

# Occasional Paper

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SEMINAR  
On  
**In-Depth Analysis - Chinese Economy:  
—The Challenges and Reforms in New Era—**

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This report serves as documentary record of the first seminar hosted by the Institute for International Monetary Affairs (IIMA) on July 12<sup>th</sup>, 2016, in its Chinese economic series for this year. The title of the seminar was “In-Depth Analysis - Chinese Economy: The Challenges and Reforms in New Era,” and the lecturer was Dr. Qiyuan Xu from the IWEP, CASS.



## **Welcome Remarks**

*Mr. Koji Sakuma, General Manager and Chief Economist of IIMA*

First Mr. Koji Sakuma welcomed the guest speaker Dr. Xu and all the attendees and expressed his thanks to all for their continuing support for the IIMA, then introduced Dr. Xu's experiences and main coverage of his research: macroeconomic development and RMB internationalization.

## **Seminar**

*Dr. Qiyuan Xu, Senior Research Fellow, Director, Division of Economic Development Research, Institute of World Economics and Politics (IWEPP) at Chinese Academy of Social Sciences (CASS)*

Dr. Xu first thanked the IIMA for the invitation to the seminar, and introduction by Mr. Sakuma. He started with a brief introduction of his institute (CASS) comparing with "DRC (Development Research Center of the State Council)." He said that both institutes are think tanks directly responsible for the State Council, but CASS is more focusing on academic research while DRC is more policy-oriented.

### *The Present China Economy*

First, Dr. Xu invited the audience to a graph that described the relation between the "GDP growth rate" and "CPI inflation". He explained that if we divided the eras into "1999Q4 - 2010Q4" and "2011Q1 - 2016Q2", the latter trend was steeper than the former, which suggested that China's recent potential growth rate was declining. However he said, the reported GDP growth still maintains around 7%, which is indeed a fairly sound growth rate, so it bears a significant question whether the data is true or not.

Dr. Xu said at the seminar, he would analyze and clarify four things described below;

- (1) Whether the Chinese economic growth rate figure (6.7% yoy) is true or not.
- (2) If any, what is the difference between present China and Japan in the 1980's?
- (3) What are the real troubles of China?
- (4) Is there a feasible way for supply-side structural reform?

### *Whether the Chinese economic growth rate figure (6.7% yoy) is true or not*

Dr. Xu said that this question was very hard to answer because many people compared with the "Keqiang Index" which indicated the Chinese economy was rather weak.

He said if we looked at the electricity consumption growth, it fluctuated between 10% and 20% (yoy) after the Lehman shock (2008) through 2011 and became just around zero after the

middle of 2014. Many observers query if the zero growth rate of electricity consumption could support the GDP growth rates of nearly 7%.

Against this question, Dr. Xu suggested to divide the electricity consumption growth into the “secondary industry (manufacturing sector)” and “tertiary industry (service sector).” The consumption of the latter is growing about 10% (yoy) after the end of the 2014 although the former occupies a larger share (about 74% in 2015) in the whole consumption. On the other hand, the tertiary industry’s contribution to the GDP growth rate accounts for more than a half (54%) in 2015. So he concluded this was the reason why the weak “Keqiang Index” and GDP 6.7% growth rate do not contradict to each other. Dr. Xu said that the GDP growth rate figure is reliable in his personal view.

In addition, Dr. Xu introduced the “Composite PMI” figures to catch the country’s economic situation, which include both manufacturing and non-manufacturing and are provided on a monthly basis. Though it is declining, it still stays at the level of above 50, so we can say that Chinese economy is still expanding. Further, he also introduced the “Composite Employment PMI,” which has been below the level of 50 since 2015, meaning that the labor demand is weak. However, the supply side of the labor market is also decreasing at the same time because of the aging population. So the pressure on the labor market is not as serious as “Composite Employment PMI” seems.

The conclusion of this chapter is:

- (1) While the traditional industries (manufacturing, coal, etc.) are having difficulty, the emerging and very competitive industries (internet, 3-D print, high-speed railway, aircrafts, etc.) are gaining much momentum in the economic activities. So this can be said as a situation of “Half in the Ice and Half on Fire.”
- (2) And when we observe the whole picture, whether we should be optimistic or pessimistic, it depends on if China can switch the old engine (traditional industry) to a new engine (emerging industry) smoothly.

### *The Difference between Present China and Japan in the 1980’s*

On one hand, Dr. Xu explained the similarities of the economic situation between present China and Japan in the 1980’s. Those are;

- (1) GDP growth is slowing down.
- (2) Bubbles are occurring in asset prices, especially in the real estate sector.
- (3) Both central and local governments are facing accumulated deficits and debts.
- (4) In the private sector, especially in the corporate sector, the leverage is high. (We must investigate it very carefully because local government funding vehicles (LGFV) debts may

be included in this figure in China.)

