

China's Third Plenum Reforms: Implications for Growth

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Third Plenum is about Reshaping Governance

One Principle

Market
Decisive

Two Groups

Security

Economic

Three Themes

Unify
Urban-Rural

Restructure
SOEs

Realign
Center-
Local

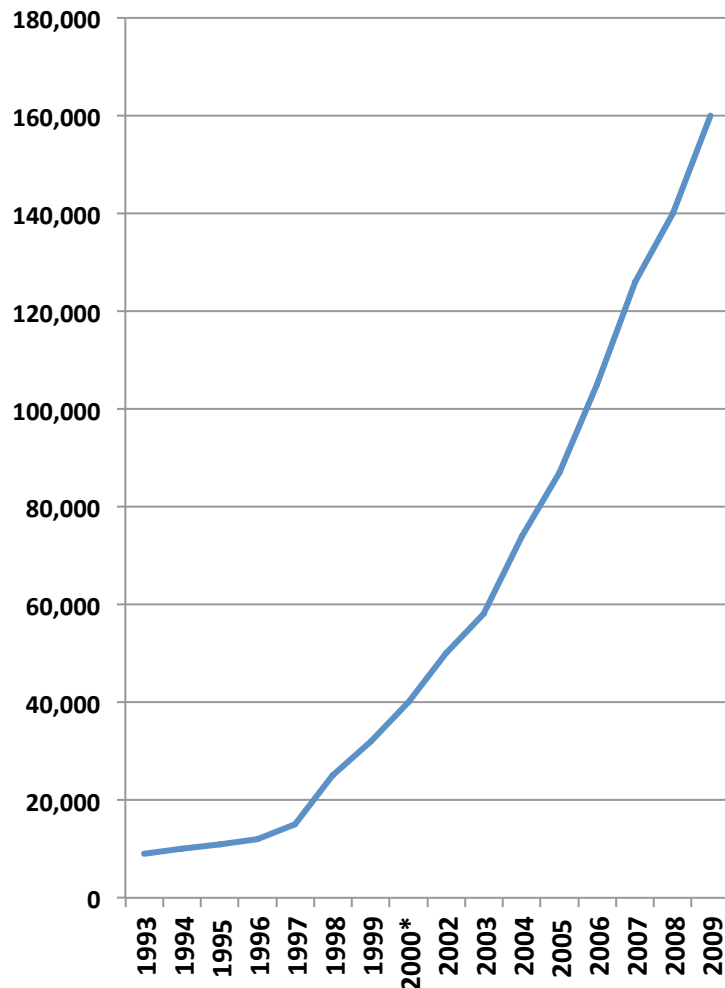
+ Tools – Revamp Fiscal System, Rationalize Financial

(1) The Principle

- **Market is decisive in setting key prices and allocating resources while Government's role is to complement the market.**
- **But principle requires sound institutions and competitive markets. Not the case yet in China, especially for labor, land and capital.**

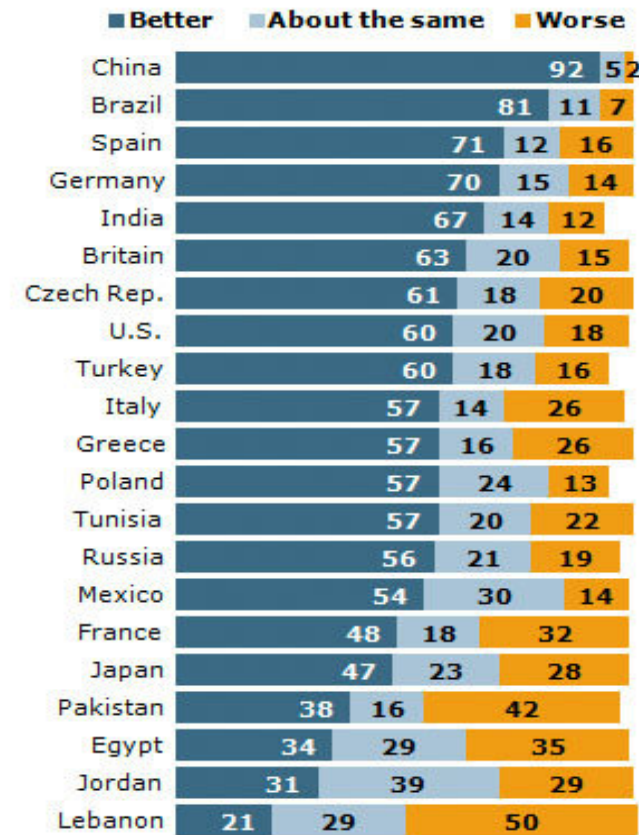
(2) Two key groups dealing with security and economy

Contain Surge in Mass Protests



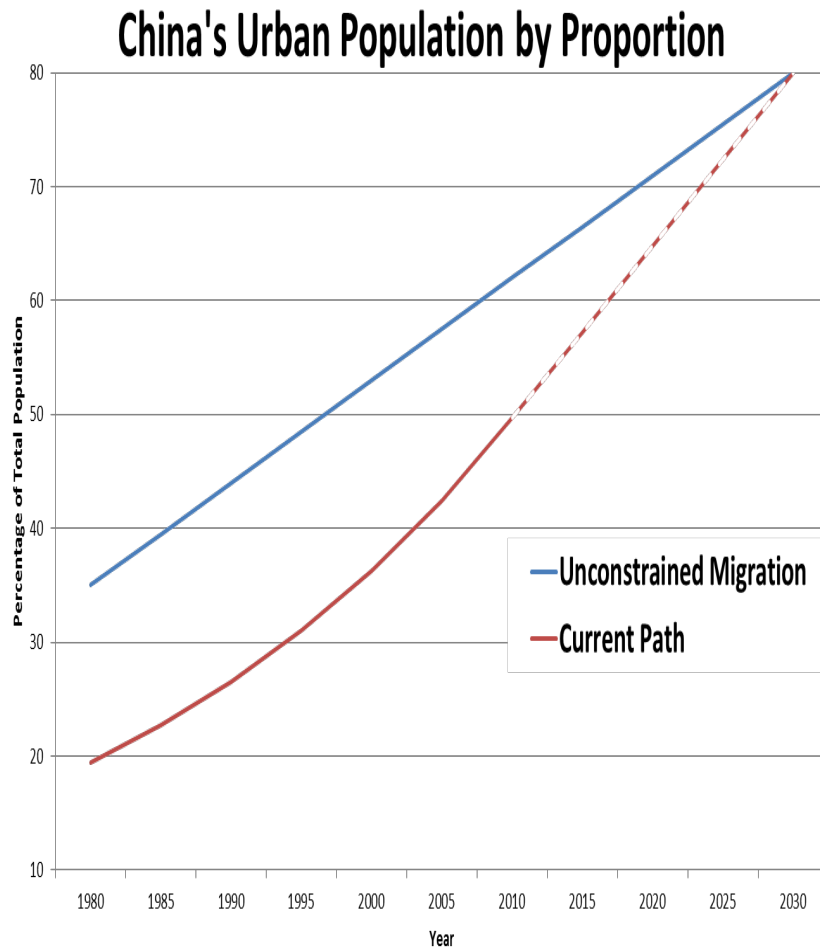
Maintain Economic Progress

Standard of Living Compared to Parents at Same Age



PEW RESEARCH CENTER Q64b.

