

China Economy: macroeconomic scenarios and prospects for reform

Key judgements:

- **China's economy remains imbalanced.** Investment levels are too high, supported by excessively fast credit growth. Consumption's share of the economy is very low. The root of the imbalances is structural;
- **There are many economic reforms that would address the imbalances.** These include liberalising prices for capital, energy and water; establishing a better business environment and further improving the social security system;
- **China's leaders understand which reforms are needed.** They also understand that accelerating reform carries risk: potential economic instability, reduced capacity of the CCP to control the economy, and challenge to the different vested interests;
- **Unless reform is accelerated, China is likely to face economic difficulties in 3-5 years caused by the misallocation of investment.** This would entail a progressive deterioration, rather than a sudden stop. But lower income growth and higher environmental degradation are likely to have social stability implications;
- **China's elites want to minimise instability.** They face a choice between more likely, and more likely widespread, economic difficulties in the future if reforms aren't accelerated, or potential, more localised, difficulties if they are. In the one Party state, either outcome has direct implications for the current leadership;
- **A gradual, staged approach is the most likely outcome.** This is a well tested approach to reform in China. Partial hukou and land reform represent the 'quick-wins', followed by price liberalisation and SOE reform. Tax increases and capital account liberalisation will be the most difficult. The sum of such changes will be transformational; and
- **All indications are that a major push on economic reform is beginning.** This autumn's Third Plenum and Central Economic Work Conference will be pivotal. The first is political and has a longer horizon. The second is technocratic. What matters most is which areas of reform are emphasised.

British Embassy Beijing
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More recent analysis by the British Embassy in Beijing, including covering the November Third Plenum and the December Central Economic Work Conference, is available at:

http://www.ukti.gov.uk/pt_pt/export/countries/asiapacific/foreast/china/fcouupdates.html?null.The

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INTRODUCTION: CHINA'S IMBALANCED MACROECONOMY

1. China's macro economy is imbalanced. Investment's share of GDP is around 49 percent, an unprecedented level (see chart).

2. The efficiency of this capital investment has fallen since 2008, as shown by falling returns on capital and the inability of recent credit growth to deliver faster growth.

3. The cost of this inefficient investment is born by China's savers. The deposit rate at commercial banks is held low by the government. This reduces household incomes from savings but ensures that China's banks retain high profitability despite their relatively inefficient lending.

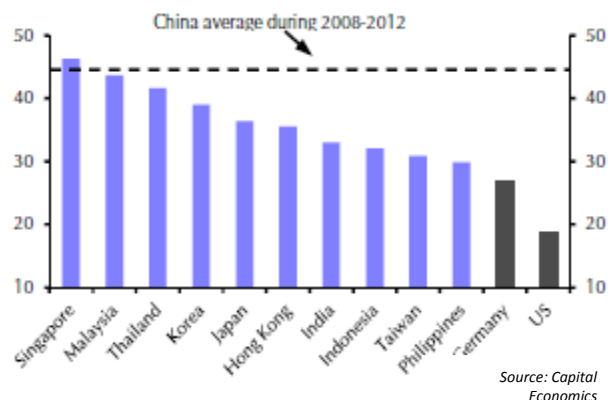
4. China's high investment level has a number of causes:

- **artificially low input costs skew incentives towards resource intensive sectors like manufacturing and heavy industry, at the expense of less resource intensive sectors, like services.** The low deposit rate keeps Chinese banks' funding costs low. A historically undervalued exchange rate incentivises investment in tradeable goods. Subsidised energy and water disproportionately benefit heavy industry;
- **the land system combines with central-local fiscal relations to fuel real estate investment.** Currently only local governments can freely sell rural land or reclassify rural land into urban land. This allows them to capture big profits when land is bought from farmers at low cost and sold to property developers at high costs. The revenues from such deals helps meet the large, structural shortfall between local governments' spending obligations and the funds they receive from central government. Demand at the high end of the property market is sustained in part by speculative investors who, thanks to China's repressed financial system, have few alternative investment opportunities;
- **subsidised banking profits and cronyism, reduces incentives for risk management.** China's banks are extremely profitable thanks to artificially low funding costs (via the fixed deposit rate). They therefore face little competitive pressure to lend to risky organisations (i.e. those lacking collateral, which tend to be smaller companies) preferring to lend to heavy industry, which has lots of collateral. SOEs dominate heavy industry. SOEs' links to government and the implicit sovereign guarantee they further encourages bank lending, even though they are usually much less profitable than private companies.

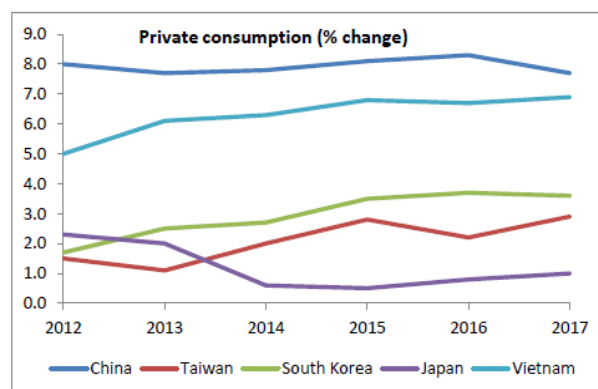
5. A necessary corollary of China's extraordinarily high level of capital formation is a very low level of consumption as a proportion of GDP.

