

Reform directions for China's socialist market economy: a macroeconomic perspective ¹

Introduction

China enjoyed very substantial growth from 2000 until the global financial crisis hit in 2009 (see Figure 4.1). In March 2012, for the first time, the Central Government Work Report revised down the GDP growth rate target from 8 per cent to 7.5 per cent. Again in March 2015, the Central Government Work Report revised the growth target to 7 per cent. China's economy has entered into the period of 'New Normal'. The New Normal is a government narrative about the era of double-digit expansion being over. The potential for infrastructure investment has contracted, returns on assets have fallen, export growth is slowing and overcapacity has soared. The old engines of growth, investment and export, are spluttering. Furthermore, China has consecutively suffered from the global slowdown that followed the U.S. financial crisis, the debt crisis in Europe, and then the exit strategies of the Federal Reserve. It is now a factory too big for the world market.

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Since 2009, the contribution of net exports to GDP growth has turned from significantly positive to negative - a telling development (Figure 4.2). At the same time, China is now experiencing an aging population which undermines population dividends, and faces higher financing costs and deleveraging pressure which deteriorates private investment momentum. Furthermore, the gap between China and the global technical frontier is much smaller now than it once was, which means there is rather limited space for China to make technical progress through an imitation strategy. In other words, China is staring at the ‘middle-income trap’, that is the tendency for countries to stop growing quickly once they reach a certain level of annual per-capita income. Although optimists suggest China has a way to go before it falls into the trap, others are not convinced. From a macroeconomic perspective, new sources of growth are urgently needed.

This chapter investigates, from a macroeconomic perspective, new sources of growth as follows: (1) In the short term view, sources of economic growth can be described from the demand side, such as consumption, investment, net exports and government expenditure. Based on a ‘demand framework’, reform directions for China are expected to behave in this way: *from* export-oriented *to* domestic demand oriented; *from* investment-driven *to* consumption-driven. During this transformation, public expenditure could play a ‘buffer role’. (2) From the middle-long term view, the new sources of growth should be analyzed through a ‘supply side’ framework. In this sense, production factors like labor, capital and technology constitute the bigger picture from a long term perspective. The following reform directions could alleviate the decelerating potential growth rate: *from* demographic dividend *to* human capital bonus; *from* technological imitation *to* innovation; and *from* a regulated financial system *to* a market-based financial system which will support the real economy more efficiently. All the above reforms will bring changes for China *from* strong growth *to* sustainable development.

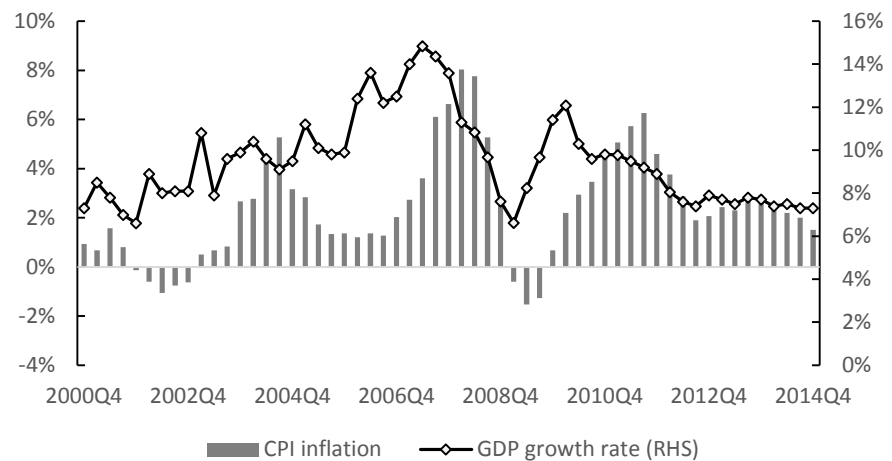


Figure .1 China's potential growth rate has been slow down.

Source: National Bureau of Statistics of China

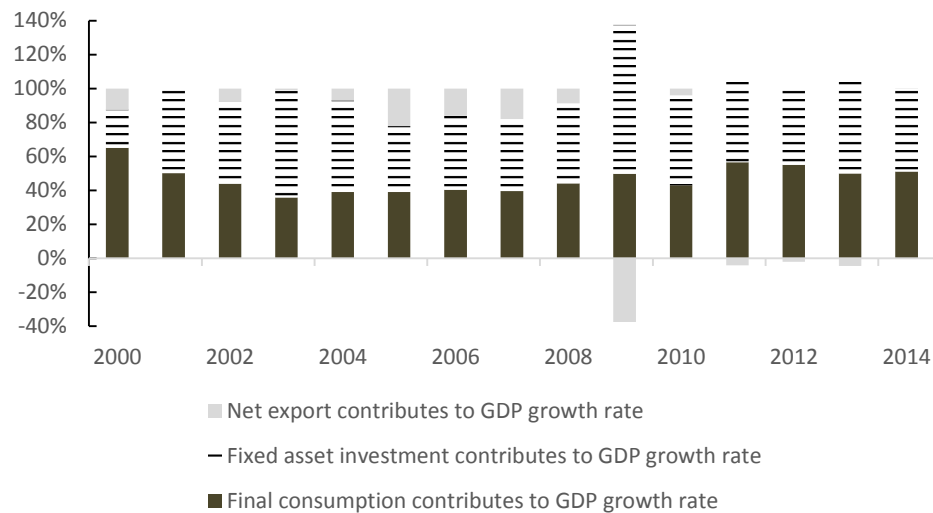


Figure .2 The contributions of final demands to GDP growth rate

Source: National Bureau of Statistics of China

From export-oriented to domestic demand led

Export and investment have been for some time the two most important engines for China's economy. Since entering the WTO in 2001, China has become more deeply involved in global affairs. At the same time, the economy had become more dependent on external demand. For instance, between 2005-07, net export contributed approximately 20 per cent of China's GDP growth (see Figure 4.2). China's dependence on exports (i.e. export to GDP ratio) ranged from 20 per cent in 2000 to 35 per cent in