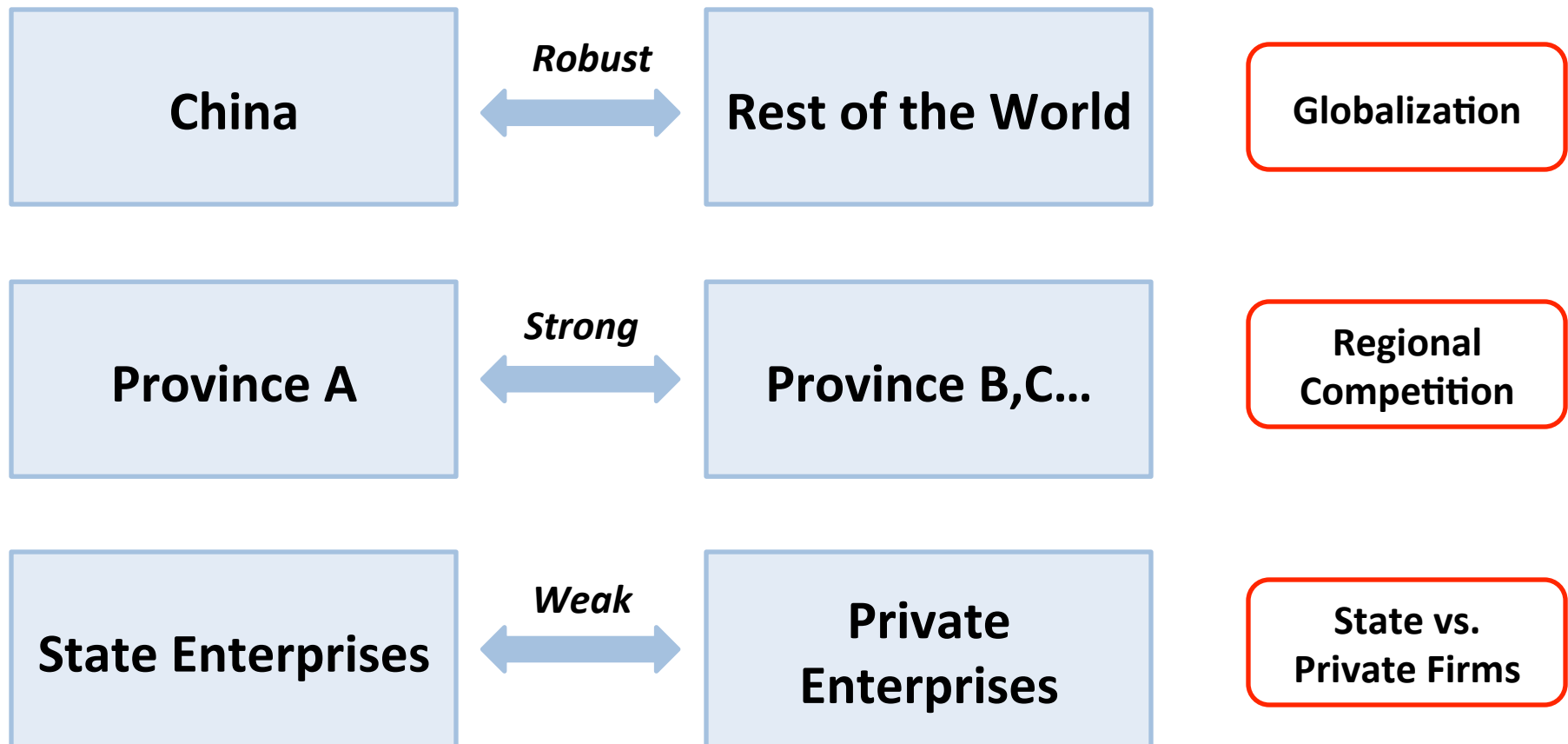
(3a) Better managed urbanization to promote productivity and urban-rural equity



Mega-Cities should get even bigger



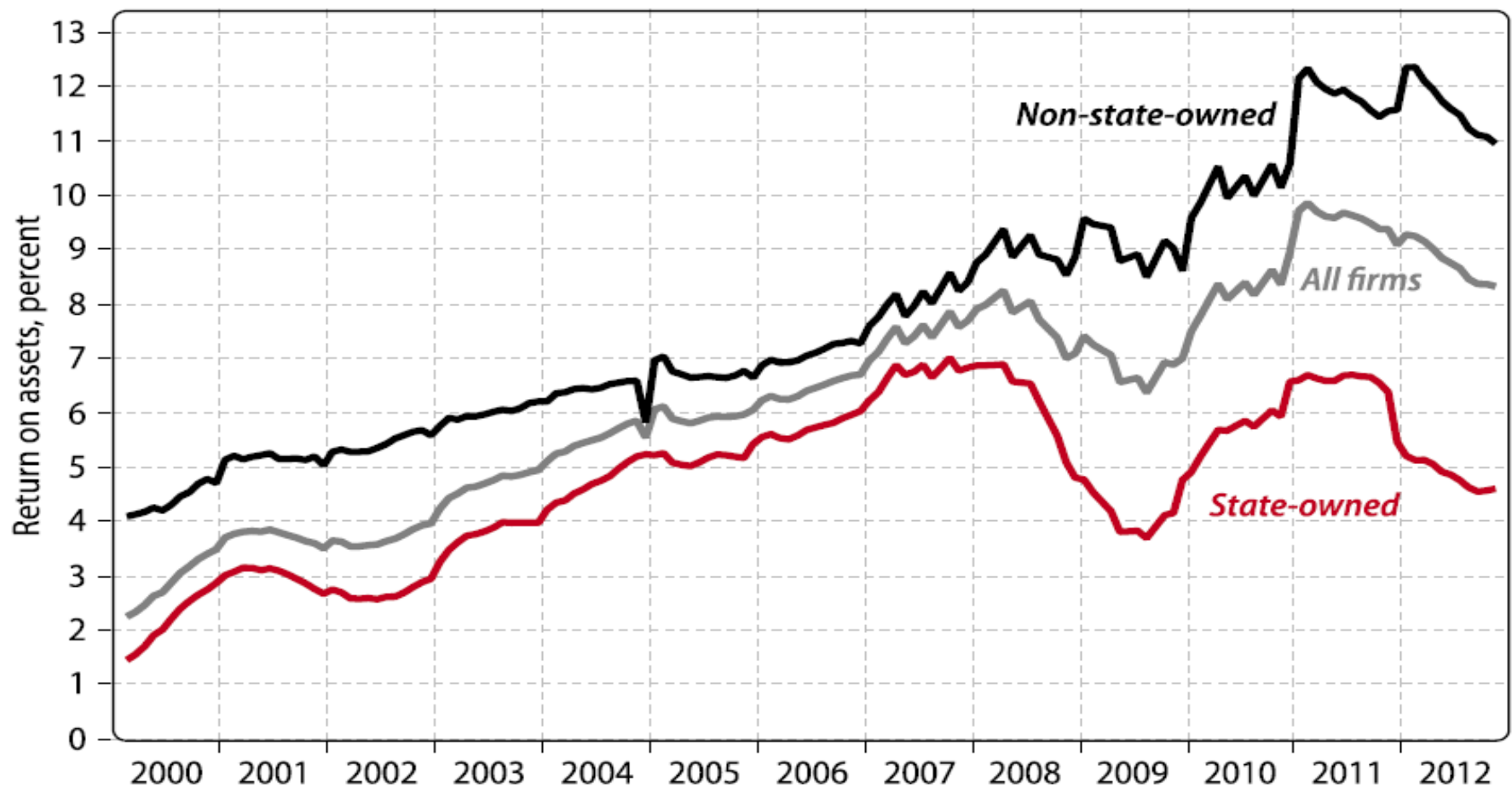
(3b) Strengthen competition between SOEs and private sector to drive future growth



