The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

A 5-Year Plan to Change China's Growth Path

By Michael Spence

April 18, 2011

China is poised to begin its transition from middle-income to developed-country status. Only five economies successfully managed this transition while sustaining high growth rates, and they are all in Asia: Japan, South Korea, Taiwan, Hong Kong and Singapore. No country of China's size and diversity has ever done so.

China's 12th Five-Year Plan, adopted last month, provides the road map it will follow. Yet it is not really a plan. Rather, it is a coherent interconnected set of policy priorities to support the economy's structural evolution — and thus to maintain rapid growth — over the period of the plan and beyond.

So a great deal is at stake, both internally and externally. Growth in the world's emerging economies now depends on China, the main export partner for a growing list of major economies including Japan, South Korea, India and Brazil.

There are at least five important interconnected transitions embedded in China's new Five-Year Plan:

- Changing the economy's growth model or supply side structure, as labor costs rise, global market shares become large enough to limit expansion and advanced countries' growth momentum slows for an unknown period of time;
- Rebalancing demand, from investment and exports to domestic consumption;
- Accommodating a rapidly urbanizing population and ensuring that incentives are structured to bring about as orderly a process of social change as possible;
- Building the institutions necessary for achieving inclusiveness and equal opportunity;
- Assuming international responsibility for stability, growth and sustainability, including tackling climate change.

The challenge for China is implementation, which means reform and systemic change. International experience suggests that the balance between planning and markets shifts toward markets as countries becomes richer. The structural evolution that underpins growth will increasingly be driven by market opportunities and entrepreneurial initiative. A huge number of new businesses need to be created.

To support this shift, much is required. Labor-intensive industries in the tradable sector must be allowed to decline. Many companies may survive, but only by moving to different parts of the global economy or up the value-added chain domestically: up or out. A rising nominal and real exchange rate can propel structural change; a weak-currency policy is a trap.

The financial sector must be developed to create more savings options and supply credit and equity capital efficiently to new and growing businesses, which China needs to attract the rural population to cities, even as export sectors move up the skill and value-added hierarchy. Many of these jobs will be in the domestic, urban and nontradable service sector.

But urbanization faces another obstacle: the hukou system of residency permits, which restricts mobility and bars migrants — an estimated 200 million people —from becoming full-status urban citizens. Chinese officials' reluctance to eliminate hukou quickly reflects their observation of the social consequences of rapid or unbalanced urbanization elsewhere, though problems caused by internal migration in other countries typically reflect the absence of opportunity in rural areas, not the attraction of opportunities in urban areas.

As the scope of the private sector expands, legal structures and policies that support competition, entry and exit, market openness, intellectual property and social safety nets will also be needed. The move to higher-value-added links of domestic and global supply chains will require more effective education and expanded investment in the economy's intellectual and technological underpinnings. The balance between technology imports and domestic innovation will continue to shift steadily toward the latter.

The Chinese public sector has a huge balance sheet, including land, a vast array of infrastructure, massive foreign-exchange reserves and major equity positions in state-owned enterprises, which account for more than one-half of net fixed assets and one-third of profits in the corporate sector. In all countries, these assets should be held in trust for citizens and deployed in pursuit of economic and social development. China has an exemplary record in this area. Unlike most countries, China has not struggled to get public-sector investment up to levels that support sustained high growth.

But there are now issues. Investments are justified and support economic and social development when they have high private and social returns. Elements of the investment portfolio in the public sector and the state-owned enterprises are beginning to fail this test.

To be fair, given the legacy costs of state-owned enterprises — which stem from their responsibilities for social services and insurance — together with their financial distress in the 1990s, it made sense for a while to let them keep their retained earnings and not place additional claims on them through the government budget.

No longer. If state-owned enterprises' reinvested income is not subject to a high return criterion, growth will eventually slow. The portion that falls short needs to be redirected to higher-return investments in either the public or private sector, to household income or to essential public services and social insurance.

The state-owned enterprises compete in product and labor markets with the private sector, but less so in capital markets. While wages and incomes are rising now and appear to have broken the iron grip of the surplus labor pool, the growth pattern requires this structural demand-side shift toward more disposable income, greater government consumption and high-return investment. We suspect but do not know that consumption will increase. Properly recycled savings, including corporate profits, could go back mainly into high-return public- or private-sector investments. Both contribute to aggregate domestic demand, and the structural shifts on the supply side will be driven by the "right" mix of aggregate demand, with the low-return component on the investment side removed.

Thus, the Five-Year Plan's goal is to recompose — not expand — aggregate demand to sustain growth and avoid the diminishing returns trap that is the principal risk of China's current investment pattern. Changing that pattern will require a restructured financial system that allocates savings efficiently based on fiscal and capital-market discipline and corporate-governance reform. Designing that system will be an important part of achieving the high-return investment and expanded consumption that Chinese leaders want — and that China's economy needs.

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