

# KIEL POLICY BRIEF

## China's Growth Challenges

A close-up photograph of a silver, metallic telescope mounted on a pedestal. The telescope is angled towards the left, and its two objective lenses are visible. The background is a blurred view of the ocean under a clear sky.

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# ZUSAMMENFASSUNG / ABSTRACT

Vor dem Hintergrund einer in den vergangenen Jahren kontinuierlich zurückgegangenen Wachstumsrate der chinesischen Wirtschaft stellt sich für China die Herausforderung, die Wirtschaft an „die neue Normalität“ (the New Normal) anzupassen. Unter „der neuen Normalität“ wird die chinesische Wirtschaft nicht nur mit einer niedrigeren jährlichen Rate von etwa 6-7% weiter wachsen. Wichtig ist auch, dass die Qualität der wirtschaftlichen Entwicklung zunimmt. Dazu gehören vor allem Innovationen und ein effizienterer Ressourceneinsatz. Zu diesem Zweck müssen neue Reformschritte eingeleitet und die bereits verabschiedeten Reformmaßnahmen umgesetzt und erweitert werden.

Das Papier gibt einen Einblick in die drei Kernherausforderungen, denen sich China stellen muss: die Förderung des einheimischen Konsums, die Unterstützung für Innovationen und privates Unternehmertum, sowie die weitere Öffnung Chinas im Außenhandel und gegenüber Auslandsinvestitionen.

Damit Reformen Erfolge zeitigen, bedarf es der Konsistenz, Glaubwürdigkeit und Transparenz staatlicher Reformen und ihrer Vermittlung, um unklare bzw. verwirrende Signale an alle Marktteilnehmer zu vermeiden.

Against the background of the continuously weaker economic growth in China in the past few years, the Chinese government is convinced that the Chinese economy needs to adapt itself to getting used to “the New Normal”. Under “the New Normal” the Chinese economy will grow at lower rates of about 6-7% annually, whereas China would strive for substantial quality advancement that should become a core element in its future growth model in the long run. To realize a more quality- and domestic-market-oriented sustainable economic development, several reform measures need to be implemented and expanded and new reform policies need to be initiated.

Focusing on three key growth challenges faced by China—domestic consumption, innovation and entrepreneurship, and foreign trade and investment, this paper aims at providing more insight into these challenges and sketching potential policy measures that are required to deal with them. Reforms and policy measures to be implemented need to have a clear long-term orientation to support adequate long-term structural changes, and such orientation requires consistency, credibility, and transparency in order to avoid confusing signals received by market participants.

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# CHINA'S GROWTH CHALLENGES

*by Wan-Hsin Liu and Rolf J. Langhammer*

## 1 INTRODUCTION

China's economic development over the past decades was highly impressive. Driven by stepwise and irreversible domestic economic reforms, a number of reversible policy experiments and compliance with global trade rules it has moved from a planned and rather closed economy to a market-oriented economy that is now intensively integrated into the world economy. In 2008 China became the second largest economy of the world and in 2010 it overtook Germany and became the world export champion. While many countries, particularly the advanced economies, suffered a lot from the financial crisis in 2008 and the following economic recession, China was still able to keep its high economic growth rate during that time, partly thanks to a double-digit fiscal expansion program (about 27% of GDP in 2009; see Wong 2011) which was the largest among all crisis-ridden countries. China's economy still grew at a high rate of 9.3% in 2011. This was much higher than the growth rate of the US (1.6%), the EU (1.8%) and the OECD countries (1.9%) in the same year.

Over the past four years China's economy has slowed down, however. Although the growth rates were still visibly above not only the world average but also the emerging markets average, they were significantly lower than before, with about 7.7% in 2012 and 2013, 7.3% in 2014 and about 6.9% in 2015. Data inconsistencies provide food for assuming that true growth rates are already lower. Lower growth rates and the likely downward trend have raised huge concerns both domestically and globally over China's economic perspective in the medium run. The economic slow-down of China would not be a challenge for China itself only. Due to its strong interlinkages and joint supply chains with richer and poorer countries alike and its growing role in international financial markets, China's economic slow-down will leave a substantial footprint in the global economic relations. Thus, it is understandable why the world is now even more eager to gain more reliable insights into China's strategy of how it plans to sustain its economic development in the long run.