Narrow ROA between SOEs and private firms

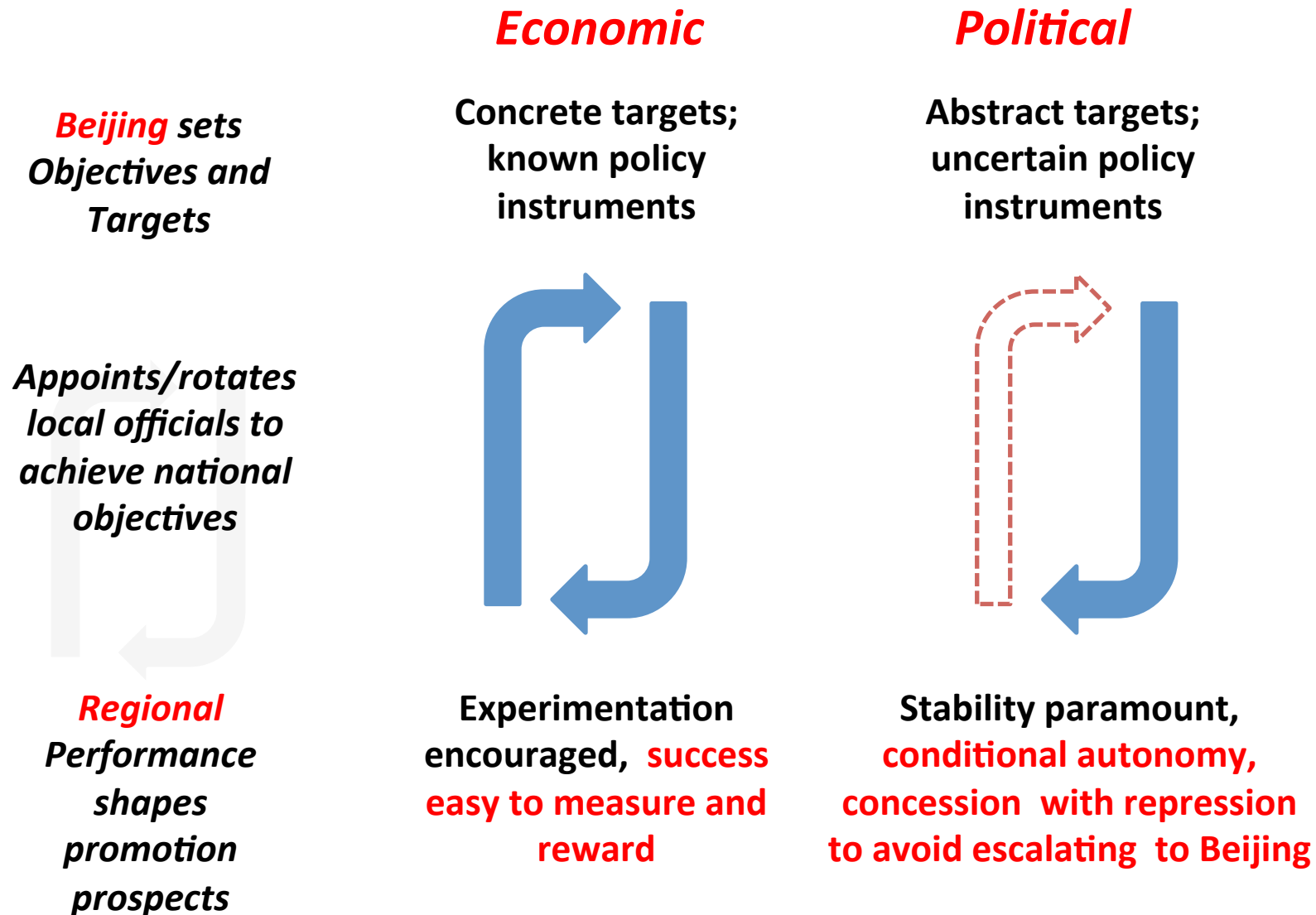
The productivity gap between state and non-state firms is widening

Return on assets, by type of industrial firm



CEIC, GaveKal Data

(3c) Reform decentralized administration to support both economic and political objectives



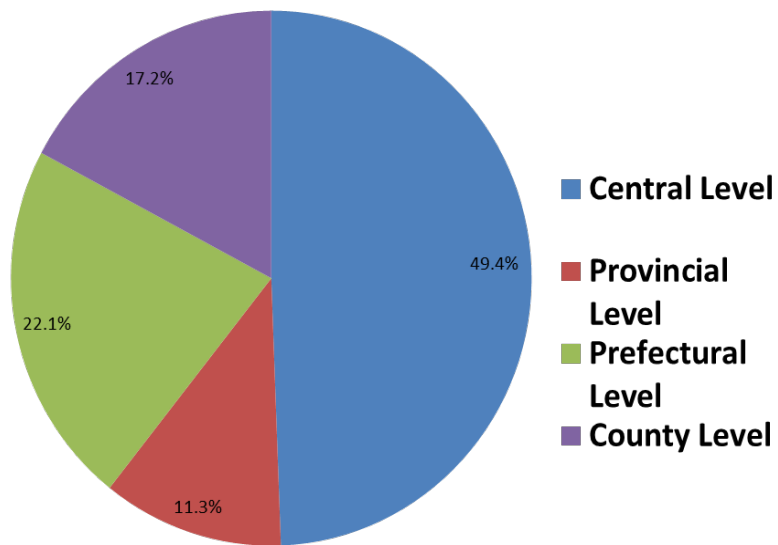
(4a) China's budget needs to play a larger role (% of GDP, 2008)

	High Income OECD	Middle Income Upper Lower	China
Total Expenditures	42	33 36	26
Social Expenditures	27	16 15	9
Other	15	17 21	17

Fiscal System is Misaligned

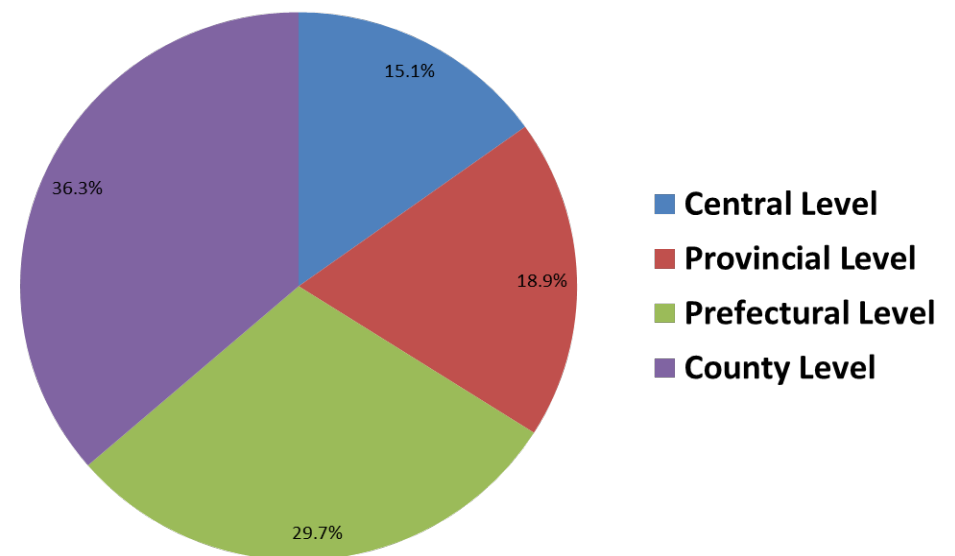
Taxing power centralized

Share of Revenue Collection at Different Levels of Governments (2011)