2006 and 2007 in the peak (see Figure 4.3). In 2009, for the first time, China exceeded the U.S. as the world's largest exporter. Thereafter, in 2014 China's GDP has surpassed the U.S. in terms of purchasing power parity (PPP), becoming the largest in the world. China's economy has shifted from a relatively small economy to a very large one within a short timeframe. It has become a factory that is too big for the world market. What it implies is that the export-oriented strategy will become less effective over time.

At an earlier 'takeoff' stage, China enjoyed the benefits of the export-oriented strategy. However, once it became a large economy, external demand seems to have been restricted by global market limitations and imbalances. Under more restrictive conditions, the export-oriented strategy has been confronted by diminishing benefits and increasing costs. Because of its high dependence on exports, China has experienced its own imbalance. Such a growth model is characterized by high vulnerability to external shocks. Another serious problem, emphasized by Premier Li Keqiang in 2014, is caused by excessive foreign exchange reserves accumulated through trade surplus, which is not only a wealth but also a burden and a risk (Guo 2014). Compared to the service industry, a typical non-tradable sector, manufacturing is tradable and more capital intensive. As a result, an economy that is heavily dependent on exports will be more capital intensive and less labor intensive. Consequently, the income distribution will incline to capital but not labor. This may result in a widening income gap between capital and labor (Zhang and He 2006). Along the same lines, pollution and general welfare benefit less from the export-oriented strategy.

Due to growing labor costs and currency appreciation, China's export growth rate has declined since 2008. At the same time, net export to GDP ratio also decreased. After the financial crisis, the net export contribution to GDP growth has been negative or near zero.

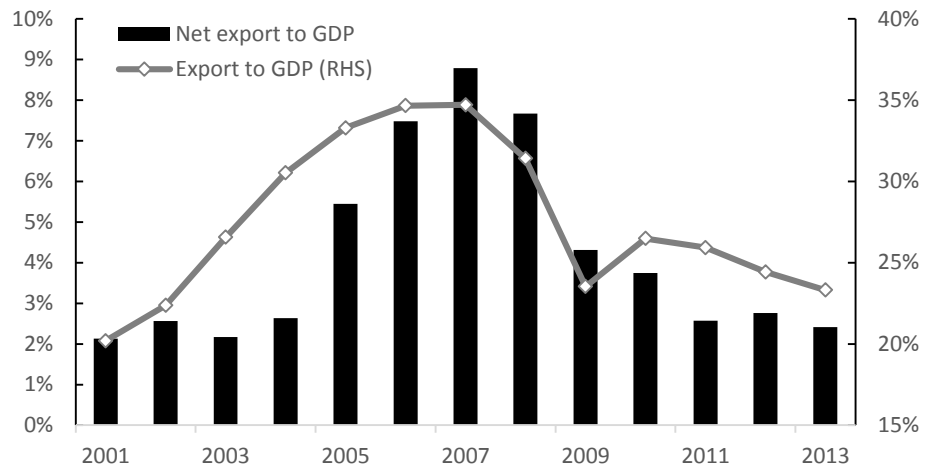


Figure .3 Export is a key driver to China's GDP

Source: National Bureau of Statistics of China

Although the IMF (2012) believes the decrease in China's current account surplus is just periodic and unsustainable, other economists think it indicates a *trend* towards current account balance (Feldstein 2011; Sun and Lu 2012, Zhang 2014). So far, the data in recent years has proved the latter. With such a trend, export and net export will contribute even less in the future. Consistent with the trend, the Twelfth Five-year Plan published in 2011 pointed out that China's growth should change from being 'export-oriented' to 'domestic demand-oriented'.

Three aspects to boost domestic demand

Until domestic demand replaces external demand, how could China manage to realize the transformation and keep growth stable? From the demand side, the answer will be discussed in the next section of the chapter, and includes a solution to boost domestic consumption. From the supply side, it is interesting to find out why there are so many producers who prefer to export rather than doing the same business domestically. Xu (2009) points out three reasons as follows:

- First, *export rebates*. The tax reimbursement for exports can be as high as 17 per cent. For example, for tire products, the export rebate ratio is 9 per cent which, although not as high compared to other items, is still fairly important to the exporter's profit margin. If producers are to sell the precisely same commodities

in the domestic market, they will lose their export rebates. Although export rebates should be a 'neutral' policy (to avoid duplicate taxation), the authorities have had a tendency to employ it as a macroeconomic policy tool. For instance, in 2009, when China's exports met difficulties, the export rebate ratios for various commodities were revised up to three times.