Against the background of the weaker economic growth in China, China's President Xi Jinping stated in 2014 already that China needs to adapt itself to getting used to "the New Normal" of the Chinese economy. Under "the New Normal" the Chinese economy will not only grow at lower rates of about 6-7% per year, compared to the two-digit growth rates on average over the first three decades after the beginning of the reform. But what is even more important while pursuing "the New Normal", is the recognition of the key relevance of quality advancement in the future growth model of China. To realize a more quality- and domestic-

market-oriented sustainable economic development, several reform measures need to be implemented and expanded and new reform policies need to be initiated.

Looking at the two sources of growth, factor accumulation and innovation, it is clear that policy aiming at fostering sustained and quality-oriented growth must try to deal with not only current but—more importantly—long-term challenges related to the development of **domestic consumption, innovation and entrepreneurship, and foreign trade and investment**. This paper aims at providing more insight into these three challenges faced by China and sketching potential policy measures that are needed to deal with these key challenges. Reforms and policy measures to be implemented need to have a clear long-term orientation to support adequate long-term structural changes, and such orientation requires consistency, credibility, and transparency in order to avoid confusing signals received by market participants.

The remaining paper is organized as follows. Section 2 describes some critical aspects related to the three key growth challenges, respectively, followed by some policy implications. Section 3 concludes and specifies other key challenges that China needs to deal with efficiently and effectively as well to support sustained and quality-oriented economic development in the long run.

## **2 CHINA'S THREE KEY GROWTH CHALLENGES**

### **2.1 DOMESTIC CONSUMPTION**

China's economic growth has been strongly investment- and trade-driven in the past. The financial crisis in 2008 and the following economic recession in many advanced countries in the world reduced the world demand on goods and brought the super commodity cycle to an end. This affected China, one of the most prominent world factories, as well. The decreasing demand both globally and domestically has led to an increasing excess capacity of production which partly originated also from the post-crisis fiscal expansion program in China. To compensate the decreasing world demand on Chinese products, it is crucial to release domestic consumption from barriers which in part were built up to raise private domestic savings for financing capital accumulation and covering social security expenditures.

It would definitely not be sufficient just to “call for”, for example, private households to spend more money in consumption. It is crucial to abandon incentives that have discouraged domestic consumption for years to enhance households' willingness and capability to consume more. According to World Bank the gross savings in China have been extremely high (about 50% of its GDP in 2013 compared to 18% in the US). Chinese save a substantial part of their income to ensure that they are able to deal with unpredictable needs due to diseases, accidents or unemployment. They do so also for some predictable reasons such as for financing their lives after retirement, and their children's education and living expenses. Given the visible surplus of males in China, this includes higher savings in families with boys

than girls in order to improve the wealth position of marriageable men (Wei and Zhang 2011). Keeping all these considerations in mind, it is understandable why Chinese would be more careful in spending even if they actually have the capacity to do so (including access to consumer loans).

To free Chinese households from such considerations at least to some extent, a reliable, functioning, nationwide social insurance system needs to be finally established, incl. social insurance for health care, for unemployment, and for pension etc. Reliable and effective rules and institutions need to be set up and discriminatory treatment by province, by region, by business affiliation and by personal background (e.g. Hukou) needs to be gradually removed. The establishment of such a social insurance system helps ensure a minimum level of life quality for the time without regular income. This is expected to reduce income concerns among the citizen, lower their time preference rate and would motivate them to spend more money in consumption. To finance a public social insurance system, the tax base should be widened and the tax administration be improved and strengthened.