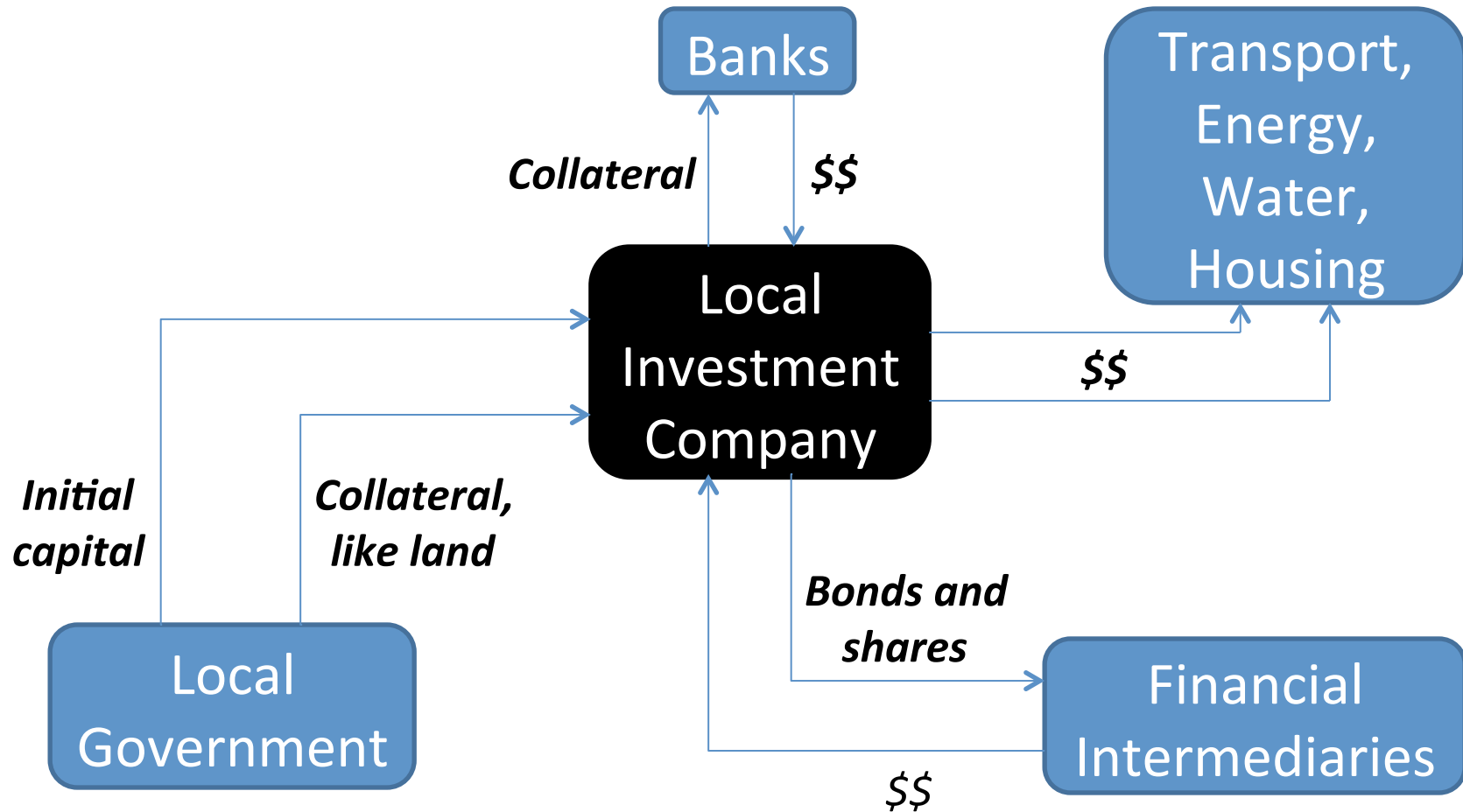


Expenditures decentralized

Share of Direct Expenditures at Different Levels of Governments (2011)



Local-government investment companies creating debt risks

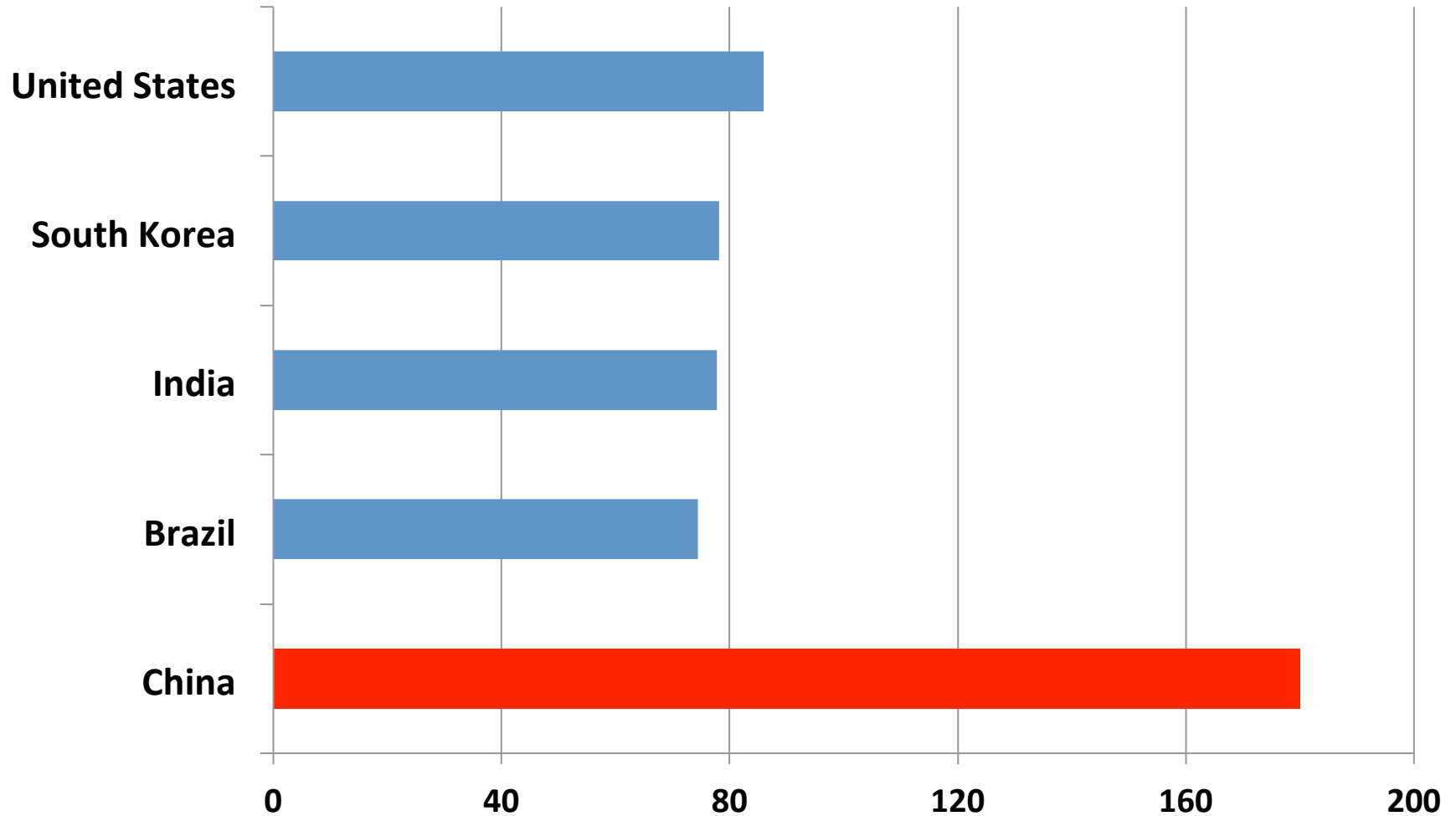


(4b) Key Financial Reforms

- **Promote competition between banks, strengthen capital markets, eliminate bias favoring state banks and borrowers, and improve regulatory system.**
- **Develop capital markets to support more flexible but not necessarily higher interest rates.**

