

# Turning Points in China's Development

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May 1, 2012

# Three Simultaneous Turning Points

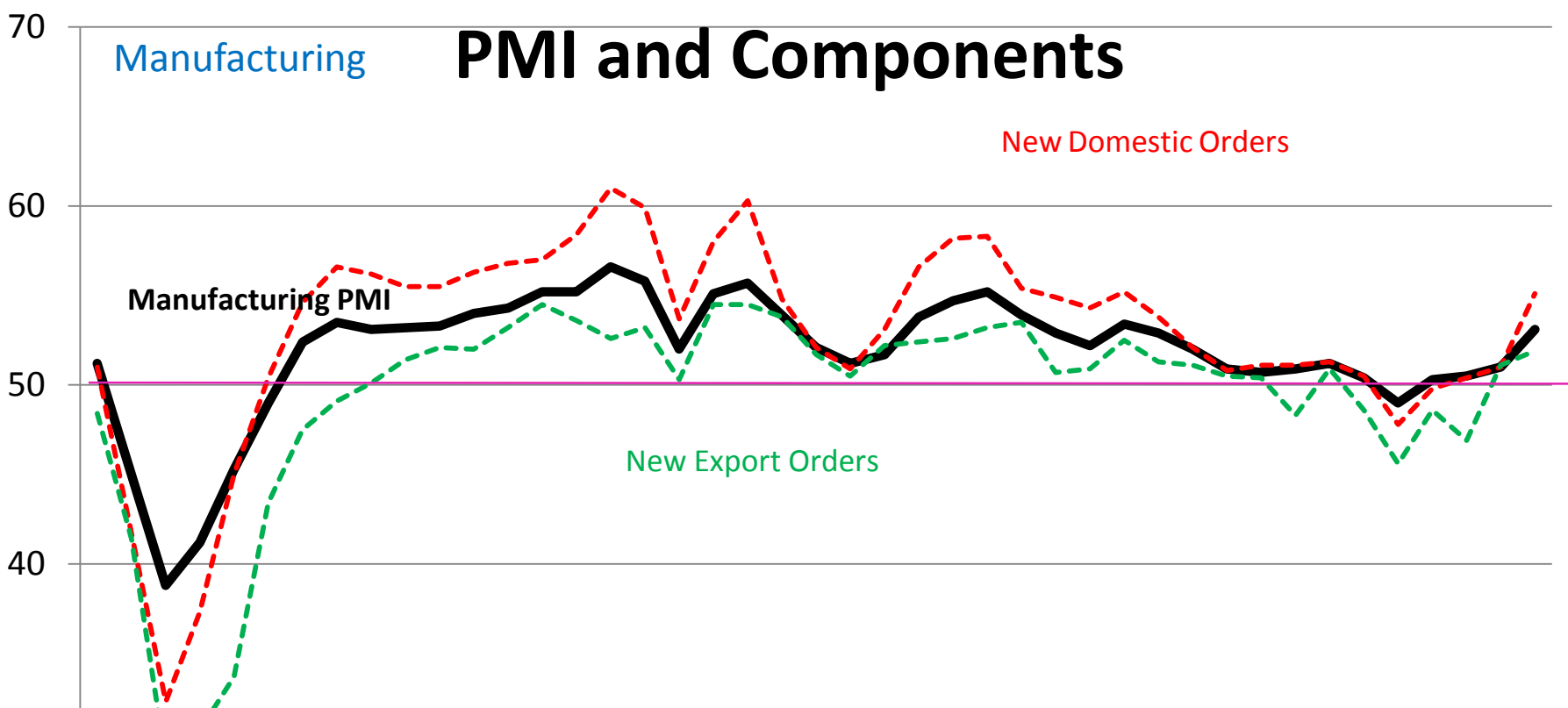
1. A short-run macroeconomic turning point, as orthodox macro policy turns an excessively expansionary phase.
2. A medium-run policy turning point, as China's leadership changes and re-assesses its approach to economic reform and growth.
3. A long-run shift in the growth model, as China's changing labor markets outpace action in "transforming the growth model."