Another issue related to stimulating the domestic consumption is how to establish a reliable institutional framework to better regulate online transactions. With the technological advancement and increasingly easy access to internet, more and more people search for and purchase products they need by visiting online shops. This leads to booming online transactions, particularly in China. China's biggest online commerce company, Alibaba, recorded online sales of about 250 billion USD in 2013, more than the total online sales of Ebay and Amazon (WSJ 2014: <http://projects.wsj.com/alibaba/>). The Taobao website, the biggest online shopping website of Alibaba, has—according to its website—about 500 million registered users and about 7 million merchants selling almost every possible product, incl. goods and services.

How to protect the rights of consumers and merchants engaging in this new type of transaction, how to ensure the product quality, how to deal with innovative payment tools, how to ensure data protection and ownership for households, and how to deal with transaction disputes between customers and merchants and between the users of the shopping websites and the website operators etc. are key issues that need to be dealt with. The existing laws, rules and regulations have not kept pace with the spread of online transactions and digitalization of trade. They need to be adjusted to the increasing demand and new requirements of online transactions. A better established regulatory system provides a more reliable framework, within which online transactions and thus domestic consumption can be fairly stimulated.

## **2.2 INNOVATION AND ENTREPRENEURSHIP**

Having climbed up the wealth and income ladder, China can no longer rely on low-tech, low-priced manufacturing. To emancipate from a low-cost “finishing touch” producer with small local content, Chinese firms need to engage in innovation activities much more intensively than before. Innovation does not mean, however, just applying for patents. What is more

important is to develop new or significantly improved products to satisfy or even create market needs. To make this possible, investment in innovation activities is required.

To encourage innovation investment and engagement, financing is a critical issue, particularly for the small and medium-sized enterprises (SMEs) which often are discriminated in access to loans against state-owned enterprises (SOEs). Reforming the financial system to expand the potential financing channels for firms, particularly SMEs, is of high relevance. It is inevitable that not all existing firms would be able to succeed in innovation activities and in introducing better products to the markets. More competent firms would succeed, supporting the further advancement of the economy, while the others would exit from the markets, leaving room for newcomers. Innovation was thus argued by Joseph Schumpeter as a creative destruction process.

The expanding human capital reservoir of highly qualified graduates in China is an important source for modern and innovative start-ups as market newcomers. Through creating their own firms to better make use of their qualifications, highly-qualified graduates are able to explore and utilize new business opportunities with higher added value, further supporting the industries' general upward development along the global value chains. This would, however, only be possible, if the institutional business and economic environment in China is well-established to encourage the formation of these new start-ups with stronger innovation potential.

Active policies providing, for example, tax preferential treatment, would be important to encourage graduate start-ups in general and university spin-offs in particular. Such start-ups could be financed by phasing out loan subsidies for loss-making SOEs and by organizing the insolvency-rooted exit of SOEs. To minimize collateral shocks for state-owned banks as their creditors, the exit of loss-makers should be organized as a process rather than as a "once and for all" event. Private SMEs should be allowed to participate in this process in order to ensure that the capital stock of SOEs finds its best use after conversion. More general policies to, for instance, better protect innovation outcomes, deal with product piracy issues, and support related legal transactions of innovation outcomes are at least as important as the active policies for innovation promotion.

Another critical issue related to China's potential success in climbing up the global value chains regards its general capability of seizing emerging market chances during the fourth industrial revolution. China's new strategy "Made in China 2025" announced in 2015 with such an orientation tries to combine the advanced ICT tools and products and the manufacturing activities to modernize production processes and to realize smart manufacturing. A comparable strategy from the other countries is the "Industry 4.0" of Germany. Industrial strategies supporting basic research on ICT developments can be indeed useful. What should be avoided by Chinese authorities is to directly earmark "future industries" in order to subsidize their output. Authorities do not have better knowledge in doing so than companies and other market participants.

Additionally, the financing issue should be solved differently with companies and banks as the main actors. To be able to make use of ICT tools and products and integrate them into business operations, firms need to make appropriate capital investment in related ICT tools

and products at first. They also need to invest money in training personnel who would be able to efficiently use these new technologies. Moreover, for the fourth industrial revolution, ensuring firms to gain stable access to high-speed internet is key. To make it possible, large-scale public investments in improving the quality of internet access nationwide is required.