China's banks play too large of a role

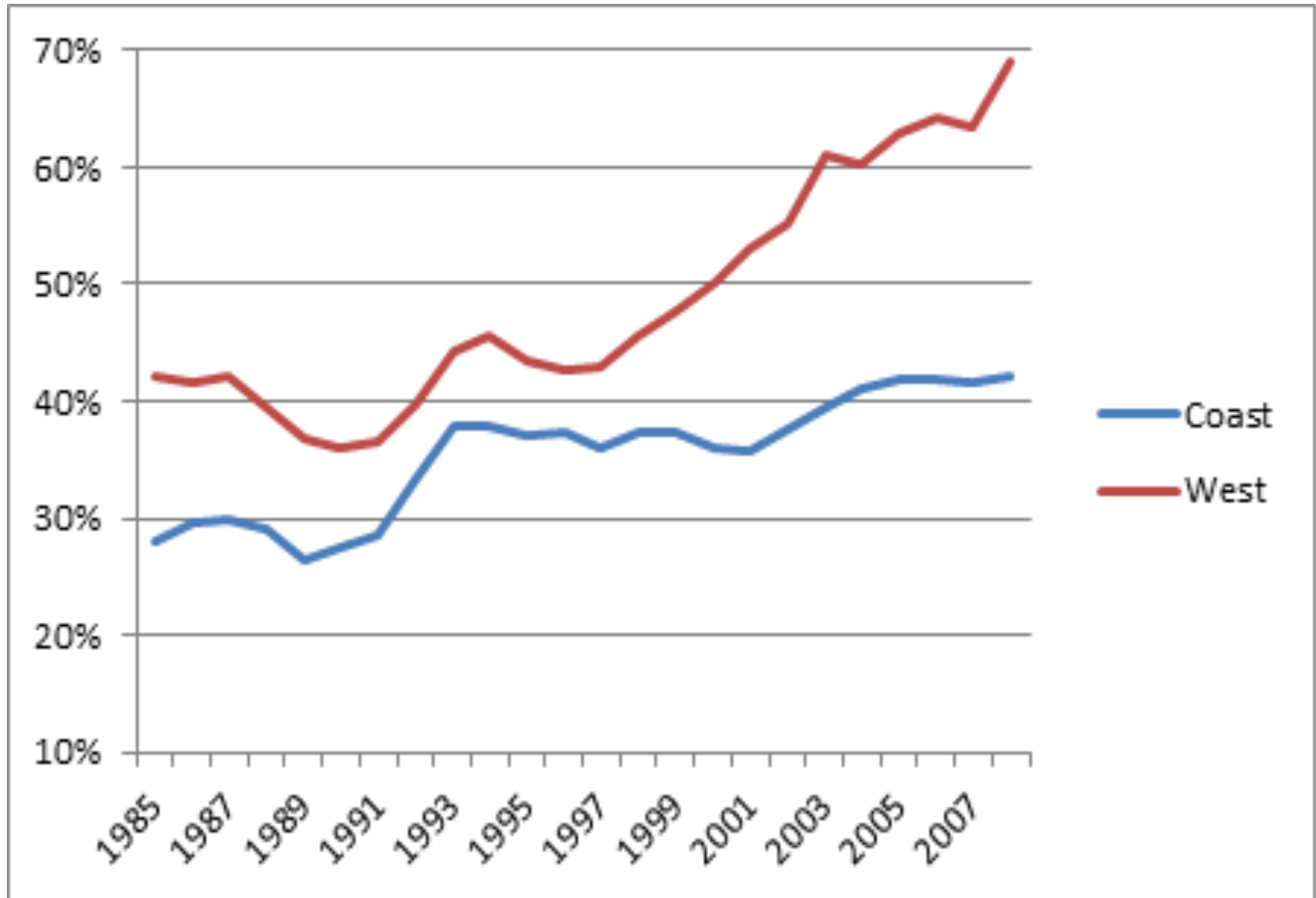
Money Supply (M2) as Percent of GDP, 2011



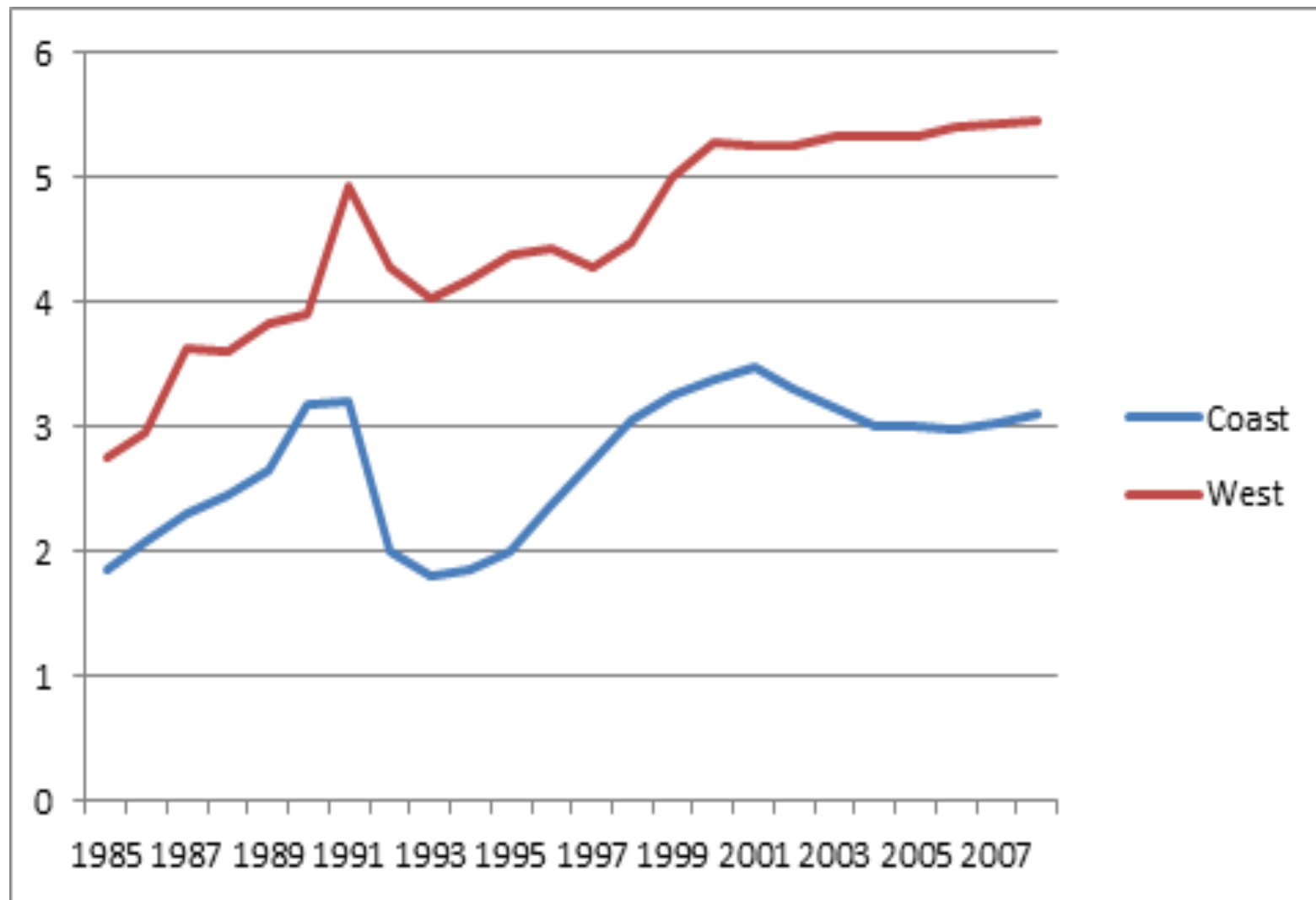
China's deposit rates are not low!

	One year deposit rate	Inflation (yoy)
China	3.25	2.5
Japan	0.20	1.6
Singapore	0.25	2.6
South Korea	2.30	1.1
Taiwan	0.55	0.3
UK	1.40	2.0
US	0.20	1.2

**(5) Regional strategies drove increase in investment
(regional investment rate as % of GDP)**



But Investment Efficiency (incremental capital output ratio) is a problem in the western region (lower is better)