6. Chinese consumption of itself has been growing rapidly in recent years, averaging over 9 percent annual

Chart 1: Maximum investment share of GDP in last 50 years



Source: Capital Economics

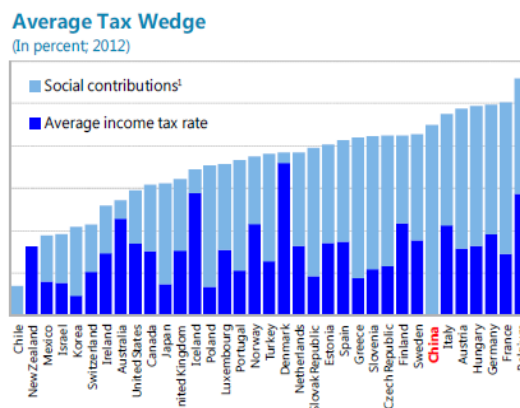


growth since 2008, faster than any other East Asian Economy. Most analysts forecast China’s consumption to continue to grow rapidly (e.g. see adjacent graph). The main macroeconomic problem in China therefore has long been excessively fast growth in investment, rather than lacklustre growth in consumption.

Source: Economist Intelligence Unit

7. That said, there are a number of economic barriers to still faster growth in Chinese consumption:

- **incomes are suppressed.** Chinese people pay extremely high social security contributions (see adjacent chart). In addition, the fixed deposit rate reduces incomes from savings. IMF analysis has consistently shown that the income effect of higher deposit rates in China would dominate the substitution effect;

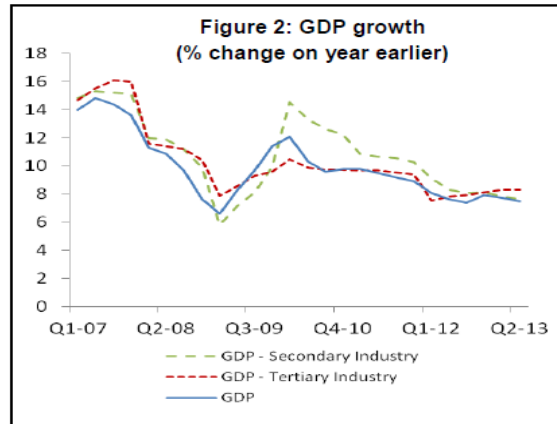
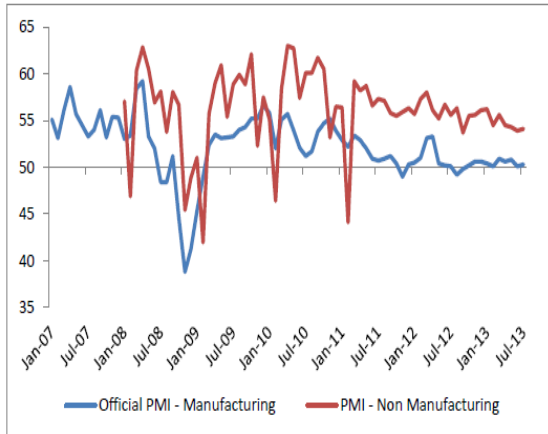


Source: World Bank/State Council, China 2030

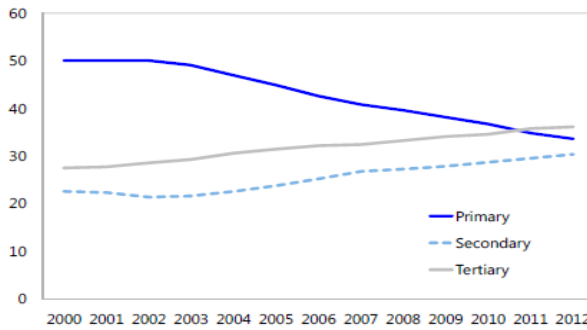
- **high levels of precautionary savings are still incentivised by inadequacies in China’s social security system.** The coverage of China’s social security system was extended extremely rapidly in the past 10 years. But two weaknesses remain. First, access to social services is still, to some extent, tied to one’s household registration (hukou), ensuring that in reality many of China’s 200 million migrant workers lack coverage. Second, coverage is quite shallow: without private medical insurance, everybody still faces crippling out-of-pocket expenses for any big interventions;
- **service sector development is held back.** China’s services industry is developing rapidly (see box below) but structural forces are preventing still more rapid development. Controlled prices for capital and other resources incentive investment in other sectors. Services companies find it harder to secure lending, as they frequently lack suitable collateral. State-Owned Enterprises and government bureaucracy crowd out competition, especially from foreign companies.

Box: How confident can we be about robust service sector development?

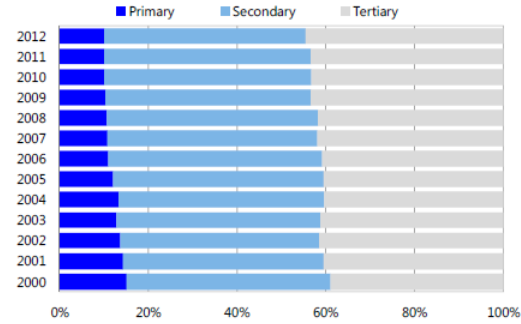
China's official data for service sector development is not seen as particularly robust. But the metrics we do have point to sustained and robust growth, as shown in the graphs below.