These three will interact, but we should be careful: we have not "turned the corner" in any one of these three.

# 1. Short Run: Macro Turning Point

- Current Slowdown: External demand, to some extent; but also intentional deflation of domestic bubbles.
  - Resembles old-style US recessions brought on by increased interest rates (to fight inflation), rather than today's western style chronic insufficient demand recession.
  - The good news is that these bubbles *needed* to be deflated; policy is being implemented with reasonably good timing and in reasonably steady fashion (nobody's perfect).
- Deflating bubbles: can the process be contained?
  - Housing bubble
  - Local government infrastructure bubble
  - High tech industry bubble
  - Hard to give a definitive answer, but so far, so good: recent PMI readings are reasonable.

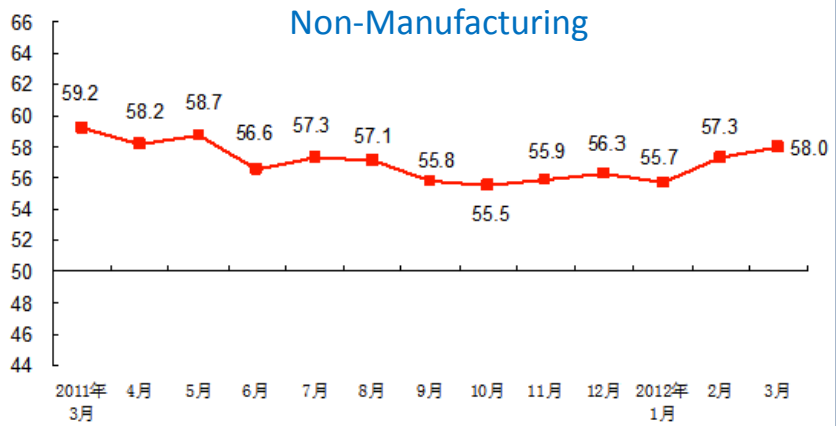
# PMI and Components



非制造业商务活动指数 (经季节调整)

(%) 50%与上月比较无变化

## Non-Manufacturing



March  
May  
July  
September  
November  
Jan 2011  
March  
May  
July 2011  
September  
November  
Jan 2012  
March