- (5) Undergoing of the financial reforms, both domestic and international.
- (6) China is now facing a turning point to the era of aging population. In 2006-2010, annually there was a 7mln/year of net increase of the labor supply. In 2011-2015, the net increase shrank to 2mln/year, and in 2016-2020, it is estimated to turn to a net decrease of 2mln/year. The situation of the demography will be much worse than in Japan, because in Japan there is still a buffer of labor supply by the females which are housewives and still not working, but in China double income family with both husband and wife working is the main style.
- (7) Appreciation of the currency exchange rate, increasing land price and labor cost, and the low productivity causing hollowing of the industry of China. That means that the foreign-owned factories and companies in China, which generates about 40% of the trade surplus, are now gradually transferring to the overseas.

On the other hand, he pointed out that there were differences between present China and Japan in the 1980's (but this does not necessarily mean that China can naturally avoid the same crisis which occurred in Japan after 1980's). Those are;

- (1) Even though the Chinese GDP share in the world had increased to 15.5% in 2015, its per capita GDP is low because of the large population. This means there are still large spaces to grow.
- (2) There are enormous regional gaps between big cities and rural areas. For instance, the PPP (Purchasing Power Parity) of the big cities like Beijing, Shanghai, Guangzhou and Shenzhen is on the same level of South Europe, but that of rural areas is on the level of North Africa. This means that there is still a big room to develop at the rural regions.
- (3) It is true that there are some property bubbles in China, but the land policies are different from Japan. If there are any different factors, China borrowed them from Hong Kong. As Chinese residents have to rent land from the government and the land supply is fully controlled by the government, the government can decrease or stop the supply of the land if the land price decreases. China is also introducing the "renting and purchasing model", where the local governments buy the properties and rent cheaply to the residents. The bottom line is that the capital account transaction is under control by the government.
- (4) As China is the second mover, it can learn from the experience of Japan in 1980's, including failures of the Japanese government.
- (5) China's central government is very strong and the Chinese people can benefit a lot from it. Though the government debt ratio (vs GDP, total of central and local) is around 50% to 60% (as of the end of 2013) and the total debt amount is accumulating faster, it is still very low compared to Japan's. And also, the government's total assets are still much bigger than liabilities as of the end of 2013. The debt level is sustainable if we see it in the context of

national balance sheet.

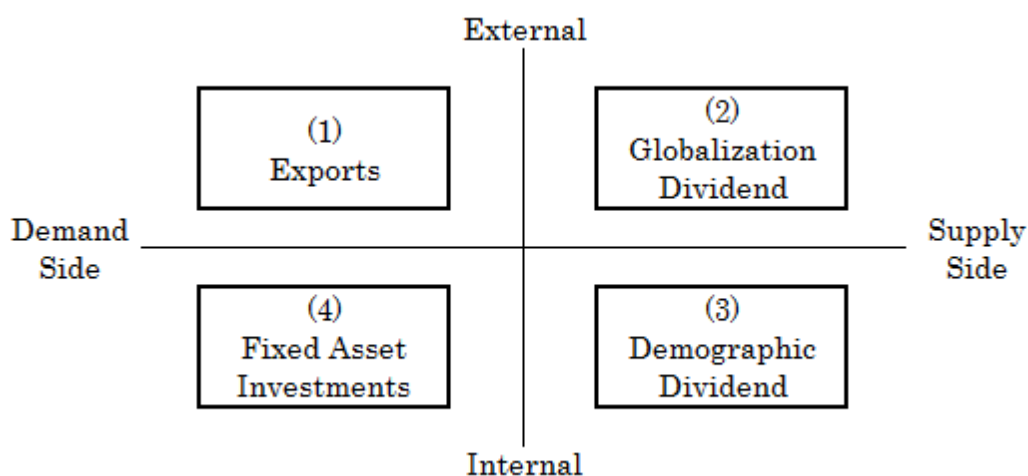
The conclusion of this chapter is:

- (1) There is still a big space to develop in China considering the GDP per capita is low and the regional gaps exist.
- (2) Real estate price and debt risk are under control by the strong government.
- (3) But, the problem of “Aging before getting rich” has to be solved in order to prosper further.
- (4) And the increasing labor cost causing hollowing the industry of China.

Above (1) and (2) are good signs, but (3) and (4) are bad signs.