China: Employment Shares by Sector
(In percent of total employment)



China: GDP Shares by Sector
(In percent of total)

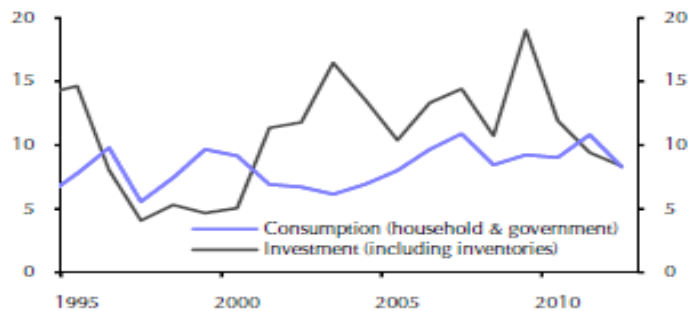


Source: CEIC database, IMF. Note: Primary = agricultural; secondary = manufacturing; tertiary = services

RECENT DEVELOPMENTS: NO DECISIVE SHIFT TOWARDS REBALANCING.

8. The balance between investment and consumption appears to have stabilised in the last two years. In 2011 and 2012, consumption (private and government) grew at least as fast as investment – see adjacent graph from Capital Economics.

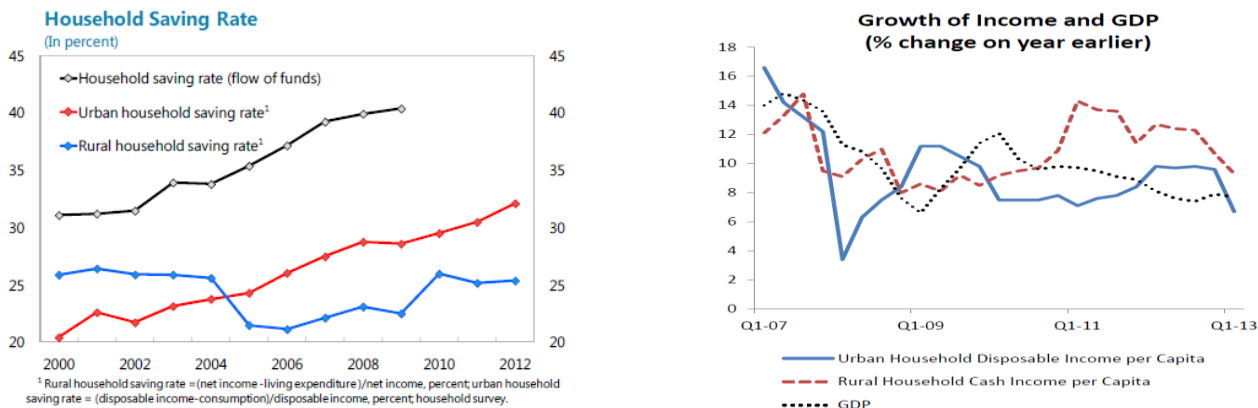
Graph: Investment & Consumption, Real %-growth



9. There is some evidence that aspects of the economy are changing in ways that will in time support rebalancing. In particular, appreciation of the RMB has accelerated which, over time, should reduce incentives to invest in trade-able goods (the undervalued exchange rate was essentially a subsidy on China's exports). As discussed above, services continue to grow strongly, and now employ more people than manufacturing. Finally, rural and migrant incomes growth has consistently outpaced GDP growth, meaning a greater share of national wealth is going to these households.

10. However, these positive signs can be matched by less encouraging developments. Urban income growth has dipped below headline GDP growth for the first two quarters of 2013. It would be worrying if this trend continues as urban workers consume a much larger proportion of their (much higher) incomes than either rural or migrant workers. Furthermore, the household savings rate continued to increase last year (see graphs below).

Graphs: savings rates continue to rise and urban income growth has recently slowed.



Source: CEIC database

ECONOMIC REFORM: THE MAIN VARIABLE IN CHINA’S MACRO-REBALANCING

11. China has therefore yet to experience a decisive shift towards more balanced growth. This will not happen until there is decisive push on economic reform. The policies that China needs to implement are well understood. China's leaders themselves have been talking about them since at least the start of the 11th Five Year Plan in 2006. (An argument can be made that were it not for the global financial crisis Hu and Wen would have made much more progress in implementing structural reform).

12. The main objectives of these reforms are to **raise incomes, reduce savings and improve the business environment**. The policies needed to achieve these objectives will have significant spill-over effects, for example:

- reducing social security contributions will raise incomes but leave a gap in government finances; and
- liberalising the deposit rate should in time lead to better lending to service sector companies, but it will also reduce banks’ profitability, potentially leading to financial instability.

13. A further two requirements of any reform effort will therefore also be to ensure **fiscal sustainability** and preserve **financial stability**.

14. An analysis of the different policies needed to achieve these five broad objectives is provided in Annex A. Table below provides an overview summary.

'Proactive' objectives to achieve macro-rebalancing	Policies
Raise incomes	Reduce social security payments; raise minimum wages; liberalise deposit rates to increase savings incomes.
Lower savings	Deepen social services reform; reform the household registration system (the hukou).
Improve the business environment	Reduce red-tape and simplify approvals; liberalise factor prices (e.g. capital, energy, water); promote more competition (including from private domestic and foreign firms)
'Spill-over mitigation' objectives to prevent instability	Policies
Ensure fiscal sustainability	Broaden the revenue base; improve budget transparency; reform of the land system.
Preserve financial stability	Improve financial sector regulation; liberalise interest rates; gradually open the capital account.