- Second, *higher risk premiums in the domestic credit system*. This makes it more difficult for enterprises to run a domestically-oriented business. With risks in the credit system, if receivables are not received on time, sometimes this can even cause default. If the borrower lives in another city, the cost of dispute solution will be perceived by the creditor as too high. Producers, therefore, are reluctant to sell commodities in the domestic market, or forced to quote a higher price that includes the risk premium. In contrast, the international trade credit system is supported by bank letters of credit, which facilitates quick and safe settlement. Exporters can enjoy the safer credit system and quick turnover velocity of capital.
- Third, *high transaction costs in the domestic market*. High costs result from local protectionism, corruption and logistics costs. As to logistics costs, in 2011 it accounts for just 8.5 per cent of America's GDPⁱ, compared to 17.8 per cent for China.ⁱⁱ For railways, the U.S. has a track network of 300,000 km, while for China in 2014 it is estimated to be 110,000 km. On a per-capita basis, the length is thus 8.2 cm for the Chinese, shorter than a cigarette! Further differences apply as the American railway has a major function in logistics; China's railway plays a critical role in passenger traffic (see Suo 2014 for details). Suo (ibid) also claims that the price of road tolls in China is much higher with highway tolls, in general accounting for up to 20 per cent of total company transportation costs.

Considering the above constraints, international trade has been boosted while the domestic market has been restricted. To realize the transform to a domestic-demand led economy, China should make reforms to at least the following: (1) restoring export

rebates as a neutral policy; (2) constructing a more mature social credit system, and (3) reducing transaction costs in the domestic market through anticorruption, enhancing the transparency of the fiscal budget of local government, and breaking local protectionism through fiscal reforms. In addition there needs to be reform to officials' evaluation mechanisms.

From investment-driven to consumption-driven

The twelfth five-year plan declared the strategy to transition from investment-driven to consumption-driven economic growth. This is expected to feature in the next five-year plan again. Figure 4.2 shows the final consumption/GDP ratio has been deteriorating since the financial turmoil in 2008, although the ratio has subsequently improved moderately. The ratio was 51 per cent in 2014, 14 percentage points lower compared to the early 2000s. Moreover, government expenditure is included in final consumption. The challenge of realizing the transformation remains arduous for Beijing. Based on existing literature, the following reforms should help set priorities:

Improving the social welfare system

The existing literature (Luo 2004) denotes that 'uncertainty factors', such as unemployment risk, uncertainty of medical expenses and educational expenses, have significant negative effects on China's household consumption. A sound welfare system will benefit consumption by reducing such uncertainty. Yet a sound welfare system demands strong support from fiscal budgets. For a country like China which is still developing this is not straightforward and longer-term sustainability issues must be faced. The 18th Party Congress report stressed that China should institute a fully covered, multi-tiered and sustainable system for basic social security provision - for both the urban and rural population. On the one hand, it is a popular decision to expand the welfare system to all households. But on the other hand, this has to be affordable. China can thus draw on lessons from the recent management of the European debt crisis which had to take into account the development level of member states including 'middle income' countries. The policies to establish a comprehensive welfare system in China will be active in the

foreseeable future, but cautious on fiscal sustainability.

Household registration reforms

China's social inequalities are well documented (Sun and Guo 2012). There is a large rural-urban disparity influenced by the household registration institution, or 'Hukou' system. This separates rural migrant workers in cities from access to the urban welfare system. That partially explains why rural migrant workers save more of their wages. Consequently their consumption is restrained. Chen et al. (2010) found that the marginal consumption rate of migrants is lower than that of urban residents by about 14.6 percentage points. If Hukou restrictions were removed, it is estimated the average consumption of migrants would rise by approximately 20.8 per cent (ibid.). Chen et al conclude that the extent to which migrant consumption is constrained by the Hukou system may account for up to half of the decline in household consumption between 2000-05.

China's history reveals a trend associated with economic development whereby the agriculture population (including the population living in rural areas) declines in growth periods. The Hukou system may help slow down this process. But its negative side-effect includes a deteriorating household consumption pattern. In terms of political economy, reforms need to be implemented gradually to take account of the various vested interest groups. In 2014, the third plenary session of 18th Party Congress specifically referred to 'advancing urbanization', emphasizing the need to strictly control the urban population size in megacities like Beijing, Shanghai and Guangzhou. In spite of this, Hukou reforms could be expected in most of small and middle sized cities. In 2014, the CPC's political bureau of the central committee published the *Document on Further Promoting the Hukou System Reforms*. This sets a target of one-hundred million people immigrating to urban areas who can be registered in the urban Hukou system. Clearly the government is targeting reform of the Hukou system as one way of boosting domestic consumption.

Reducing income disparities

Besides uncertainties in expenditure, income disparity also deteriorates the average propensity to consume. The poor may consume with very limited income, while the rich stores substantial wealth. Zhu et al. (2002), Li (2003) and Yang (2009) show that income disparity plays an important role in China's low consumption share of GDP. For instance, in 2008 and 2009, the income gini index in China reached 0.49. Then it slowly declined from its peak. In 2014 it was 0.47, still high above what is generally considered 'the danger level' of 0.4, but heading downwards. Moreover, comparing with the income gini index, the wealth gini index is even higher, recording 0.73 in 2012 -- the top 1 per cent of households occupied one third of the national wealth, while the bottom 25 per cent of households own 1 per cent of the total wealth (Investigation Center of Chinese Social Sciences, Peking University 2014)! Such income and wealth disparity seriously undermines consumption and has other serious social and legal consequences well documented elsewhere in this book.

