013).

[16] For OECD (2015) "the prices of capital, land and energy do not reflect the true social and environmental cost of production, making for a widespread misallocation of resources. Misallocations has been exacerbated by local authorities' growth seeking behaviour as they competed to offer low-cost of free land, cheap credit, tax concessions and other subsidies to attract investment" (p.22).

years wage increases have outstripped productivity gains – (see Lee, Syed and Xueyan, 2013), China has still room for further wage increases, which could prove instrumental in putting consumption growth on a strong and self-sustained path. Against this background, Chinese authorities should not try to oppose wage increases, in particular when they are driven by tight labor markets. In addition, given the rise in income inequalities, subdued inflationary pressures and a strong external position, an increase of the minimum wage would send an important signal of the authorities' commitment to move to a more consumption-driven economy. The costs of a minimum wage increase (which eventually would spread also to higher wages) would not be dramatic in terms of unemployment[17], and the rise in the share of wages in the national income would contribute to the rebalancing of the economy. In addition, it would help the country to move up the technology ladder. In this respect, Mayneris and Poncet (2014) found that the increase in the minimum wage had provided strong incentives to raise productivity and competitiveness by improving the production processes and the replacement of non-competitive firms with new, more competitive, firms. These results seem to be compatible with the findings of Benkovskis and Woerz (2015), indicating that in recent years most of China's gains in overall competitiveness came mostly from non-price factors.

Figure 8. Share of Labour Compensation in GDP

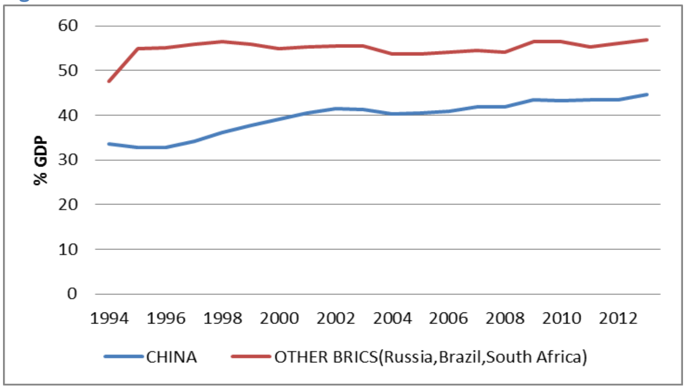


Source: FRED, Federal Reserve Bank of St.Louis

[17] Loungani (2014) finds that, on average across Chinese firms, "an increase in the minimum wage leads to a small decline in employment: a 10% increase in the minimum wage lowers employment by a little over 1%". In an economy like the Chinese one, in rapid expansion and that could become more labour intensive if the service sector grows in importance, most of job losses would be reabsorbed. Mayneris and Poncet (2014) found that job losses due to the increase of minimum wage in China were perfectly matched by job creation generated by the set-up of new, more efficient firms.

(iv) Services. As China becomes a more affluent society, the structure of consumption is also changing. The share of material goods will decline, while the share of services (from tourism to commercial services, from education to insurance, from culture to transportation) will increase. Therefore, if the authorities really act in the optic of a more consumption-driven economy, they need to make sure that consumers will be able to find what they look for. Still, China's service sector remains underdeveloped when compared to countries with a similar level of development (see figure 9). Therefore, this is a field where there is a lot of unexploited potential and where significant productivity gains can be achieved over the medium-term (while in the short-term, services can be a significant source of job creation). As shown by the IMF (2013), higher productivity growth in services is instrumental in boosting consumption on a permanent basis and therefore completing the transition towards a new growth regime. In addition, since "*service-driven growth can be relatively inclusive and sustainable as services tend to be labour intensive and less polluting than manufacturing*" (OECD, 2015, p.29. See also Barnett, 2013 and IMF, 2014), bolder reforms aimed at liberalising the service sector and at reducing the weight of SOEs in services would effectively would have manifold beneficial effects on the Chinese economy.

Figure 9. Share of Services in GDP



Source: International Historical Statistics

(v) The financial sector. China has high saving ratios, but the allocation of credits is far from optimal. This is because political and administrative interference in credit provision, despite the huge progress made in the last decades, is still too strong. While, on the one hand, banks are encouraged to act more according to market principles, on the other hand, they have strong incentives to lend to SOEs and large companies. The spectacular rise of the shadow banking system (which is in part an off-balance sheet offspring of the banking sector) is the result of this direct and indirect interference and, if not tackled properly, can generate systemic risks in the economy (notwithstanding substantial efforts to rein in shadow banking activity over the past year bringing some of these activities back on-the-balance-sheet). This is why the implications of SOEs' reform go well beyond SOEs themselves and may have positive spillovers for the financial sector as a whole (IMF, 2014), potentially increasing the efficiency of the banking system, changing the way in which it determines credit allocation[18], and reducing credit creation (Magnus, 2015). Therefore, the rapid implementation of SOEs reform, would have beneficial effects on the banking sector, which would be put in the position of being better able to finance the private sector and consumers. Such a development would also make it easier for economic policy authorities to bring the rapid expansion of the weakly regulated shadow banking sector under control, which, while providing much needed financial support to credit starved firms, has also increased systemic financial risks. Finally, the rapid liberalisation of deposit rates would promote consumption growth through a number of channels: (a) higher income for households; (b) lower saving rates, since households would be able to reach more rapidly and then maintain the desired level of savings; and (c) higher lending rates, which lead to a less capital intensive economy and to more job creation, and therefore higher disposable income for households (Lardy and Borst, 2013; Barnett, Myrvoda and Nabar, 2012).