15. Of course, all reforms have **unintended consequences**, which will greatly complicate the actual implementation process. We should bear this in mind when considering likely future developments: reality will always be much messier and compromised than the stylistic scenarios that are discussed below.

PLAUSIBLE MACROECONOMIC SCENARIOS

16. This section describes the three most plausible macroeconomic scenarios for the years ahead.

Scenario 1: a decisive, proactive push on reform

17. The IMF has recently modelled the effects of a more proactive approach towards reform – see table below. This assumes a steady but realistic pace of reform, with implementation starting at the beginning of 2014.

Decisive Reforms	2012	2013	2014	2015	2016	2017	2018
Real GDP	7.8	7.8	7.0	6.9	6.7	6.8	7.0
Total capital formation (%gdp)	48.8	48.8	48.8	48.5	48.0	47.4	46.7
Consumption	8.4	8.5	7.8	8.4	8.5	8.9	9.5
Investment	8.4	8.4	7.2	6.0	5.3	5.1	5.4
CPI	2.6	3.0	3.0	3.3	3.5	3.8	4.0
Current account balance (%gdp)	2.3	2.4	2.1	1.8	1.5	1.2	1.0

Source: IMF Article IV, July 2013. All numbers are y-on-y growth, unless stated otherwise.

18. Under this scenario, capital formation will fall to around 46.7 percent of GDP in 2018, down from 48.2 percent today. This implies annual investment growth falling from 8.4 percent today to 5.4 percent in 2018. Consumption growth rises from 8.4 percent today to 9.5 percent in 2018. This comparatively small change in consumption growth illustrates both China's already high growth in consumption, and the lagging way in which consumption behaviour develops.

19. The economy remains very unbalanced in 2018. But if the scenario were extended a further few years you would see capital formation continue to fall steadily to around 40 percent of GDP around 2023-2025.

20. Many of the policies needed to rebalance the economy have a negative impact on short-term growth (see annex A). As a result, under the rebalancing scenario, headline GDP growth is forecast to fall to 6.7 percent in 2016 (vs. forecast growth of 7.5 percent in 2016 with no rebalancing).

21. Some reforms will also be inflationary, at least in the short-term, as current prices of capital and natural resources are held low by implicit or explicit subsidies.

22. However, if the reforms are implemented, the quality of growth is likely be higher: higher incomes, more job creation and less environmental degradation. As a result, social stability should be easier to achieve (as pointed out recently by Michael Pettis in ['China is going to slow down but it can handle it'](#)).

23. In economic terms, all countries ultimately benefit from a stable and sustainable Chinese economy. Many countries will feel these benefits quickly. Global imbalances will be lower, which should enhance stability and reduce trade tensions. Commodities' inflation will be lower on the back of less rapid growth in demand from China. Demand in China for imports in services and consumable goods will increase.

24. It is likely, however, that commodities' exporters will need to undergo an adjustment. Demand from China for natural resources will continue to increase, but at a slower rate to what we've seen in recent years.

Scenario 2: kicking the can until it hits the wall

25. Absent decisive policy action, the most likely trajectory is only a very gradual improvement in the situation, as set out in the IMF's recent Article IV (see below). This suggests that consumption will grow marginally faster than investment each year, but by 2018 total capital formation will still be close to 49 percent of GDP.

Kicking the Can	2012	2013	2014	2015	2016	2017	2018
Real GDP	7.8	7.8	7.7	7.6	7.5	7.5	7.5
Total capital formation (%gdp)	48.8	48.8	49.0	49.1	49.0	49.0	48.9
Consumption	8.4	8.5	8.1	7.9	7.6	7.6	7.4
Investment	8.4	8.1	7.9	7.3	6.9	6.8	6.5
CPI	2.6	3.0	3.0	3.0	3.0	3.0	3.0
Current account balance	2.3	2.5	2.7	3	3	3	3

Source: IMF Article IV, July 2013

26. The return on capital in China has been falling since the 1990s, suggesting the misallocation of investment is getting worse. Since the start of the 2008 stimulus, the credit intensity of GDP growth (i.e. the amount of additional credit to provide an additional boost to growth) has risen significantly.

27. Without productivity-enhancing reforms, investment efficiency will continue to fall, and the credit-intensity of future growth will further increase. Over time, this increases the likelihood that China's banking system will be overwhelmed with non-performing loans, as it was in the 1990s and early 2000s.

28. It is uncertain when this point would be reached. Despite high growth in credit in recent years, the ratio of non-performing loans (NPLs) seems quite low, with estimates ranging from 1 percent to 6 percent, compared with an NPL ratio of 20 percent in 2003. The main banks have high levels of core capital and the vast majority of their lending is funded by deposits rather than through the wholesale markets.

29. It therefore seems likely that the current model could continue for a few more years. But, **this scenario is unsustainable**. In time, the amount of bad debt would reach a critical level, making it difficult for banks to continue to lend, causing growth to deteriorate. This would necessitate a recapitalisation, which ultimately would be underwritten by the government (which means China's taxpayers and savers). Financial losses and deleveraging would in turn generate an adverse feedback loop that would hamper employment and growth. Absent structural reform, the IMF project that economic growth would fall to around 4 percent of GDP, with income growth plateauing at around 25 percent of US levels – see adjacent graph.

