Avoiding the Blind Alley
China’s Economic Overhaul and its Global Implications

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China in the Global Economy: 2000 vs. 2012*

China’s % share of global total

Sources: PBOC, UNCTAD, IMF, UNWTO, RHG. *Latest available data used when 2012 is unavailable.
Diminishing Demographic Growth
Population by age group, % of total

* Ratio of people younger than 15 and older than 64 to working-age population (15–64).
Diminishing Investment Growth: Capital at the Turning Point

Investment as % share of GDP v. per capita income (constant 2013 $US)*

* Investment is equal to gross capital formation, or new investment on assets plus net changes in stocks of goods held by firms.

Diminishing Total Factor Productivity: Reform is the Key

Components of potential growth and actual growth (annual %)*

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital</th>
<th>Labor</th>
<th>Total Factor Productivity</th>
<th>Potential Growth</th>
<th>Actual Growth</th>
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<tbody>
<tr>
<td>1994</td>
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<td>0.4</td>
<td>13.1</td>
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<tr>
<td>2010</td>
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<td>2011</td>
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<tr>
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<td>0.6</td>
<td>3.7</td>
<td>3.7</td>
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<tr>
<td>2014</td>
<td>7.7</td>
<td>-0.7</td>
<td>0.7</td>
<td>3.8</td>
<td>3.8</td>
</tr>
</tbody>
</table>

* Potential growth is the maximum growth rate an economy can achieve without accelerating inflation. Potential growth is a function of the available capital stock, labor force, and total factor productivity (residual output from technological upgrading and structural adjustment that enhances the productive capacity of capital and labor).

China’s GDP Outlook with and without Reform

GDP growth (% change year-on-year)

A Revised Mission for Government

• Maintain macroeconomic stability
• Strengthen and improve public services
• Safeguard fair competition
• Strengthen oversight of the market
• Maintain market order
• Promote sustainable development
• Promote common prosperity
• Intervene in situation where market failure occurs
## Key Regulatory Objectives

<table>
<thead>
<tr>
<th>Cluster</th>
<th>Center-Local Fiscal</th>
<th>Competition Policy</th>
<th>Financial System</th>
<th>Trade and Investment</th>
<th>State Enterprises</th>
<th>Land</th>
<th>Labor &amp; Welfare</th>
<th>Environment</th>
<th>Innovation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Design</td>
<td>Major systemic re-alignment of responsibilities</td>
<td>Clear embrace of uniform elevation of competition as default mode with defined negative list, SOE coverage</td>
<td>Near-comprehensive coverage of internationally recognized reform agenda</td>
<td>Trade opening and the same laws and regulations for Chinese and foreign investment</td>
<td>Withdrawal from state control in competitive sectors; negative list; regulatory neutrality; competitive access to resources</td>
<td>Enforcement of land tenant rights; full registration of over 1 billion plots; due process in expropriations; partial end of hukou system</td>
<td>Education equality; employment/job creation priority; public expenditure reform; One Child Policy abolition</td>
<td>Cross-cutting imperative; quality of growth above quantity; emissions registration; utilize market mechanisms</td>
<td>Encourage market mechanisms in innovation; publicly funded research publicly available; education reform</td>
</tr>
</tbody>
</table>

### Indication (examples)
- June Overall Plan for fiscal and tax
- Initial steps to remove anti-competitive authorities, upgrade enforcement, but uneven, and negative list still to come
- Strong ongoing adjustment of financial price systems, partial new steps on capital markets, regulation, market entry (domestic), and financial account opening
- Piemeseal trade opening but modest liberalization; good OFDI movement, modest and piecemal FDI opening; piecemal portfolio opening
- Dividend reform; restructuring preparations; modest private investment; audits and management changes; rising private credit formation and market entry
- Promising launch to registration campaign; audit of all 2008-2013 land takings; approval for 100 million urban hukous
- Notable new business employment gains; public expenditure reform signs; OCP reform; minor education /health change but fiscal reforms are supportive
- Amend EPL to permit public interest lawsuits; enhanced energy/coal policy constraint; emissions transparency
- Modest incremental steps on IPR protection; steps on education reforms; action on public research availability

### Outcomes (examples)
- Unfunded mandates; property tax
- Negative list coverage; due process
- Interest rate liberalization, financial account opening
- Trade balance; negotiation completion; negative list promulgation; 2-way FDI balance
- Negative list terms; change in controlled sectors and firms; foreign restructuring of SOE JVs
- Titling progress; hukou assignment; rural land prices
- Increase rural education/health spending; labor & welfare data improvement
- AQI improvement; NGO litigation; heavy industry market exit
- Government directed/private R&D spend; 2-way IPR financial flows; indices of local innovation
China’s Trade Profile in 2020 under Baseline, Hard-Landing, and Crisis Scenarios
Constant 2013 $US (billions)

Sources: People’s Bank of China, State Administration of Foreign Exchange, Rhodium Group estimates.
Financial System: Decision 12

- Private market entry into banking (small and medium)
- Repair equity markets and convert to registration-based issuance
- Deepen market-oriented bond markets
- Rationalization of the insurance sector
- Market-determined exchange rates
- Move to market-based interest rates
- Marketize the government debt sector
- Open financial account for two-way capital market flows, with RMB convertibility for those transactions
- Redefining financial system regulatory functions to facilitate marketization
- Introducing deposit insurance
- Facilitate financial institution market exit (avoid “too big to fail”)
China’s Ascent to the World’s Third Largest FDI Exporter

Countries’ % share of total global OFDI flows, 3 year moving average

Source: UNCTAD, Rhodium Group.
Concerns: Economic Considerations

FDI Restrictiveness Index, China vs. OECD, 1=closed, 0=open

Source: OECD.

Constant 2013 $US (billions)

<table>
<thead>
<tr>
<th>Scenarios</th>
<th>ASSETS</th>
<th>LIABILITIES</th>
<th>NET FOREIGN ASSETS</th>
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<tbody>
<tr>
<td>2013 Baseline</td>
<td>5,937</td>
<td>3,965</td>
<td>1,972</td>
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<tr>
<td>2013 Hard-Landing</td>
<td>11,204</td>
<td>8,684</td>
<td>2,520</td>
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<td>2013 Crisis</td>
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<td>5,044</td>
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<td>2013 Crisis</td>
<td>10,548</td>
<td>4,549</td>
<td>5,999</td>
</tr>
</tbody>
</table>

Sources: People’s Bank of China, State Administration of Foreign Exchange, Rhodium Group.
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Conclusions:
1. A Game-Changing Reform Program
2. A Convergent Economic Picture – with Idiosyncrasies
3. Plenty of Exceptions and Counter-indications
4. A Notably Fast Start, and a Move to Transparency
5. A Real Prospect for Political Adjustment?

Recommendations
1. Gauge Incremental Progress
2. Demonstrate Support for Reform
3. Focus on a Domestic Response
4. Include a Multilateral Element
5. Stop Negotiating for What Beijing Is Already Doing