# Reasonably steady, moderately dis-inflationary policy

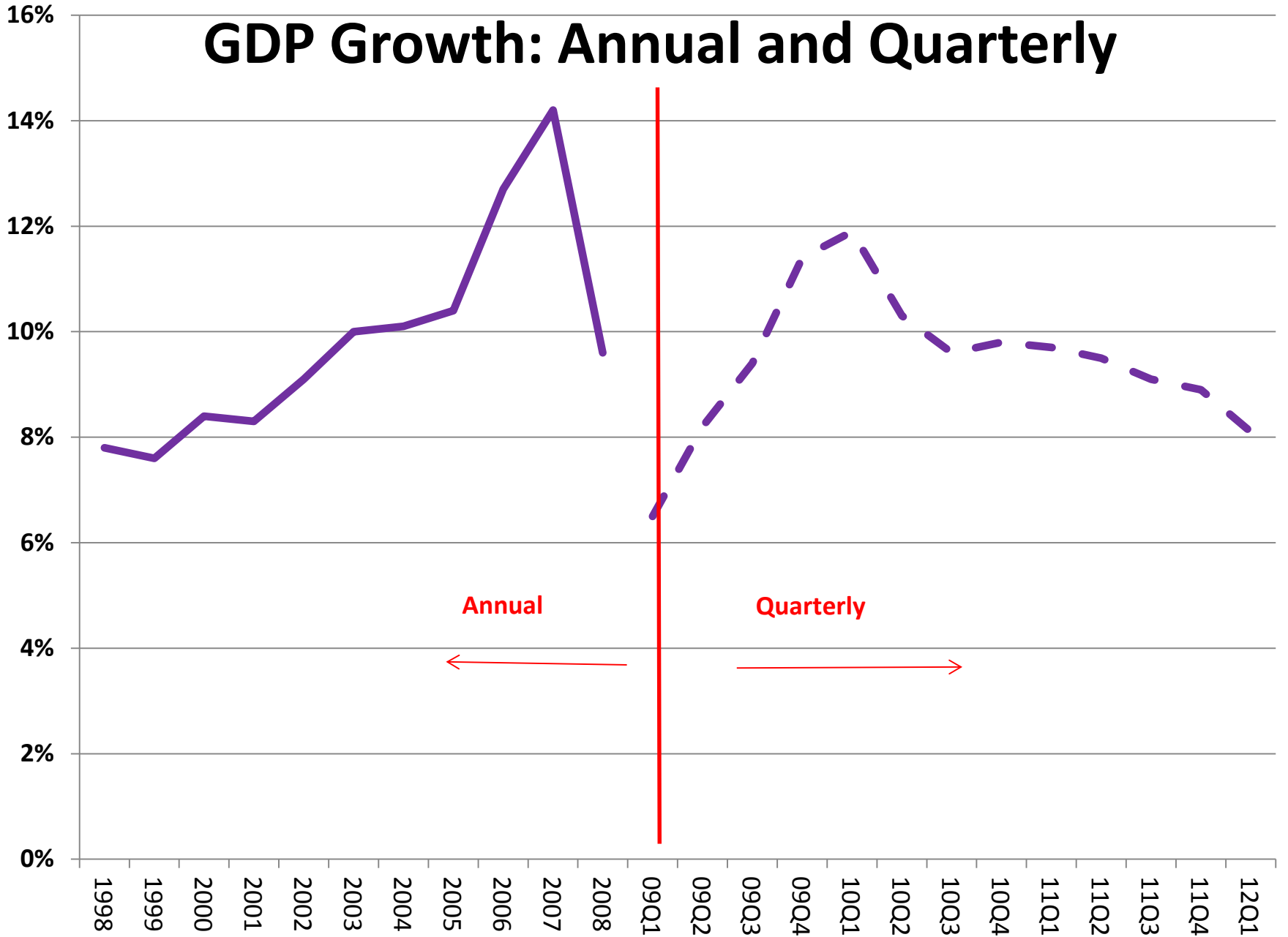
Some of the pressure has eased because of moderation of global commodity prices. Domestic CPI has inched down, but then rebounded to 3.6% in March.

Central bank—PBC—has reclaimed voice in setting monetary policy, has now purchased a modest amount of credibility and flexibility.

Enormous volume of resources tied up in incomplete investment projects: total value 134% of GDP at year-end 2011. So far, this stock has not been reduced as politicians, bankers fight over cancellations.

Beginning to address local government funding platforms, with 5-category differentiation, roll-over some, begin to cancel some.

# GDP Growth: Annual and Quarterly



# “Bubble” in High-Tech Industry is *Not* Under Control: Strategic emerging industries (35 Sectors)

Strategic Emerging Industry	Focus
New information technology (IT) industry	New mobile communication, next generation Internet, tri-networks integration (broadcasting network, telecommunication network, internet), Internet of things, cloud computing, Integrated Circuit, new display, high-end software, high-end server and information service.
Energy-saving and environmental protection industry	High efficiency and energy saving, advanced environmental protection, key technology, equipment, product and service for resource recycling
Biology industry	Biomedical, biomedical engineering products, bio agriculture and bio manufacturing.
High-end equipment manufacturing industry	Aviation equipment, satellite and their applications, railway vehicles equipment, Intelligent-manufacturing equipment
New energy industry	New generation nuclear power, solar energy-thermal application, solar thermal and solar PV(photovoltaic) electricity generation, wind energy technology equipment, smart grid, and biomass energy.
New material industry	New functional material, advanced structural material, high performance fiber and its composite and common basic materials.
New energy automobile industry	Plug-in Hybrid Electric Vehicle (HEV), Battery Electric Vehicle (BEV) and Fuel Cell Electric Vehicle (FCEV) technology

## 2. Medium-term: Political Transition brings Unusually High Uncertainty

Natural to focus on top leadership: New Communist Party chief Xi Jinping (recent successful US visit); presumed new Premier Li Keqiang.