30. China's impact on the global economy in the years leading up to the stagnation would be mixed. Commodity exporters would continue to benefit from the sustained investment-led demand from China. Moreover, under this scenario China runs a larger current-account surplus, causing the reserves to balloon to \$6.3trn (up from \$3.3trn now). All else equal, this would keep global interest rates lower and increase the flow of China's outward investment. Under this scenario, you'd still expect incomes to continue to rise briskly, sustaining strong growth in UK exports to China, but at a lower rate than what the rebalanced scenario could deliver.

31. The impact of economic stagnation in China would be significant. China contributed nearly 40 percent of global economic growth last year. A sharp fall in Chinese growth to around 4 percent followed by long-term stagnation would therefore leave the global economy without a one of its most significant engines.

32. Moreover, under this scenario, income growth is likely to be lower, fewer jobs would be created and environmental degradation would remain high. All these would presumably lead to a rise in public dissatisfaction, with implications for social stability.

Scenario 3: imminent economic slowdown

33. It is unlikely that China is headed towards an imminent economic crisis. Data this year has been consistent with 7.5 percent growth, with the latest figures suggesting growth in the second half of 2013 will marginally exceed growth in the first half of the year.

34. However, it is not inconceivable that underlying conditions are much worse than people think. Three possibilities stand-out:

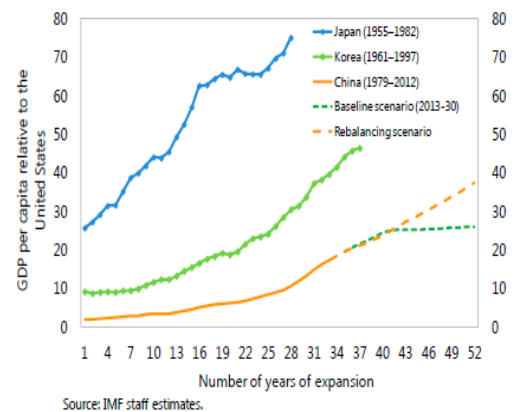
- **survey data of firms could be misrepresentative**, either due to deliberate data manipulation or due to the incomplete coverage of the surveys (for example, the industrial profits' data is focused on big firms. The conditions for smaller firms could be much more difficult);
- the level of **non-performing loans could be much higher** than even the most bearish of commentators fear, for example due to methodological problems. This would accelerate the type of problems envisaged in paragraph 29.
- there could be a **random exogenous shock**, for example a contained 'flu pandemic or a short localised conflict.

35. It is likely that any of these problems would quickly be felt in the banking system:

- if business conditions reach crisis point, you'd expect a wave of defaults by smaller companies, with bosses fleeing the country and workers losing their jobs (as happened in parts of Zhejiang province last year). This would cause a deterioration in consumer spending and in the balance sheet of smaller financial institutions;
- an NPL crisis would manifest itself with a sharp slow-down in credit, as banks are forced to hoard their capital. Recapitalisation would then be necessary, which could come either from the capital markets (unlikely, especially for the smaller banks) or from the government;
- a contained 'flu pandemic or a short war would likely precipitate a collapse in business activity, eventually leading back to the banking system.

36. This scenario is therefore essentially an accelerated version of the second scenario – i.e. absent structural reform, economic growth would fall to around 4 percent of GDP, with income growth plateauing

Convergence Process of Per Capita GDP: China, Japan, Korea (PPP, relative to United States)



at around 25 percent of US levels. The wider implications of this scenario are therefore likely to be similar to what is outlined in paragraphs 29-31 above.

LESS LIKELY SCENARIOS: ACUTE CRISIS OR PROTRACTED SLUMP

Scenario 4: acute crisis

37. Periodically there is talk of China's economy experiencing 'a hard-landing'. It is rarely clear what people mean by this, but it is often presented as a precipitous collapse in Chinese economic growth, comparable to the acute economic crises experienced in other countries, for example the US and Europe from 2008, or South East Asia in the last 1990s.

38. China's repressed financial system ensures China is unlikely to experience this sort of dynamic, volatile crisis. In particular:

- the banking system is reliant on deposits, rather than more volatile wholesale funding. A run on deposits is unlikely, given all banks are currently ultimately owned by the CCP and there are strict limits on taking RMB out the country;
- the \$3.5trn reserves prevent a balance of payments crisis. They could also be used to recapitalise the banking sector, as happened in December 2003 and April 2005 when Central Huijin transferred nearly \$40bn of reserves onto the balance sheets of the main commercial banks; and
- capital controls are still binding. This prevents a) the build-up of foreign debt (that could suddenly be withdrawn at times of crisis) and b) large outflows of domestic capital in times of stress.

39. In addition, while the pace of recent credit growth has been far too fast, the IMF judge the current stock of debt to be reasonable, with 'augmented debt' (central and local government, including off-balance sheet lending) estimated at 50 percent of GDP. On top of this, corporate sector debt has expanded rapidly in recent years to reach 100 percent of GDP. But the authorities also have large assets: SOE assets are estimated at around 200 percent of GDP. Provided the rate of credit growth slows significantly in the coming months and years, China ought to avoid systemic debt problems.

40. These factors don't give China immunity from a banking crisis. Nor do they mean that nobody pays the price for such a crisis: taxpayers and savers are likely to take the first hit, with asset sales to follow if necessary. But they suggest China has the means to manage a banking crisis.