### *What are the Real Troubles of China?*

Dr. Xu explained that there were at least four engines in China’s economic growth. Those are the “Exports,” the “Globalization Dividend,” the “Demographic Dividend,” and the “Fixed Asset Investments.” These engines can be divided by vertical (external / internal) and horizontal (demand side / supply side) as shown below.



#### (1) Exports

From 2006 to 2011 (excluding 2009), the export growth rate was around 20% (yoy), but from 2012 to 2014 the growth moderated to around 8%, and it declined fast afterwards. In 2015 the growth rate turned to be negative.

While some officials of Ministry of Commerce believe that the Chinese export is still competitive in terms of China’s market share in the world, but he thinks it is doubtful when we calculate the market share by excluding commodities. This year, the export is expected to decline quickly. The first half of the 2016’s export growth is estimated at -7% (yoy).

If the export declines, income will fall, and it will cause a weak consumption. In addition,

the decline of export will induce the overcapacity and investment will also decline. As export, consumption, and investment all get weak, aggregate demand and profits will also decline, and the companies will get difficult for repaying their debt. Financial market may become unstable hereafter. This is the potential risks results from the weak export demand.

The conclusion is that, as export is no longer a strong engine in China, a new model to stimulate economic growth by the domestic demand is needed.

Of course, China needs to export high-value added merchandises, which have increased in the recent several years while total exports have declined.

In addition, China became the net exporter of the ODI (Overseas Direct Investment) in 2014, and became the 3<sup>rd</sup> largest investor in the world in 2015. In this way, China must keep reconstructing the global value chain.

## (2) Globalization Dividend

After China joined the WTO in 2001, it kept enjoying fairly stable international financial system and succeeded in attracting foreign investments including from Japan, and export-driven demand and investment-driven demand rose at the same time. On the supply side, human capital, labor quality, skills, physical capital and technology were brought to China as benefits from the globalization. In addition to the demographic dividend, the globalization was critical for China's growth in the last decade.

But, what happened after the sub-prime loan crisis has been the new challenge, changing the trend from "globalization" to "fragmentation."

First is in the trade system. The WTO is no more the only one trade platform. Besides, there are TPP, TTIP, Japan-EU FTA, FTAAP, etc. Such a stream is not favorable for China, because China is not a member of the TPP/TTIP, and RCEP whose conditions are less strict than TPP is still under negotiations. It is challenging for China.

Second is in the production system. China is famous for manufacturing, but after the sub-prime loan crisis, President Obama raised the strategy of revitalizing the USA manufacturing. There has also been a rise in the industry internet. In Germany, "Industry 4.0" was introduced as a new strategy. In Japan, the JETRO has helped Japanese companies to invest abroad for a long time but recently they are shifting to invite foreign companies to invest in Japan. In this way, as the international production system is reallocated, China has come to challenge to this head wind.

Lastly, it is the international financial system, although this may be controversial. Before the crisis, the International Monetary Fund (IMF) played the most important role. But when the crisis took place, the IMF could no longer serve all of the member economies. When the

IMF prepared a report which warned problem of the sub-prime loans in advance, the US criticized it saying that they can handle the matter by themselves and the IMF gave up publishing it. The IMF has become an institution which is too politically-sensitive to behave independently.

Dr. Xu said the IMF has two major functions. One is to monitor before the risk occurs, and the other is to provide the liquidity when the crisis takes place. But the former is too politically-sensitive and for the latter it has too poor asset to support the world. Also, as the IMF reform after the crisis had taken so long time, the other international functions like ESM, BRICS reserves, CMIM, swaps lines among six major central banks, etc. had been established instead. There are more fragmentations than globalization.

Dr. Xu said in the backdrop described above, that China had taken initiatives for both regional and global integration, such as B&R (the Belt and Road Initiative), AIIB, Silk Road Fund, and RMB Internationalization.

### (3) Demographic Dividend

There are two major scenarios for GDP growth of the future China. One is Dr. Cai and Dr. Lu's scenario<sup>1</sup> which was announced in 2013. As the forecast was made in the background of labor decrease, it is said to be a pessimistic scenario. The other is Dr. Liang's scenario<sup>2</sup> of 2011, and as this forecast was made in the background of human capital increase in the last decade, it is said to be an optimistic scenario.

Dr. Xu said that he has some evidence about the latter scenario. If we look at the number of graduates from universities, it increased from about 1.2 million people in 2001 to around 6.5 million in 2014. Also, as of the number of returned students from abroad, it also increased from about 50 thousand people in 2007 to around 370 thousand in 2014. This is a good sign for the Chinese economy.