A legitimate question at this stage is why to focus on these five priorities and not others, such as urbanization, land-use reform, agricultural reform or education reform? The reason is that, to be successful, some of them (e.g., urbanisation) encompass a number of structural reforms (safety nets, strengthening of the service sector, financial sector) that are already included in the five priorities mentioned above or, since sequencing matters, need to come early in the process to ensure that they are effective. Other reforms are important on their own (agriculture, land-use) in order to make China's economy more sustainable and less imbalanced, or to ensure that the fading demographic dividend will not translate in a dramatic drop of the growth potential (e.g., education). However, they are not as fundamental in the first phase of the transition to the new growth regime, which, as it can be extrapolated by the 12th five-year plan and the outcome of the Third Party Plenum, would have as pillars a self-sustained consumption dynamics and better quality of investment.

To achieve self-sustained consumption dynamics, rapid progress in the five areas listed above is essential. Otherwise, consumption will continue to be driven by investment growth (Bertoldi and Melander, 2013), which is a dynamic that is not sustainable over the medium term and has the potential of triggering an abrupt slowdown in growth, should – for different reasons – the business environment deteriorate suddenly.

As consumption dynamics changes its drivers, the same has to happen for investment. Until recently, investment growth was led by re-investment of profits, credit expansion, distortive financial incentives that lowered the price of capital, land and energy compared to labour, and went on quite irrespective of the imbalances it was creating internally and externally, as well as of the environmental damages it generated. In the new growth regime, investment growth would have to revert to the more traditionally accelerator model, where demand comes first and foremost from consumption.
The five reforms areas identified above would make sure that investment would grow less than GDP growth, facilitating the rebalancing among the various components of demand, but it would also create the conditions to ensure a better quality of investment, which would increase its efficiency and reduce environmental costs. In the medium-term, this would also facilitate the upward move in the technological ladder and ensure that in the medium-term China's total-factor productivity (TFP) does not decelerate further, while reducing systemic risks that weigh on the financial sector.

Therefore, the acceleration of reform in the five areas mentioned above would allow China to settle faster into a new normal[19]. With the rapid implementation of these reforms, it

[18] A similar point is made by OECD (2015):"An effective corporate governance system –that affects the environment for access to capital, the allocation of resources between competing ends and the monitoring of investments once they are in place – is essential to China's ambitions to boost the role of the capital market in optimizing resource allocation"(p.12)

[19] IMF (2014) scenarios and spillovers analysis reach conclusions similar to ours. The IMF studies three scenarios: (a) fast reform; (b) baseline (medium scenario, similar to our gradual scenario) and (c) no reform. Their conclusion is that "in a scenario with fast implementation of reforms growth would be somewhat slower in the near term. However, compared to alternative scenarios with slower or no reforms, income and consumption per capita would be higher by 2019. Debt is falling and credit growth is likely to be slower, leading to a faster reduction of vulnerabilities and eliminating the risk of a sharper slowdown" (p.18).

could not be excluded that consumption could surpass investment as a share of GDP at the beginning of the next decade[20], bringing the composition of the Chinese economy more in line with the rest of emerging market economies, and significantly reducing internal and external imbalances. As a result, China would also find itself much better equipped for the daunting challenges that still lie ahead in order to avoid falling in the middle-income trap, to counter the structural factors that in future will lower its growth rate (rapid ageing of the population, the nearing of the "Lewis turning point"), to move up in the technological ladder and to tackle the environmental fallout on air, land and water.

In our reading, the decisions taken in the Third Party Plenum and the way they have been implemented so far leave both the accelerated option and the gradual one open. Put into perspective, the progress made in the transformation of the Chinese economy in the last decade has certainly been impressive. Nevertheless, the transition is still ongoing and, in this respect, it may be too early to speak about a "new normal", in particular if it is intended to designate the emergence of a new growth regime and not merely the lower but still sustained rate of GDP growth in the years to come.

Conclusions

The transformation of Chinese economy in the last decade has been impressive and credit has to be given to the Chinese authorities for engineering it. However, the transition to a more sustainable, inclusive and environment-friendly growth regime is far from achieved and many obstacles still lie ahead.

The pace of implementation of the decisions taken at the Third Party Plenum will be crucial to determine whether in the years to come there is a gradual or an accelerated transition to this new growth model. In the short term, the accelerated transition scenario presents higher risks than the gradual transition one, but the situation is reversed in the medium term, where the economic, social and environmental benefits of an accelerated transition clearly outweigh its short-term costs.

So far the pace of implementation put in place leaves both options open. Significant progress has been made in tackling corruption; cutting red tape (especially in the Shanghai FTZ); advancing interconnectivity in Asia and Chinese companies 'going global'; as well as improving debt management of local governments, while in other areas, such as 'SOE reforms'; reduction of pollution; aligning the power and spending responsibilities for central and local government; and rural land reform, substantial further measures still have to be taken.

If the Chinese authorities opt for the accelerated transition scenario, rapid action has to be taken in the areas lagging behind. However, for a successful accelerated transition to a new normal, the mere rapid implementation of the Third Party Plenum is a necessary, but not sufficient condition. To achieve a new stable and coherent growth regime, based on very different drivers (i.e., domestic consumption, quality of investment, inclusiveness, environment) than those that were in place before the global financial crisis (i.e. quantity of investment, external demand, employment), this paper argues that additional measures are needed in a number of areas. The upcoming 13th five-year plan, whose preparations are already under way, may provide the Chinese leadership with the opportunity to introduce these new measures, taking in this way a decisive step in the completion of China's economic transformation.

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[20] Lardy and Borst (2013) simulate a ten-year rebalancing scenario (2013-2022), where China's growth would be mostly driven by consumption and investment would grow on average about 2 percentage point less than GDP (whose growth would average 7.5% over the period considered). In their simulations, household consumption and investment share on GDP would equalise already in 2020.

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