Corruption and monopolistic practices are two critical causes of income disparities (Wu 2006). The authorities have cracked-down hard on corruption (see Ho in Chapter 7). This has the potential to reduce some income disparity and promote consumption. But this requires a long term view. Yue et al. (2013) also found that there is more than a 50 per cent income gap between monopoly and competitive industries. They argue that this is unreasonable. If the implicit welfare costs are included, this level of income gap would likely be even larger. From a macroeconomic perspective it follows that anti-monopoly and SOE dividend reforms should be expected to make income distribution more equitable. Whilst some well-connected 'princelings' might be unhappy about this, politically it is very likely to be popular.

Reshaping the industry structure

Figure 4.2 shows that investment has contributed to approximately half, or even more, to GDP growth for the last decade. Compared to other major economies, this ratio is truly extraordinary. However, the investment-driven model corresponds to the peculiar

industry structure in China. For manufacturing for example, the proportion of the country's potential economic capacity that is 'in use' has declined from around 80 per cent before 2008, to around 60 per cent in 2012 (The IMF 2012). Whilst there may have been overcapacity in manufacturing, the service sector has lacked investment and is therefore in short supply. Finance, education, and healthcare suffer from excessive regulation and lack of competition. Water and environmental conservation, which are important public goods, have not been given sufficient attention including investment for the longer term. All of the above contribute to supply constraints and high prices; shortages in the supply of services inhibits consumption. Medical treatment, education and financial services are often difficult to access and expensive - a very hot topic for many Chinese.

These constraints also contribute to important structural problems in demand. On the one hand, there is oversupply in the manufacturing industry; on the other hand the service sector is short of supply, and the consumption of services restrained. Figure 4.4 compares employment structures in the service sectors of China and the U.S. Compared to the U.S, China's employment ratio is lower in education, banking and insurance, scientific research, polytechnic services and, especially, in water conservancy, environment and public utility management, health care, social security and social welfare. In order to make these service industries more competitive and increase their capacity, Chinese authorities should do well to set them free of excessive regulation, and bolster transparency. Again, reforms to establish a sound social welfare system are necessary.

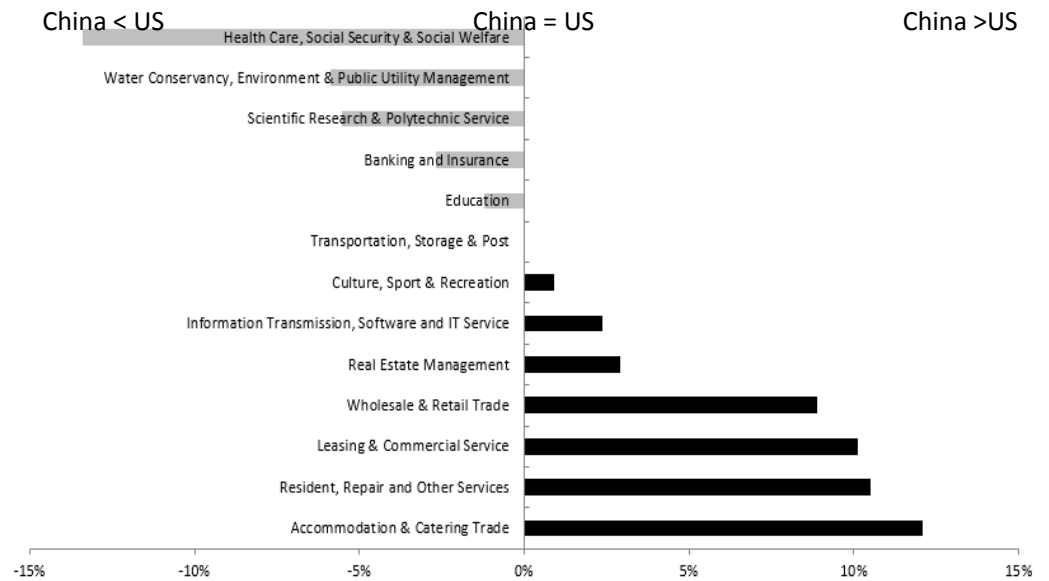


Figure .4 Structure of employment in service sector:

a comparison between China and US.

Source: China's Ministry of Human Resources and Social Security, United States Department of Labor. Note: The data shown in the figure is the difference between the employment ratio in an industry in China and US.

The transformation from an investment-driven to a consumption-driven economy is feasible. In the short term, the high levels of fixed-asset investment (that is, investment in long-term physical assets such as property) could be redirected towards investment in services. This would relieve the shock of currently falling investment levels. Given the supply constraints outlined above, returns on investment could be even higher in services than they have been in the manufacturing industry and perhaps even property. In the long run, the development of services is needed to produce enough supply to match domestic consumer demand. In this model, structural unemployment amongst university graduates would decrease; their wages would increase; national income distribution could be made fairer; and consumption in innovative services could be fuelled. The corollary is less reliance on investment and foreign demand.