Roads can have a high or low return

Western region - Xinjiang

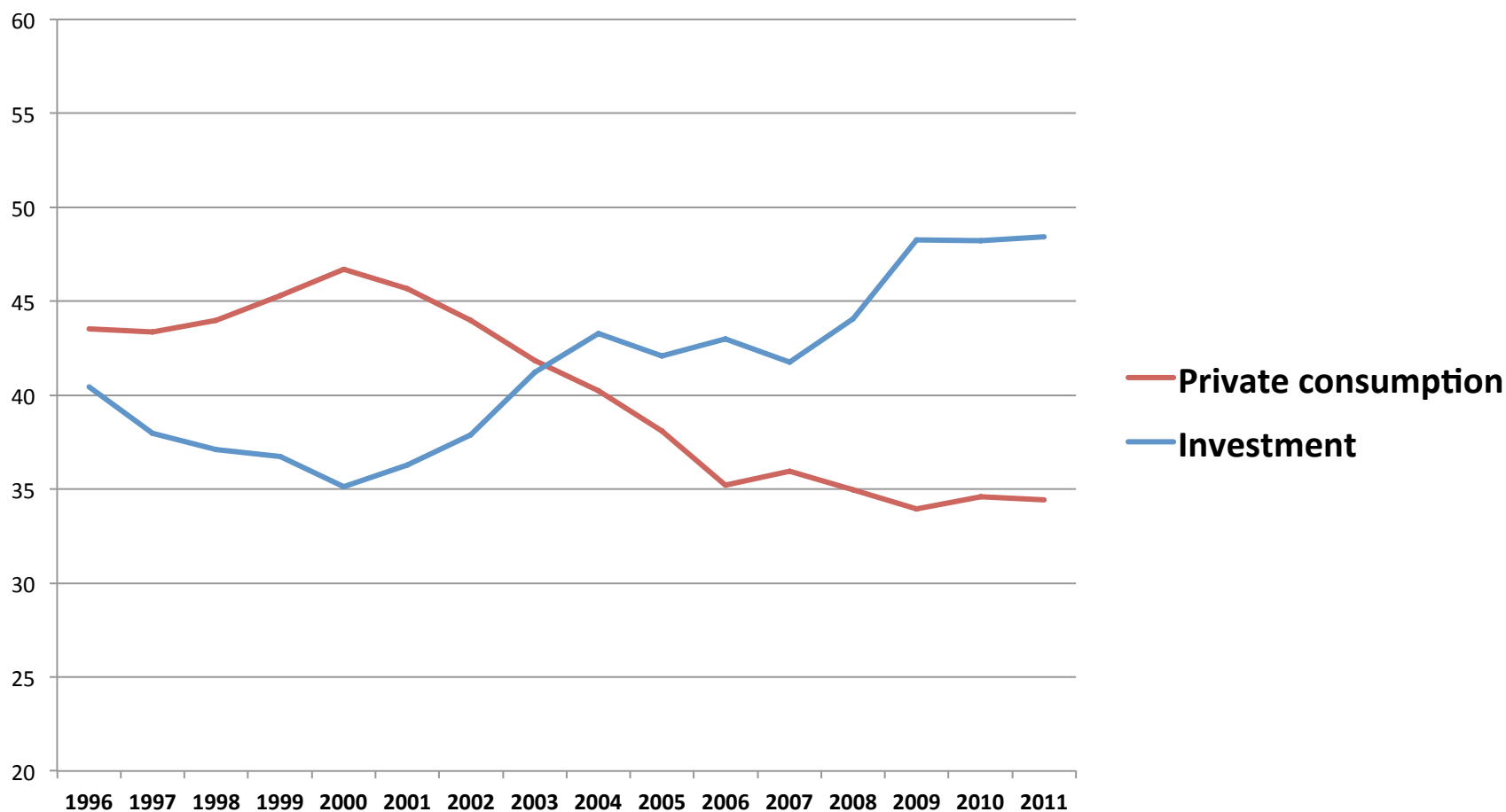


Near Beijing

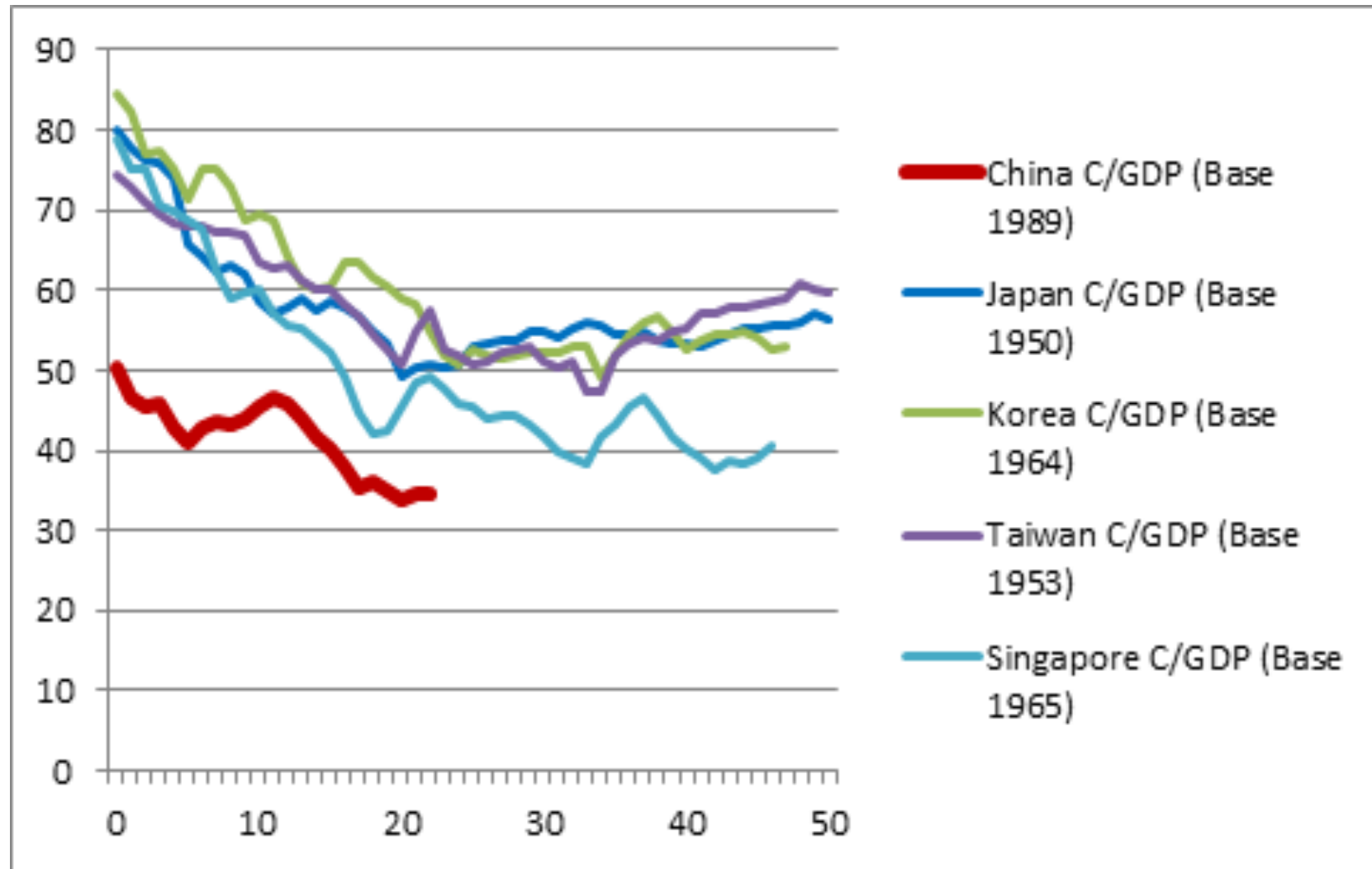


(6) Third Plenum reforms unlikely to alter perceptions about China's unbalanced growth

(Percent of GDP)



China's unbalanced growth resembles other successful Asian economies (year 0 – start of decline)