41. A corollary of this argumentation is that financial sector reform, in particular the opening of China's capital account, is likely to proceed slowly and gradually. Many in the Chinese system are likely to conclude that current arrangements represent the best protection China has from the sort of instability that has affected other financial systems.

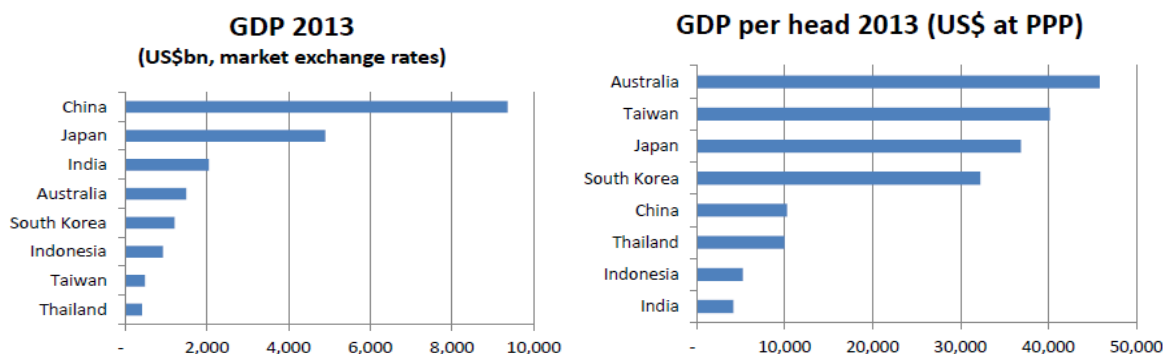
Scenario 5: protracted economic slump

42. There is widespread agreement among economists that without a decisive push on economic reform, the Chinese economy will hit a wall.

43. However, while a slump is more plausible than an acute crisis, it is not the most likely outcome. China still has a lot of catch-up growth left: as the graphs below illustrate, per capita incomes, even

adjusted for purchasing power, are still low. Chinese average incomes (in PPP terms) are only around 20 percent of US incomes; by the 1990s, Japan's incomes had already risen to between 70-80 percent then-US incomes.

Charts: China's economy is big, but per capita incomes remain low



Source: Economic Intelligence Unit

44. There are clear ways China could support future growth, as described in annex A. Implementing these reforms will be difficult and implementation will give rise to unintended consequences. But the key variable is not the availability of growth-enhancing measures; it is the availability of the incentives to implement these measures.

RETAINING CCP POWER: A SHARED INTEREST OF CHINA'S ELITES

45. It is tricky to generalise about a country as large and diverse as China. As elsewhere, there are a huge number of different interest groups, advocating and blocking different elements of policy development depending on the specific impact of individual policies.

46. It is, however, reasonable to generalise that the majority of China's influential voices (including non-CCP members) share the belief that China is currently best served by the CCP retaining a monopoly on power. This in turn rests on the majority of Chinese people believing that their interests are best served by the CCP. These interests are still most closely defined by economic factors.

47. The CCP as an institution would, all else equal, choose to retain both political power and economic control. This is partly because it offers opportunities for rent-seeking and they know that structural reform will be a difficult process. But it also reflects a belief that CCP control over the economy has helped China avoid the volatility that characterises the business cycle in other countries.

48. Ultimately though the CCP will pursue more liberal reforms if that is what is needed to ensure economic and therefore social stability. The experience of SOE reform in the 1990s provides some precedent for this. The CCP would not have willingly caused 40 million workers to lose their jobs and privatise so many state owned enterprises. But at the time it represented the best policy option available for achieving economic, and by their logic social, stability.

49. The parallel today with the 1990s is inexact. The economic situation then was more desperate than it is today. As a result, the interest of the elites was closely tied to the national interest. This isn't necessarily the case today.

50. However, China is not monolithic. As Annex A makes clear, a diverse range of different groups are affected by different reforms. There obvious pro-reformers among the new political leadership and many SOE executives are also likely to be pro-reform, seeing the benefits of less central government interference as outweighing the costs of withdrawn subsidies.

51. Private business-leaders are also likely to support more reform, and their influence is substantial. Many of them are firmly part of the Chinese 'establishment', a process that was accelerated by President Jiang Zemin's 'Three Represents' theory in 2000. More importantly, private firms are now responsible for nearly all employment generation in China.

52. Local governments (provincial and municipal) feature most consistently among the 'losers' from reform. Since the reform of China's fiscal architecture in 1994, an ecosystem of unsustainable funding practices has evolved, designed to fill the funding gap that exists between local government's spending obligations and the resources they get from the centre. However, local governments will also be responsible for implementing most of the reforms. Securing this support will therefore be critical.

53. But here it's important to acknowledge the diverse situation of different local governments. Shanghai has a GDP per capita of around \$25,500 (in PPP), compared to Tibet's \$5,000. The impact of reforms will therefore be felt differently. As a result, the central authorities are likely to stagger the introduction of reforms, as can be seen with new free-trade zones in Shanghai and Guangzhou provinces. They can also increase intra-country fiscal transfers, raising central government deficits and delaying the introduction of revenue-raising measures, thereby softening the blow.

HOW CAN WE JUDGE WHICH SCENARIO IS THE MOST LIKELY?