From demographic dividend to human capital bonus

From a 'supply side' perspective, labor, capital and technical progress are *the* resources

of economic growth. From the view of labor, China has enjoyed a young demographic structure, ‘population dividends’, over the past three decades. According to Cai (2009), the decrease of dependency ratio, i.e. the proportion of dependents to people at work, contributed to 2.3 percentage points, or a quarter to per capita GDP growth rate. But a turning point in the population dividend occurs in 2015, whereby the dependency ratio trends unfavorably (Cai 2009). For instance, in 2015 the proportion of the population above 65 years old will rise to nearly 10 per cent. Based on an aging population, Cai and Lu (2013) predict that China’s growth rate will slow down substantially in the 2020s (Figure 4.5). In this scenario, the growth rate will decline to a level of 5.6 per cent. However, it is possible that China’s economic growth will be more dependent on generating a ‘human capital bonus’ and less related to population structure. In this alternative scenario, Liang (2011) forecasts that the economic growth rate will experience a relatively stable trajectory (Figure 4.5).

As Figure 4.5 shows, the actual growth rate is located between the above two scenarios. In March 2015, the Report on Government Work declared 7 per cent as the target for GDP growth rate. Again, this target also lies between these two scenarios’ forecasts.

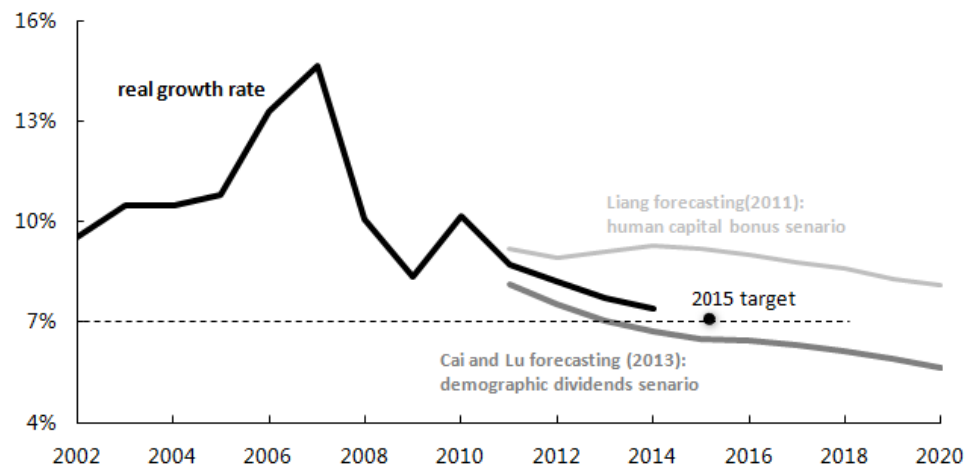


Figure .5 Forecasting of China's growth rate in 2020s: Two Scenarios

Source: Liang (2011), Cai and Lu (2013). National Bureau of Statistics of China (date)
at: <http://data.stats.gov.cn/workspace/index?m=hgnd>

The real growth rate is shown to be higher than the demographic dividends scenario but lower than the human capital bonus scenario. This implies human capital may only be partly (or not totally) turned into real productivity. If this is correct this indicates structural problems in China's labor market. Figure 4.6 shows the coexistence of unemployment for high-educated labor force and vacancy ratios for the low-educated labor force. In 2014, unemployment among the tertiary educated labor force (or higher) is 12 per cent. The vacancy ratio among the secondary educated labor force (or lower) is 18 per cent. To understand why this is so it is essential to examine the services industry. Employment here represents only 34 per cent of the total workforce, compared with 60 per cent in Malaysia and 81 per cent in the U.S (Figure 4.7). Based on China's position on a typical development path, one would expect the service sector to account for about 50 per cent of today's jobs. The deficit is particularly apparent in healthcare, finance and education, as shown in Figure 4.4.

At the same time, it is difficult for university graduates to find work, and their salaries have not risen commensurate to China's growth over the past twenty years or so. In contrast, most factories are short of workers with low levels of education, even migrant workers, and wages for them have increased by more than 10 per cent per annum for

several years. At this point in time, the development of the service sector will produce more job opportunities which can then release the human capital bonus, and consequently enhance potential growth. But the transition remains a challenge as Figure 4.6 shows.

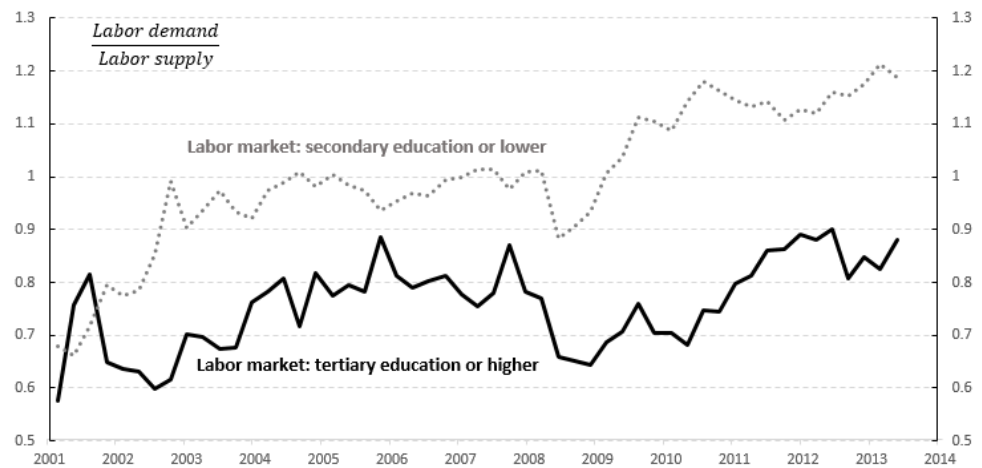


Figure .6 Structural problems in China's labor market

Calculated by the author. Source: China's Ministry of Human Resources and Social Security,