But, there are some strange structural problems in the labor market of China. These are that in the lower education labor market (≡ blue colors), the demand side is tightening from 2009, but, as of the higher education labor market (≡ white colors), the supply side is always in surplus. This means the people who were higher educated were more difficult to find a position and did not contribute to the productivity. The unbalance may have been caused by the unique industrial structure in China. In China, the employment ratio of the secondary

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<sup>1</sup> Fang Cai and Yang Lu, "Population Change and Resulting Slowdown in Potential GDP Growth in China." *China & World Economy*, Volume 21, Issue 2, 2013.

<sup>2</sup> Run Liang, "Human Capital and Economic Growth in China", Center for Human Capital and Policy (CHCP), Peking University, Working paper, Oct.26. 2011, <http://www.nsd.edu.cn/cn/userfiles/Other/2011-10/2011102415410256462049.pdf>

industry is bigger than in the similar developing economies, and that ratio in service sector is inhibited. This hypothesis was also proved by the figure, which shows difference between the employment ratio in service industry in China and that of US. This means the service sector is short of investment and employment, consequently there are some difficulties to meet the demand in the service sectors like “social services” and “producer assisting services” that need high education.

The conclusion of this category is that the human capital dividend is far from full utilization. China needs to develop the social and producer services to match the supply of the highly educated workers. Also, China needs to open the market to both the private and overseas investors, especially in the service sector, and encourage the entrepreneurship.

#### (4) Fixed Asset Investments

Looking at the financing sources of the fixed asset investment, the growth rates in 2016 (from January through May) are almost zero, as the self-raising funds are in the negative territory despite the high bank lending and state budgetary appropriation. Dr. Xu said we were worrying that this investment structure mainly driven by the fiscal stimulus of Ministry of Finance and monetary policy by PBOC (the Peoples Bank of China, the central bank) could not be sustained in the near future.

There are two solutions of these problems. One is more stimulus from the government, and the other is more aggressive reform in the future.

#### *Concluding remarks*

*(The theme “Is There a Feasible Way for Supply-side Structural Reforms?” was explained and discussed in the Question and Answer session hereafter)*

Dr. Xu pointed out that, first, there are old economies and new economies in China. We should consider both of the sectors if we want to know the whole picture of the Chinese economy.

Second, about the divergence of the opinions on China’s economy, it depends on which economies we look at. If we look too much at the traditional industries, the prospect will be too pessimistic. On the other hand, if we look too much at the new industries, the prospect will be too optimistic. We have to look at the various industries and observe all the data.

Lastly, Dr. Xu insisted that the substantial reforms are yet to come. So far, the reforms are not enough and not as effective as they have expected, but Dr. Xu definitely thinks that the reforms will come.



## Question & Answer Session

<Question from Attendee 1>

Please show us the way to solve the low productivity of service sector in China.

<Response from Dr. Xu>

Based on the experience, the service sector is a low productivity sector. But, if we look at the other side, the education, health-care and R&D industries are making profits because they are short of supply in service.

In other words, service sector can be divided into three types. That is “producer assisting service”, “social service”, and “consumption related service”. “Consumption related service” is well developed, but the other two service sectors are short of supply, and have potential of positive spill over to other industries to facilitate the productivities, especially like R&D and environment protection. So they can make profits and improve the productivity in the near term.

<Question from Attendee 2>

Will the Brexit give impact on the Chinese economy?

<Response from Dr. Xu>

As China invests mainly in the “sovereign bond” markets in the European countries, the market value of the assets could be influenced by the Brexit.

Also, China had signed a lot of agreements with the UK several months ago and started to invest, so we have some worries. But, as the UK is not the important exporter/importer relative to the world trade, there has been no significant influence so far.

Maybe, the influence will come from the financial markets hereafter.

<Question from Attendee 3>

Please explain about the background of the mismatch of the labor markets in China.

In Japan, the labor force moved to service sector in the 1980's. Although there were a lot of regulations (e.g. in the retail sector, there was a protection law for very small shoppers and big shopping centers were not allowed to open without having permission from the government), Japan had abolished a lot of them.

In China, is there a similar kind of the regulation which existed in Japan in the 1980's, or is there a basic misallocation in the labor market?

<Response from Dr. Xu>

Similarity between Japan in the 1980's and present China is that there are many regulations

that prevent the labor market from being liquidized.

Even in the FTZ (Free Trade Zone) in Shanghai, reform was announced to call in the foreign investors, but it still needs many permits not only from the local government but also from and the ministries in Beijing. We need some coordination.

The reason why there are many difficulties is that economic situation at present is not bad enough to deregulate the labor markets. There may be more decisive reforms when the economic crises occur.