Last but not least, using smart technologies in business operations implies more intensive data-sharing activities between firms and organizations. How to ensure data security would not be another challenge for firms or organizations only. This requires an adequate adjustment of public rules and regulations as well to help deal with potential disputes and infringement issues. Transparency and non-discriminatory enforcement of rules are indispensable to inject confidence in markets that data security is a key concern of Chinese policies.

### **2.3 FOREIGN TRADE AND INVESTMENT**

Furthering consumption-based inward orientation as mentioned above is important. But it does not mean that foreign trade and foreign direct investments (both inward and outward) would be less important for China's further economic growth in the future. Given that global trade deals under the auspices of the World Trade Organization have their own challenges that are difficult to be dealt with and that many countries in the world are working intensively on concluding bilateral or regional free trade agreements with each other, China will not be a passive observer of the mushrooming of such agreements often described as the "spaghetti bowl" syndrome. This, however, does not mean that China should now sign free trade agreements with as many countries in the world as possible in order to keep pace with "competitive" regionalism pursued by the US and the EU. What is more important is to use the content of those bilateral, regional or plurilateral agreements which are already concluded or in the making for those economic targets which China sees for its foreseeable future. To be more concrete, whether the agreed upon content can indeed give fresh impetus to expanding or even fully liberalizing markets for cross-border trade and investment in and with China to further stimulate fair market competition is a key question.

Taking the EU-China Bilateral Investment Agreement which is in the stage of negotiation since early 2014 as an example, it is evident that both the EU and China are interested in concluding such an agreement to replace the current legal patchwork of 26 different bilateral investment treaties between China and the individual EU member states. In doing so, it should help create a coherent legal framework to foster FDI flows between China and the EU. To have an effective agreement, both parties' interests and considerations need to be taken into account appropriately. It cannot be denied that large market and policy asymmetries exist between the EU and China. Against this background, different policy measures are highly required. Inter alia, they comprise initiatives and reforms with respect to setting pre-market entry provisions (incl. the scope of market entry, the nation/region-wide application of the negative list approach, the design of national security reviews etc.), setting post-market entry provisions (incl. the scope of national treatment for foreign firms), establishing reliable and transparent legal and regulation systems, reforming SOEs to remove unequal treatment, and

determining the content and procedure of international (investor-state) dispute settlement mechanisms.

The EU-China Bilateral Investment Agreement alone will not guarantee that all required policy measures, initiatives and reforms will be fully implemented and thus unfold their positive effects. Only when both parties recognize the crucial importance of improving a non-discriminatory market access for goods, services, capital and know-how and for sustaining their long-term economic growth, they will be more willing in seeing such an agreement as a cornerstone for domestic reforms. Negotiating such an agreement and carrying out related domestic reforms will neither be easily self-going nor a “quick fix” or an “early harvest”. And it will take even longer until the implemented rules and regulations can become fully effective at the level of market participants. Still, it will be worth the effort.<sup>1</sup>

### 3 FUTURE PROSPECTS

In this paper we briefly sketch potential policy measures needed to deal with the challenges faced by China regarding its domestic consumption, innovation and entrepreneurship, and its further integration into the world economy. Intensive discussions among experts and related decision-makers from business and policy are highly required to develop more concrete policy measures for each of the above introduced challenges. For an economic giant like China which explicitly wants to sit in the driver’s seat of global technological and economic change, there are certainly other short-term challenges. Among them, the internationalization process of the RMB, the management of exchange rates and the control of capital movements as well as the containment of the dramatic rise of corporate debt range prominently. Beyond the short-term view, medium-term challenges such as coping with climate change and other environment-related issues and the gradual fall of factor productivity seen against the aging of the population are worth receiving at least the same reform attention. However, discussing all these topics would be definitely premature, as long as the priority list of the Chinese government is still to be concluded.

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<sup>1</sup> See Bickenbach et al. (2015) for more information.

# IMPRESSUM

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