54. As a result, it therefore seems most likely that China will, either proactively (i.e. scenario 1) or more reactively (scenario 2 or 3), embrace structural economic reform. The core elements of these reforms, whenever they are introduced, are outlined in Annex A. The differences in the two approaches would be:

- **the pace at which these reforms are introduced:** proactive reforms would be delivered in a more measured pace than delayed reforms;
- **the scope of reform:** the more economic pressure the authorities face, the more ambitious the reforms will need to be (e.g. reforms brought about by a banking sector recapitalisation may need to include asset disposals, to bring government debt down rapidly); and
- **the volatility of future growth:** the greater the economic pressure, the more volatile the growth.

55. In assessing how likely the leadership will be to proactively embrace reform, we can get clues from two sources: evidence from the first 6 months under the new leadership and China's internal political calendar.

Evidence from the last 6 months

56. It has been 6 months since China completed its once-in-a-decade leadership transition. Since then there has been no conclusive evidence that the new leaders are fully committed to economic reform. But there are encouraging indications:

- the nature of the new leaders themselves. They appear much more confident than their predecessors, and more willing to take risks. They present more of a united front about what needs to be done. They appear realistic about the challenges of implementation. The right people seem to be in the important posts.
- their actions so far. Those areas where we have seen significant new policies (e.g. the rapid expansion of the VAT pilot; the 'mini-stimulus' package of measures introduced at the end of July (which contained a good proportion of structural reforms, alongside more targeted investment); the start of a potentially significant effort to reduce the number of central government approvals; the announcement of the Shanghai Free Trade Zone etc) have been consistent with the longer-term rebalancing agenda.

57. Some commentators have expressed disappointment that these 'good' policies have been accompanied by some 'bad' policies, e.g. new investment stimulus. Sceptics say that such policies prove that old habits die hard. An alternative explanation would be that:

- a) **China has huge ongoing investment needs**. Investment growth in recent years has been unsustainably high, and the lack of market mechanisms has meant that this investment has been allocated sub-optimally. However, it is also pretty clear that under most projections for growth and urbanisation, China will need to continue to invest heavily: RMB 41.6 trillion over the next 20 years, according to the latest [UNDP report](#); and
- b) **the Chinese leadership are determined to avoid an unstable growth trajectory**. If private investment falls off too quickly, as they seem to have concluded in Q2 this year, they will intervene with public investment to ensure stable growth. This will be a difficult goal to achieve and will result in continued sub-optimal investment allocation. But that appears to be the cost that the Chinese leadership are willing to let Chinese taxpayers and savers shoulder.

China's political calendar

58. China doesn't have multi-party elections. It does however have political landmarks where the leadership need to prove to both the Party and the people that they are delivering results. These landmarks can help guide expectations about future policy developments. In the coming years, three particular landmarks stand-out:

- 2016: the publication of the 13th 5 Year Plan. Here, it will be important to demonstrate progress against the goals of both the 11th and 12th 5 Year Plans, the central theme of both was the transition to a more sustainable, balanced and co-ordinated growth model.
- 2017: the 19th Party Congress. This will see five of the current Politburo Standing Committee Members stand down due to mandatory retirement rules (only President Xi and Premier Li will remain). Their guaranteed retirement may make them more willing to 'fall on the sword of reform'. Their successors are likely to include Wang Yang, Ma Kai and Li Yuanchao, all considered to be progressive reformers.

- 2020: the target year for China becoming ‘a moderately prosperous society in all respects’. This target contains two important macroeconomic elements: doubling both GDP and incomes (urban and rural) between 2010-2020. These targets are more likely to be achieved through accelerated reform.

OVERALL JUDGEMENT: CAUTIOUSLY OPTIMISTIC ABOUT INTENT, UNCERTAINTIES AROUND EXECUTION

59. Overall, the most likely scenario will be closer to 1 than 2. Reform will accelerate significantly in the coming years. The rhetoric around reform will become more forceful, and implementation will be well underway by 2018. By that point, we should already see a shift in the main macroeconomic imbalance between growth in investment and consumption, even if China’s overall investment as a proportion of GDP remains very high.

60. However, the implementation process is unlikely to proceed as smoothly or as quickly as required under scenario 1. China is a large and populous country: implementing changes will test the capacity of government at all levels. Unanticipated consequences will inevitably arise once the reform programme is underway. Deals will be struck between different interest groups that lead to suboptimal but more practicable outcomes.

61. High-frequency economic data from China will become more volatile, as the authorities continuously ‘fine-tune’ their policies. Public funds may well be needed to recapitalise particularly indebted local governments or financial institutions (but given the strength of China’s fiscal union this should not create widespread instability). The overall growth trajectory will be a slow-and-steady deceleration, accompanied by a gradual reduction in investments share of the economy.

WHAT TO LOOK-OUT FOR IN THE AUTUMN

62. The Communist Party’s Third Plenum in November followed by the government’s Central Economic Work Conference in December provides an opportunity to assess how serious the new leadership is about economic reform.

63. The Third Plenum is a political event. The communiqué issued after the week-long meeting will set-out in fairly high-level terms the expected and acceptable boundaries of political and economic development over the next decade. It will indicate the **ambition** of the future reform effort, including what **broad areas** are within its scope, and what the **main priorities** will be. But we will not get much detail about the exact timetable or sequencing of reforms.