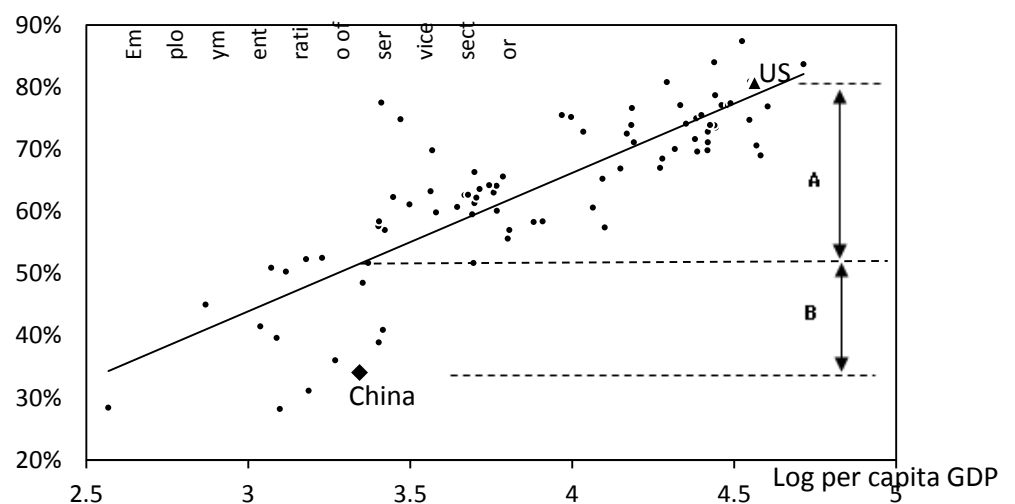


Figure .7 China's employment in service sector is inhibited

Source: World Bank, World Development Indicator Online.

A liberalized financial system to support the ‘real economy’: the ‘middle way’ to reform?

In China’s economy, capital is as important as labor. But the role of capital is played out through various distortions. For instance, the interest rate system is regulated so as to provide low-cost capital to industries. During the past three decades, the real deposit interest rate by 2012 had averaged around 0 per cent. In many years it was even negative, for example, it was -1.1 per cent in 2010. As a result, debtors, or the producers and government, benefit, while creditors and households suffer loss. Another distortion has been the renminbi exchange rate regime. For most of the time since 1994, the RMB has been either hard or soft pegged to the U.S. dollar. Since 2002, however, there have been disputes about renminbi undervaluation with many researchers believing the exchange rate undervaluation has contributed to China’s current account imbalance.

The control of China’s capital account makes the above distortions possible due to the following factors: (1) Because of central controls, depositors could not make asset allocations in the global market. They have had to choose the domestic market and accept the very low yield rate. (2) Due to the control, the central bank could keep the exchange rate stable and maintain independence in monetary policy within the ‘trilemma puzzle’.ⁱⁱⁱ This puzzle refers to a trade-off amongst the following three goals: a fixed exchange rate, national independence in monetary policy and capital mobility. The theory is that ‘in pursuing any two of these goals, a nation must forgo the third’ (Obstfeld, Shambaugh and Taylor 2005: 423).

These financial repressions of the past three decades have contributed not only to China’s high growth rate, but also to serious structural problems. For example, the fixed exchange rate system and the RMB undervaluation fuelled the model of export-driven growth with over-development in manufacturing and a restrained service sector. The regulated interest rate system has undermined consumer welfare and encouraged enterprises to operate inefficiently. Further, capital control separates the domestic financial market from the global market at a cost of achieving a more effective and integrated financial system. In

this way, resources have been allocated with distorted capital prices. A consequence is the sustainability of economic growth is challenged. This reality has reached political circles with a consensus beginning to emerge that the financial system should be reformed with a market orientation. But details such as the reach of reform, sequencing and timing remain controversial. In 2012, a questionnaire was issued to discover how divergent thinking was in relation to sequencing financial reforms and ownership (Xu 2013). Figure 4.8 reflects the different views within financial institutions in terms of ownership. The results show that interviewees from state owned enterprises are more likely to hold a view of ‘traditional sequence’ (65 per cent). From a theoretical perspective this view insists the proper order of financial reforms should commence with interest rate liberalization, followed by exchange rate regime reforms, and then capital account deregulation. This ‘traditional’ view sees any other sequencing as risky, inappropriate and could cause financial instability. Of those interviewed from foreign-owned companies, 43 per cent selected ‘traditional sequence’ and 43 per cent selected ‘no sequence’. For Sino-foreign joint companies, 50 per cent of the interviewees preferred the option of ‘no sequence’, with 45 per cent selecting ‘traditional sequence’. Whilst one should not draw too many firm conclusions from this type of survey, it does reveal that SOE financial institutions may tend to support a traditional sequencing of reform whereas Sino-foreign joint and foreign-owned financial institutions may be more inclined to support more radical reform. Here it is worth noting that, in general, SOE institutions are more influential in framing reform plans.

Figure 4.9 shows a subtle variation. Academic institutes stand closer to SOE financial institutions, and are even more conservative, in that 69 per cent support traditional sequencing. Most commercial banks are SOEs, and they share similar views to the academic institutes. On the other hand, more investment banks are totally or partly foreign-owned. It is not surprising that investment banks’ opinions are similar to Sino-foreign joint and foreign-owned institutions. What is intriguing, however, is that the government’s attitude sides with the investment banks. This is best understood from a political economic perspective, as Chinese politicians have tended to make reforms in

trial and error method or, as Deng's famous aphorism put it: 'crossing the river by feeling for the stones'.