However, note that new leaders come in at every level of the hierarchy. New head of China Bank Regulatory Commission is less hawkish than predecessor; new PBC head due early 2013.

Provincial leaders turn over at year-end. Lower-level leaders turning over now. Even company heads may change CEOs and lose backers.

Top leadership probably set, but watch for possible more important roles for Wang Qishan (current vice-Premier) and Zhou Xiaochuan (current central bank head).



# Recent Shift in Atmosphere

Economic reforms have stagnated for several years.

Suddenly, there is renewed interest in reviving reform, and increased possibilities of forward movement. Why?

1. Xi Jinping, designated successor, has expressed interest in a comprehensive reform program for fall 2013. (“Top-level design” for reform: 顶层设计 inserted into 12<sup>th</sup> Five Year Plan Suggestions). World Bank and others have responded.
2. Problems that technocrats have warned of since 2009 are now real; something must be done; credibility of finance technocrats (PBC) has recovered after 3 years of a down market.
3. Political fall of Bo Xilai in Chongqing eliminates a (dangerous) wild card nationalist and “leftist” political figure. Opens way for more open-minded politicians.

Can we be optimistic? Not yet. It’s still too early to tell.

# 3. Long-run: Profound Shift in Cost Conditions, Growth Model

China is nearing the end of its super-high growth phase. For more than 30 years, it has grown faster, longer than any other country. But that growth phase also resembles the 25-year growth phases of earlier East Asian developers: it must end.

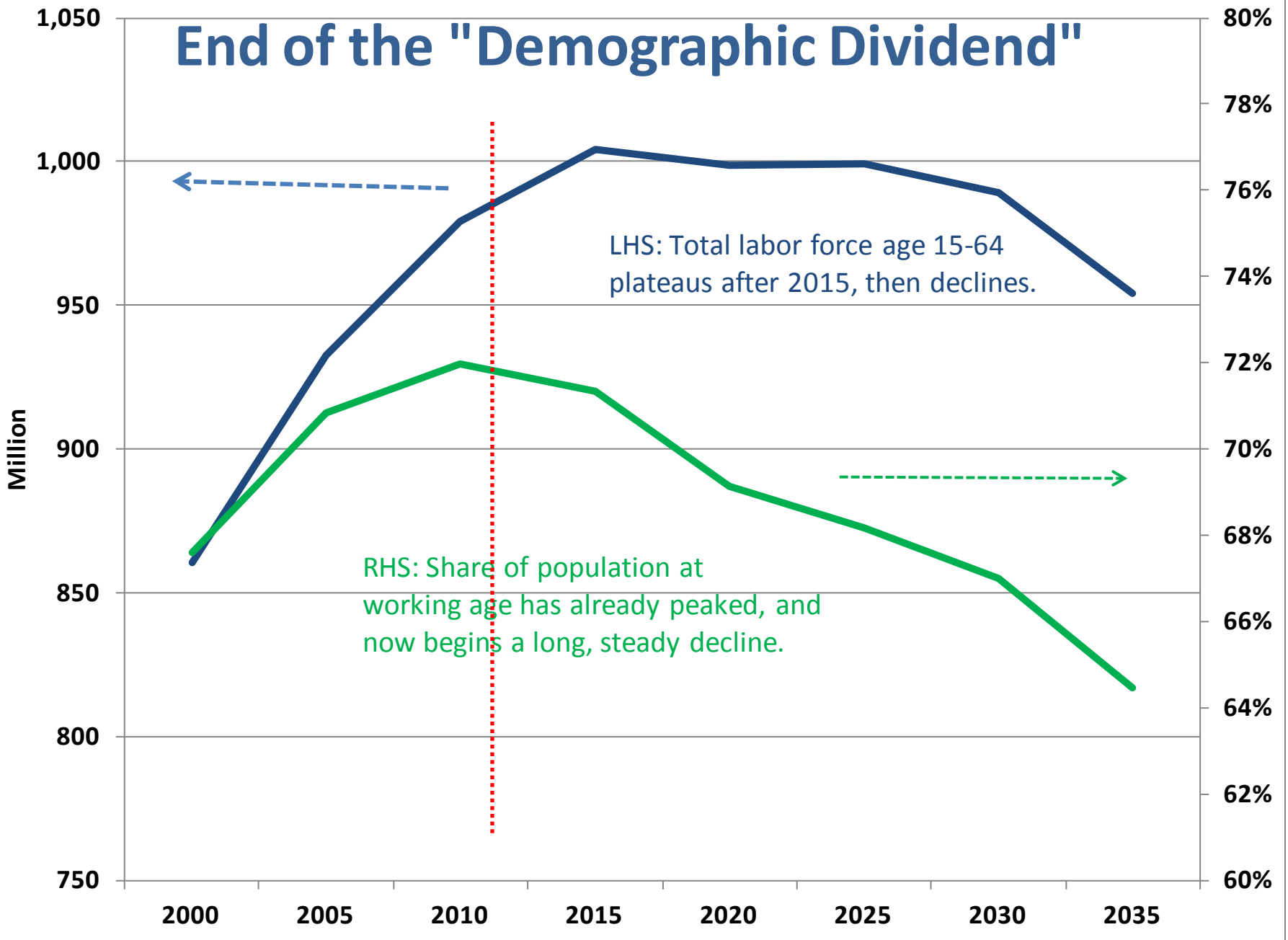
The end will be brought by a change in labor supply conditions, the end of a “labor surplus” country.