As for the mismatch of the labor markets in China, the big problem is the Hukou (户口) system (household registration system), which seriously limit the liquidity of the labor market. Now we can expect some reforms and progresses in the future in small and middle cities, but it is hard to deal with this problem for the megacities like Beijing and Shanghai. It would hamper the allocation of the labor resources.

<Question from Attendee 4>

We would like to have your specific comments about the supply-side reforms.

It seems to me that the stance of the government which you have just explained is now slightly changing. My special concern is about the labor market reform. In the southern provinces, especially coastal, that seem to have some capacity to solve, the workers have been pushed out from the problem industry such as steel industry. I would like to hear the speed and the possibility of such reforms.

<Response from Dr. Xu>

Structural reform has been very important topic since the end of 2015. At that time the central government published such strategy. And for the State Council, I think it was the most important strategy for the reforms.

There are many kinds of explanations for structural reforms. But now, the government wants more clarification. So they are not only concentrated on the issues like structural change in industries as they used to, and also the reforms for the price or for the entities. The price is like the exchange rate, interest rate and other key prices. The reform of the entity is like relationship between the local government and the central government, and also the SOEs' (State-Owned Enterprises), because the "soft-budget" is the primary problem for China's financial system. So the fiscal problem, like the budget, changing "soft-budget" to "hard-budget" is fundamentally important. So, in this way, there is a big map for the structural reform.

I want to add another point. When the central government publishes documents about structural reforms, all the time you can find a heart of the word. That is pre-condition. We should "moderately expand the aggregate demand," and at the same time we push forward the

structural reform. So when the government emphasizes the structural reforms, it does not mean that they have forgotten the monetary and fiscal policies.

<Question from Attendee 5>

Is the central government of China capable to take the right policy in the right time for reform even if it is unpopular?

<Response from Dr. Xu>

It is un-doubtful that the government of China (both central and local) is stronger than that of today's Japan.

As of Japan, the USA occupied Japan after the WW II and the strong government at that time led the structural reform. But after that to the present, the power of the government of Japan seems to be much weaker. On the other hand, as the government of China is very strong, they may and can efficiently make the right things happen.

<Question from Attendee 6>

What is the real issue of the economic slowdown for China? You have said that 6.7% growth is reasonable considering the change of the economic structure, and you do not have any serious unemployment problem. If this is true, I think China does not need any economic stimulus policy.

So, is it the correct understanding what China need now is only the structural reform?

<Response from Dr. Xu>

First of all, as China had been used to grow over 10%, they are not used to the position like 6.7%.

Secondly, there are really serious problems in China like "Zombie companies," "Half-Ice" in the traditional industries, and some tragedies in heavy industries.

Now, the negative gap between PPI and CPI has continued for more than 50 months in China. Though the gap is now shrinking, it is still maintaining 6% to 7% level. Sometimes PPI is at minus 7 or 8%. Some industrial sectors meet big challenge. So, the most serious problem is that whether China can change the economic structure and transfer the capitals and labors to the healthy industry or not.

But if the financial market is in tension, everybody worries about asset price. We are now in a delicate period to deal with over-capacity, but we also have to fight with the moral hazard.

<Question from Attendee 7>

In my understanding, the reason for a drastic change of the currency exchange rate system

on August 11<sup>th</sup>, 2015 was mainly due to the Renminbi's inclusion in the SDR basket.

On the other hand, some economists are worrying that the capital has been outflowing from China since then. The authority of China is now worrying the depreciation of Renminbi in the market and intervene the market.

Do you think such recent phenomena will slow down the de-regulation of the capital transactions?

<Response from Dr. Xu>

Yes, I think so.

In March, the premier Li published the annual government report. While last year's report mentioned many times for the liberalization of the capital account and the Renminbi internationalization, this year's report did not mention them at all and it only mentioned about Shenzhen–Hong Kong stock connection. So, now, the liberalization of the capital account has stopped. From the academic view, this policy is time varying. But the Chinese authority wants to stabilize the currency for the first thing.

Besides, I would like to explain about the relationship between the “closing price of the last trading day” and “the central parity rate which government calculates”. The figures are described on the last page of the presentation material.

The reason why August 11<sup>th</sup> is important is that the government gave up the intervention in the Renminbi market for stabilization through announcing the central parity rate. Before the changing of the exchange rate system, those two indicators had a gap. But after the reform, the movements of both indicators convert together most of the time.

So, the reform of the currency was roughly successful. But, on the other hand, another problem occurred. That is the Renminbi's depreciation and China is more dependent on the forex intervention. Now, China is using the USD reserves to stabilize the Renminbi, but if the cost is too high, the Peoples Bank of China might change the policy again (like going back to the central parity rate).

(End)

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