64. The Central Economic Work Conference is a technocratic event, involving all the main executive agencies of government. The **annual growth target** for 2014 will provide a clear indication about intentions. Lowering the target to 7 percent, as most people expect they will, would suggest a willingness to proactively reform – as shown in the table below, growth throughout the forecast horizon is lower under the ‘decisive reform’ scenario.

Growth scenarios (Real GDP, year-on-year)	2012	2013	2014	2015	2016	2017	2018
'Decisive reform'	7.8	7.8	7.0	6.9	6.7	6.8	7.0
'Kicking the can'	7.8	7.8	7.7	7.6	7.5	7.5	7.5

Source: IMF Article IV, July 2013

65. It is hoped that the communiqué issued following these meetings will be more **specific**, giving a (reasonably) clear indication about the **sequencing** and **timetable** of reforms, at least over the short-term. Taken as a whole, the likely reform package involves a significant redistribution of resources away from the state sector (including state-owned enterprises) and towards both households and smaller companies. The 'giving' element will obviously be less contentious than the 'taking away' element. As a result, it is likely that there will be a staged process towards reform.

66. A package of reforms along the following lines seems realistic:

- Stage one: **quick wins and laying the foundations for future reform.**
Likely implementation timescale: 2014-2016
- Reform of the **household registration system (the hukou)** will be the centre piece, presented as the cornerstone of China's future urbanisation. Initially, the tying of social security benefits to hukou will be abolished in the 2nd and 3rd Tier Cities. Exemptions are likely to be made for China's largest Tier One Cities, for example Beijing, Shanghai, Guangzhou and Tianjin.
- **Pilots in Shanghai and Qianhai (and probably elsewhere)** will provide the testing group for the more radical policies that, if successful, will be rapidly expanded. The likely emphasis here will be on improving the business environment (for both private domestic and foreign companies), particularly for services companies and in areas of public services delivery, for example healthcare.
- **Land reform** will provide a correspondingly large signal to the 49 percent of Chinese that still live in the countryside. This will be carried out initially to deliver larger economies of scale (outside of the North Eastern Provinces farming in China remains dominated by small-holdings). It will then be expanded to allow the direct transfer of land to developers, cutting out the local government middle-man.
- Li Keqiang's **campaign to reduce red-tape** will be sustained. The Premier has made a big thing of getting rid of government approvals as a fairly cost-free and quick way of stimulating the private sector. There has already been some progress and we should expect this to continue.
- The initial package of reforms will be expensive. Hukou reform will increase access to social services, and worker's own contributions to social insurance are likely to be reduced to raise incomes and stimulate demand, further straining local government finances. **Tax revenues may also fall in the short-term.**
- **Larger central government deficits will make up the shortfall.** The authorities will want to delay the introduction of significant revenue-raising measures until the benefits of the first reforms are visible. The central government is therefore likely to run higher deficits to pay for things. But behind

the scenes there will be huge efforts to improve the transparency of local government finances, laying the foundations for eventual municipal bond issuance.

- Elsewhere on the financial side, **the focus will continue to be to lay the foundation for further liberalisation**, including improving coordination between the different financial regulators, and establishing both a deposit protection scheme for savers and a solution mechanism for insolvent financial institutions.
- Everything will be **underpinned by government investment in targeted sectors** (e.g. social housing, rail-ways, broadband internet) and in targeted provinces (e.g. concentrated in the poorer provinces). The intensity of these investments will depend on the stability of overall economic growth.
- **Stage two: withdrawing support to the state sector**
Likely implementation timescale: 2015-2018
 - Prices: the **liberalisation of energy and water prices will be rolled out**, thereby reducing the implicit subsidy that resource intensive industries have enjoyed. This will have inflationary consequences so expect progress to be solely tied to the overall inflation environment.
 - SOE reforms: factor-price liberalisation will reduce subsidies enjoyed by many SOEs, thereby indirectly forcing them to become more productive. In addition, the **proportion of SOE profits paid into the central budget** will increase and a new wave of privatisations will occur, focused on local SOEs in non-strategic sectors suffering from excess overcapacity, for example the auto sector. It is highly unlikely that any of the 120 centrally managed SOEs will be privatised.
 - Financial side: **the deposit rate will be gradually liberalised**, for example in 25bps increments, reducing banking sector profitability, encouraging greater emphasis on risk management and increasing incomes from savers. Capital account will be opened to allow more flows of fixed investment.
- **Stage three: paying for it all**
Likely implementation timescale: from 2016 onwards
 - tax increases: **broadening the tax base** will be achieved by introducing new taxes on resources, property (akin to UK council tax), and incomes. Expect the latter two to provoke the most bitter opposition, requiring as they do the disclosure of assets.
 - financial side: **the capital account will be gradually opened-up** to volatile capital flows, and even then will remain closely relative to many other countries.

67. We shouldn't worry if some of the reforms mentioned above are not mentioned in the autumn meetings. And we shouldn't get too hung-up on the exact formulation of communiqués, as the wording of these things inevitably involves compromise. The key will be to see what changes on the ground. As President Xi is fond of saying 'empty talk is meaningless, salvation comes only through implementation'.

British Embassy Beijing,

More recent analysis by the British Embassy in Beijing, including covering the November Third Plenum and the December Central Economic Work Conference, is available at:

http://www.ukti.gov.uk/pt_pt/export/countries/asiapacific/fareast/china/fcouupdates.html?null.

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