You already see this in wage pressures in export factories. The crucial point is that these pressures will remain and intensify due to the intersection of:

- Demographic (aging);
- Structural (rural-urban migration);
- Educational factors (much higher rates of college education).

The changes that have already begun will only accelerate.

# End of the "Demographic Dividend"



LHS: Total labor force age 15-64 plateaus after 2015, then declines.

RHS: Share of population at working age has already peaked, and now begins a long, steady decline.

# Growth in Education Supply: Reinforce changes due to demography and rural-urban migration

	<b>2000-2010</b>	<b>2010-2020</b>	<b>2020-2030</b>
Total Labor Force Growth	115	20	-15
ow: With College Degrees	33	58	57
Non-College Worker Growth	82	-38	-72

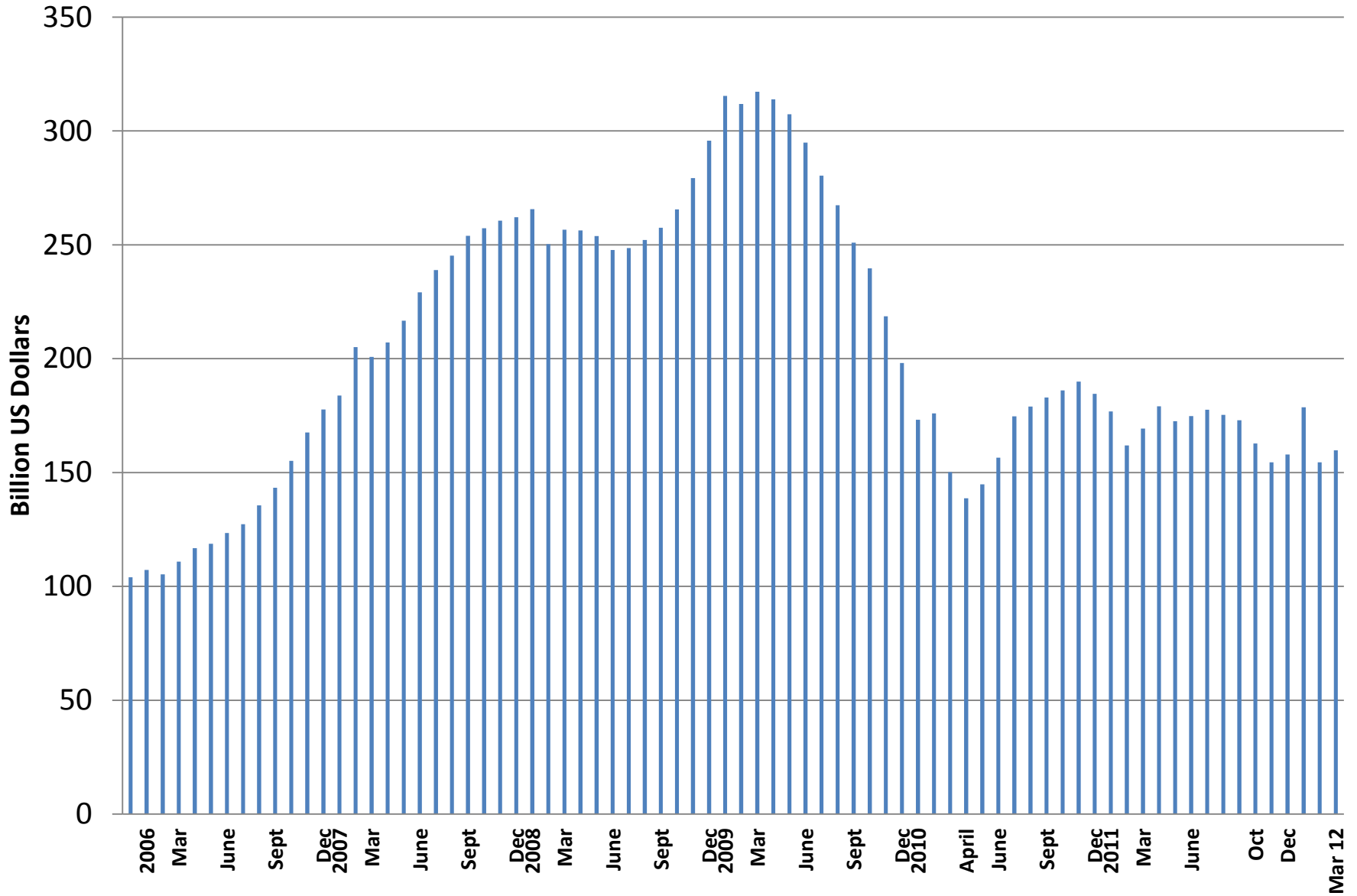
(Net Change in Labor Force, in Millions)

# Exporters: Persistent cost pressures

1. Upward wage pressure
2. Stronger regulatory efforts, including (politicized) push for union recognition and improved working conditions.
3. Persistent competition for credit, higher real credit costs for the foreseeable future.
4. Continued modest RMB appreciation (index of PBC influence).

Despite these long-run trends, China still possesses superb infrastructure; in-depth industrial supply base; still growing productivity; and opportunities in some sectors for “over-skilling,” i.e., bringing more technicians into the factory and changing work routines. China has not yet lost competitiveness in most traditional labor-intensive industries.

# China: Cumulative 12-month Trade Surplus



# Conclusion: 2 Choices, 1 Argument

1. Will the new leadership opt for a revived economic reform agenda? If so, it may surprise us when we see it in late 2013.
2. How will China opt to develop higher-skilled sectors, and avoid the “middle income trap”? China has more at stake than anyone else, but so far they have bet on the wrong approach.

Argument: The confluence of these three “turning points” greatly strengthens the argument for conservative macroeconomic policy combined with rapid liberalization. This is the only policy that is likely to address all three challenges, and give China’s rapidly multiplying young, skilled workers the opportunities that they deserve.