Rapid urbanization causes a decline in the share of consumption to GDP

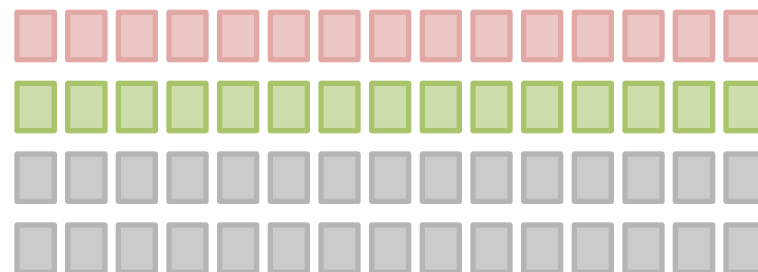
Farmer

- Value of rice = 10,000
- Income = 9,000
- 7,000 consumed, 2,000 saved



Factory Worker

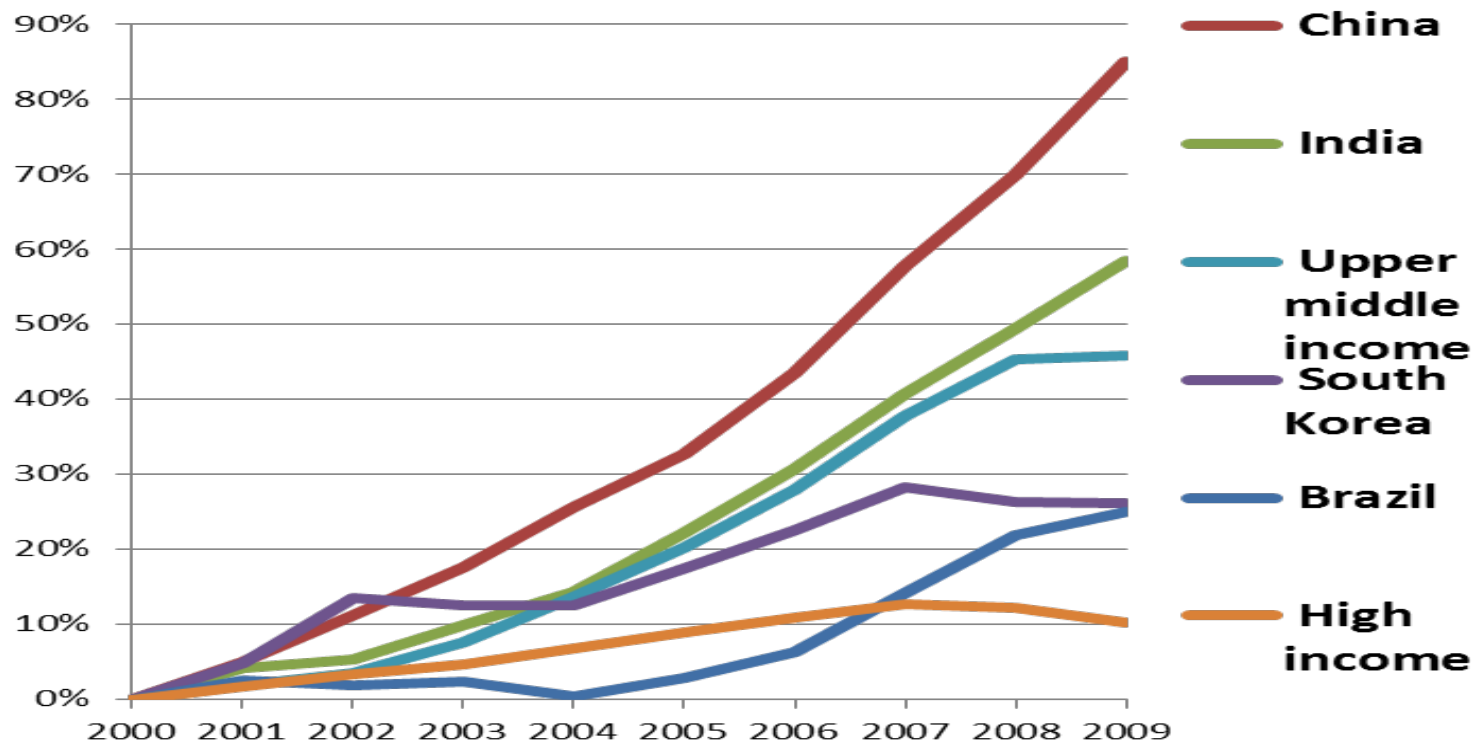
- Value added of iPod = 60,000
- Wages = 30,000
- 15,000 consumed, 15,000 saved



Labor share of output goes from 90% to 50%
Consumption share of GDP goes from 70% to 25%

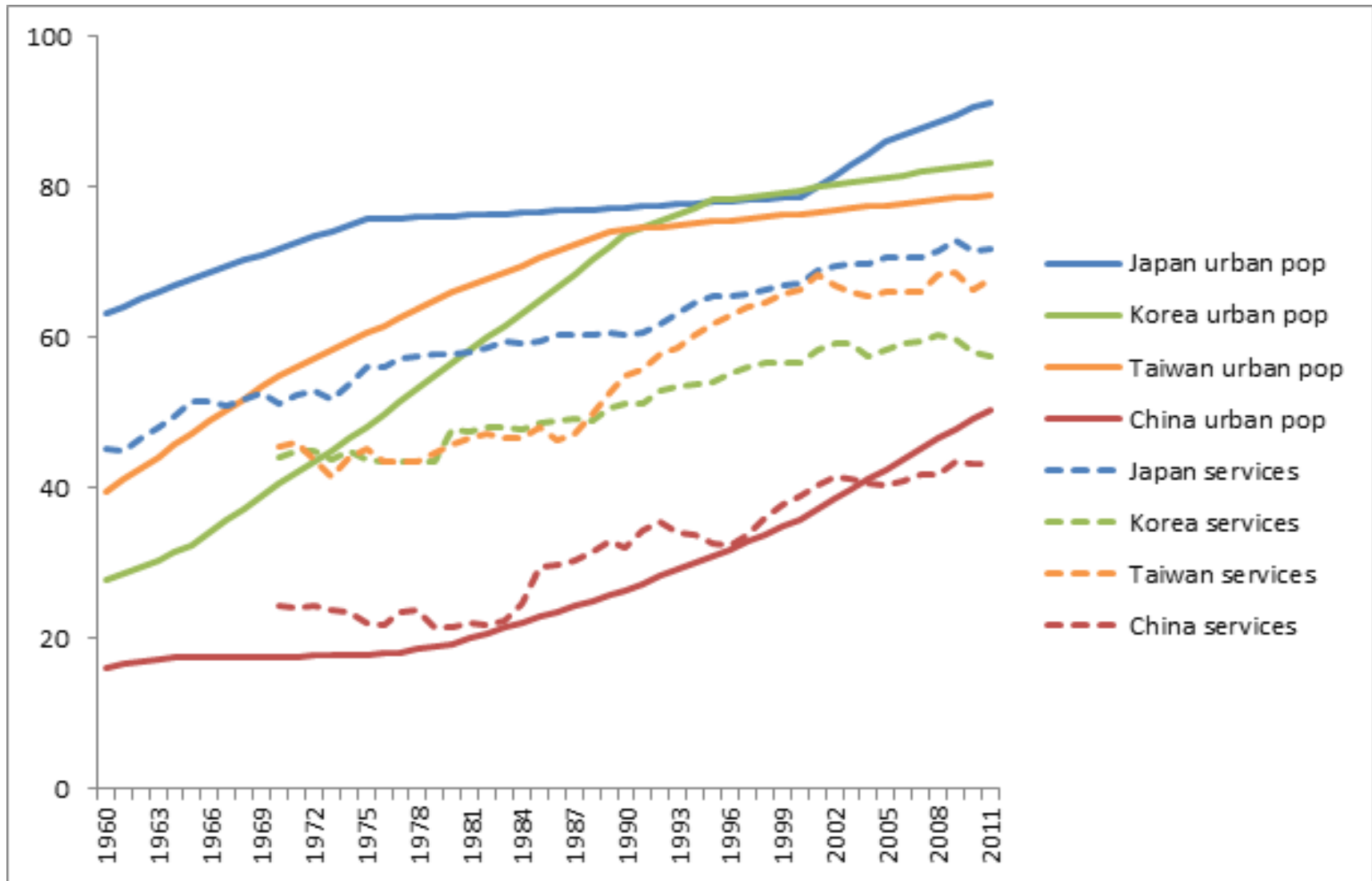
No need for more consumption driven growth since consumption is already growing rapidly