Despite some radical opinions held by government and investment banks, the academic voice and commercial banks' appeal are also influential. My expectation is that the outcome will reflect a compromise. The research group Financial Survey and Statistics Department of PBoC (2012) argues that there is no certain sequencing for financial reforms, and it could take place by way of trial and error. But in fact, the implementation scheme provided by the group is highly consistent with the academic version. Therefore, for financial reform, there is more consensus in practice than disputes in theory! Directions of financial reforms will probably take *the middle way* in the future.

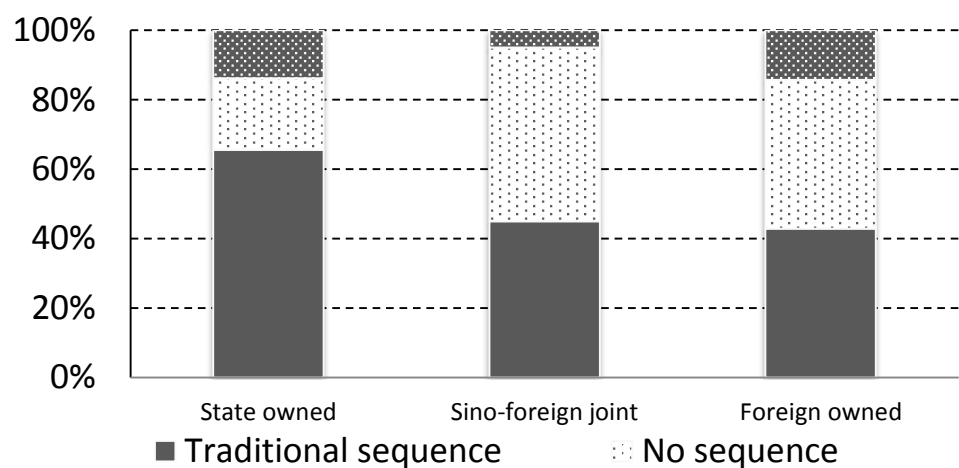


Figure .8 Divergence for sequencing of financial reforms: within financial institutions

Source: Xu(2013).

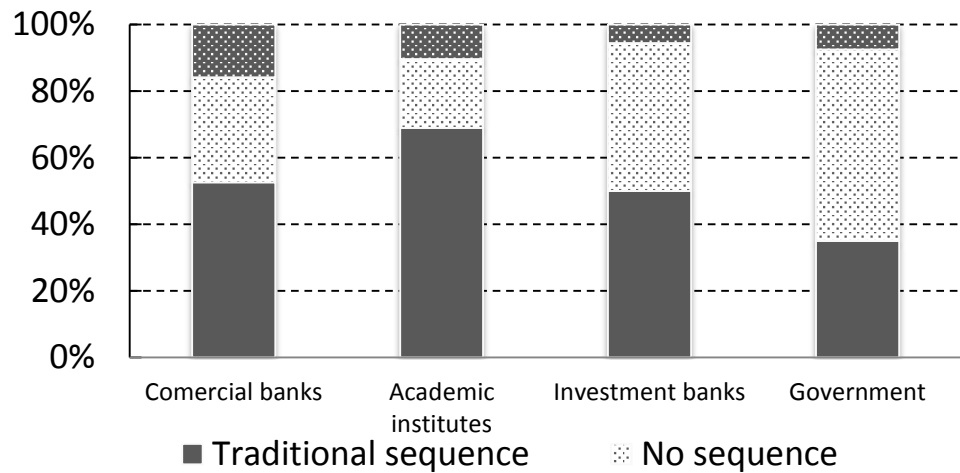


Figure .9 Divergence for sequencing of financial reforms: among different institutions

Source: Xu(2013).

From technological imitation to innovation

In the future, China's economic growth is expected to become more dependent on technological progress. From a macroeconomic perspective, 'technical progress' is best defined broadly and may also include institutional reforms. In terms of technological progress itself, Chinese economists are being asked 'what kind of technical progress could be most helpful for China's economy'? To answer such a question, we need a strong theoretical framework. From the main issues arising in this chapter, answers are need to help solve the following three 'bottlenecks': (1) labor market problems due to the aging population; (2) the dilemma of environmental degradation and resource needs, and (3) continually upgrading China's technical level. Already, as Veugelers (2011) points out, in specific fields like engineering, chemistry and physics, the gap between China the E.U. and the U.S. is closing fast. For instance, the amount of authorized patents in China reached 1.2 million in 2013, triple the number in 2000. But so far, technological progress has evolved by way of imitation. In the past decade, the ratio of inventions in authorized patents rose from 6.5 per cent in 2000 to 11.7 per cent in 2013. This compares poorly to Japan's 88.6 per cent in the same year. Designs and utility models have been dominant, amounting to 88.3 per cent of China's patents. In contrast, the ratio of designs and utility models in Japan's patents is 11.4 per cent. This structural characteristic reflects the nature and quality of China's patents. The problem of poor quality is, in part, a result of China's

developmental stage. But it is also related to the institutional design of patent law. For example, if a company is recognized as being ‘hi-tech’, it will enjoy many subsidies and advantages. According to the ‘Guidance on Recognition of Hi-tech Enterprises’ published by the Ministry of Science and Technology, intellectual property is a weighted index (30 per cent). In most provinces, the intellectual property index is measured by 1 invention as equaling 6 utility models. However, the cost to apply for 6 utility model patents is fairly low compared to one invention. Consequently, enterprises are encouraged to take advantage of this rule to get a ‘hi-tech’ recognition.

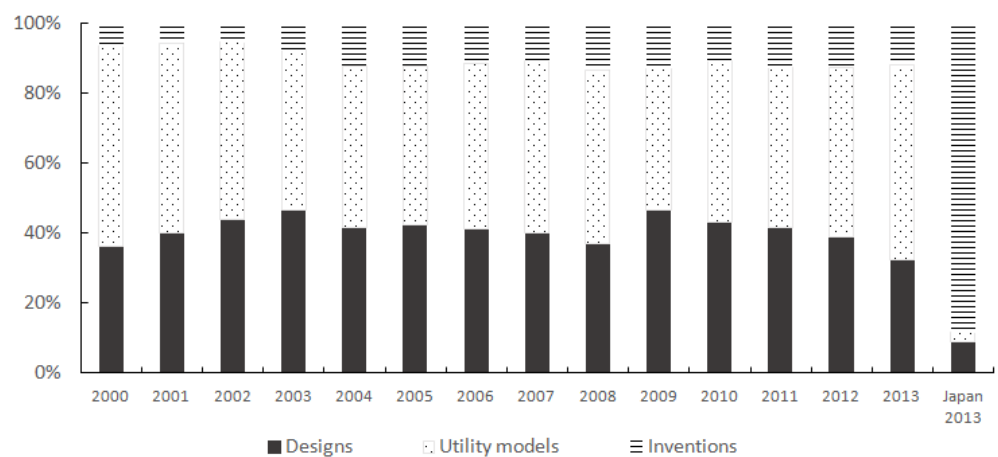


Figure .10 The structure of authorized patents: China and Japan

Source: NBS of China and Japan Patent Office(2013).

As the gap between China and the global technical frontier is smaller now than before, there is a net reduction in the space for China to make technical progress through a followed and imitation strategy. It is for this reason that ‘independent innovation’ has been adopted as a national strategy (see *Report of 18th Party Congress* 2012). In this, institutional reform is also considered as ‘technical progress’ in broad terms. This also contributes to improving the productivity of labor and capital. Premier Li Keqiang underlined ‘reforms dividend’ many times as a new resource for China’s growth. In this regard, the new leadership has since 2013 started to streamline administration and delegate power. Shanghai Free Trade Zone (FTZ) and other pilot projects in Tianjin and Shenzhen have also commenced.

Conclusion: *from strong growth to sustainable development*

China now faces multiple challenges in transitioning from economic growth to sustainable development. This chapter has argued that structural reforms must address both aggregate demand and supply side issues. With regard to the *demand side*, two transformation directions are clear enough: (1) China's growth is to shift from export-oriented to domestic demand led, and from being investment-driven to consumption-driven. To effect this shift, China will need to make reforms to restore export rebates as a neutral policy, construct a mature social credit system, and reduce transaction costs in the domestic market. Anti-corruption measures, greater transparency in the fiscal budget of local government, breaking local protectionism and reforms in officials' evaluation mechanisms will undoubtedly help. (2) To boost consumption, the authorities will have to improve the social welfare system, reform the household registration system, reduce income disparities and reshape the industry structure, especially deregulation of the service sector.

With regard to the *supply side*, sustainable development demands reform in three key areas: (1) The labor factor - from demographic dividend to human capital bonus. The analysis in this chapter reveals the supply of human capital is not in a state of over-supply; rather the problem is related to the need to deregulate the service sector to produce more job opportunities (and thus release the 'human capital bonus'). From this perspective, the following service sectors have the best potential at this stage of China's development: education, banking and insurance, scientific research and polytechnic services, and especially environmental protection, public utility management, health care, social security and social welfare. (2) The capital factor - financial deregulation to liberalize the 'real' economy. This analysis has shown that various views exist as to how reform should be sequenced. It is most likely that a 'middle way' compromise will emerge between sequential and trial and error methods. The likely outcome in terms of policy will be 'gradualism'. (3) Technical progress – encourage a transformation from imitation to innovation. To improve the quality of China's patents, the call to reform the patent law grows louder. The future law and policy system is expected to stress innovation. Reform

itself is a kind of technical progress with a so called ‘reform dividend’. From an ‘outputs’ perspective, this dividend requires a fair distribution in terms of rural and urban provision, better social welfare redistribution, more public goods like environmental protection, a just legal system and less corruption generally.

Notes

ⁱ Council of Supply Chain Management Professionals (2012) ‘Research Survey Results’,

<https://cscmp.org/member-benefits/survey-results>.

ⁱⁱ National Bureau of Statistics of China (2013) at: <http://www.stats.gov.cn/english>

ⁱⁱⁱ Obstfeld, Shambaugh and Taylor (2005: 423) explain that a ‘trilemma’, or ‘impossible trinity’ as introduced by Robert Mundell and Marcus Fleming in 1962 and 1963, refers to trade-offs amongst the following three goals: a fixed exchange rate, national independence in monetary policy and capital mobility. According to the Mundell-Fleming model, a small, open economy cannot achieve all three of these policy goals at the same time.

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