Indexed growth in household final consumption per capita, 2000-2009



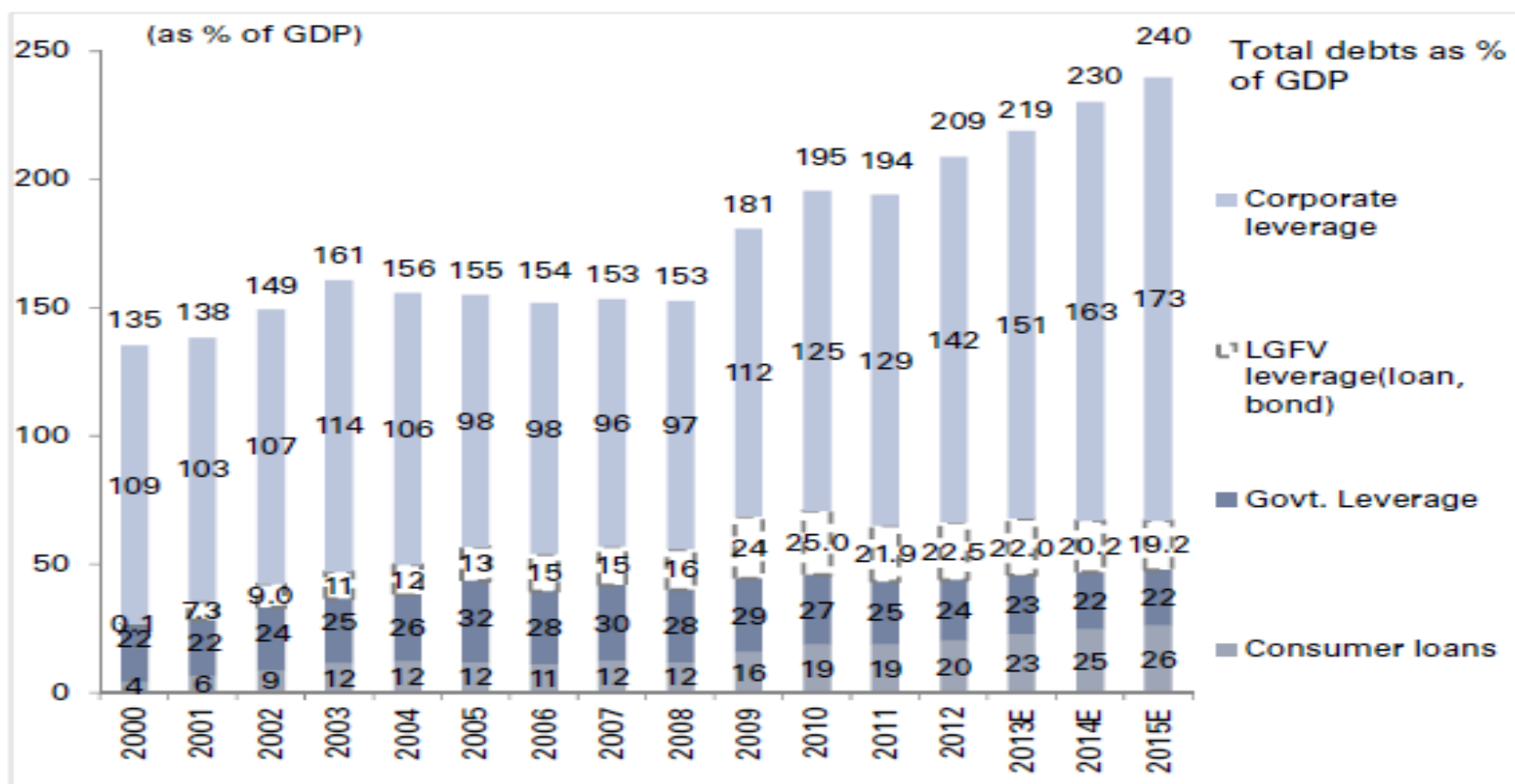
*Data Source: World Bank,

Third Plenum reforms can move China closer to others in urbanization and services



(7) China's debt has surged since the financial crisis

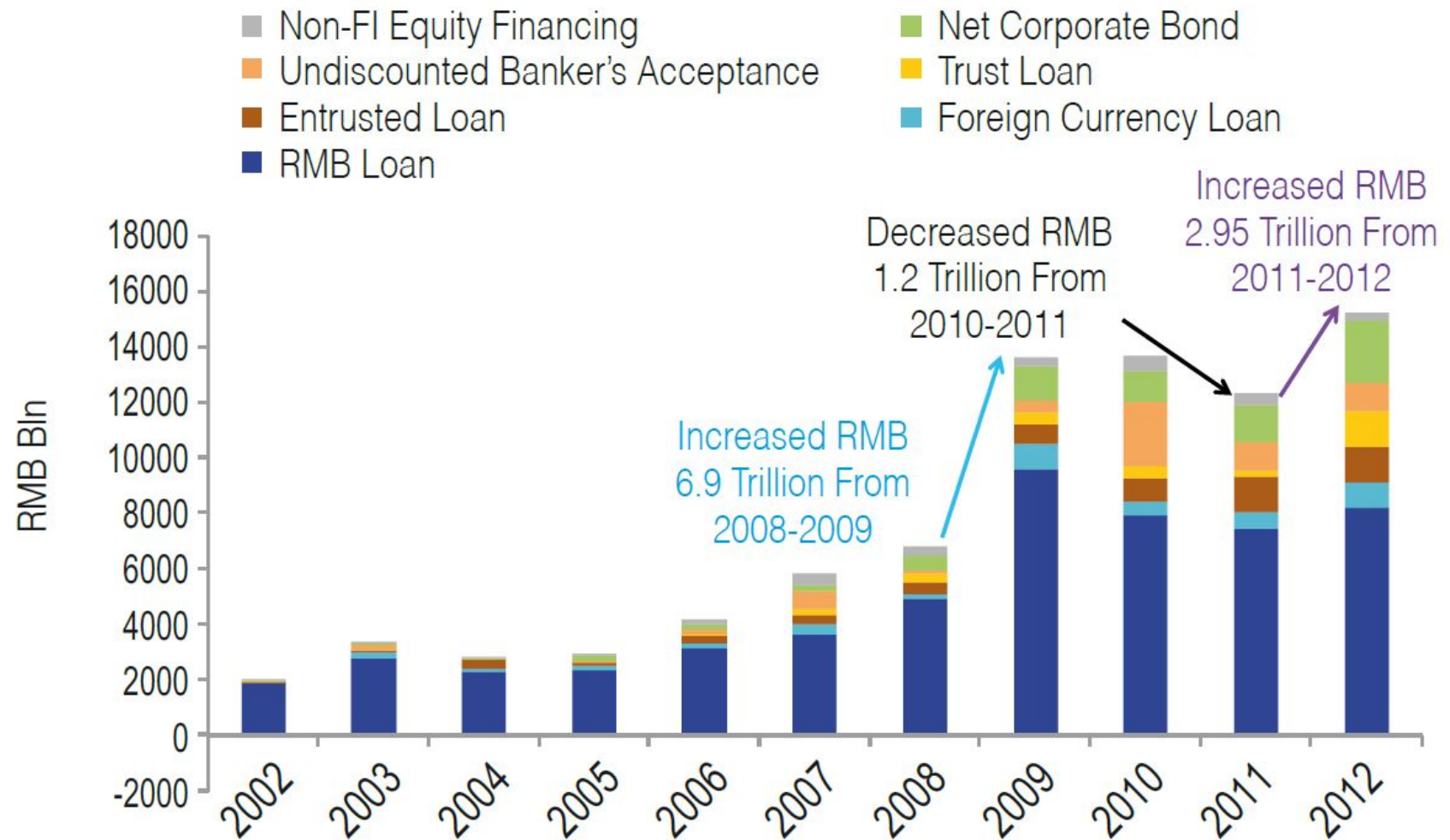
Chinese debt by type (percent of GDP)



Note: 1) financial institutions credit is excluded from this calculation 2) only half of entrust loans outstanding is tallied to avoid double counting 3) trust loan are wholly classified to corporate loans category.

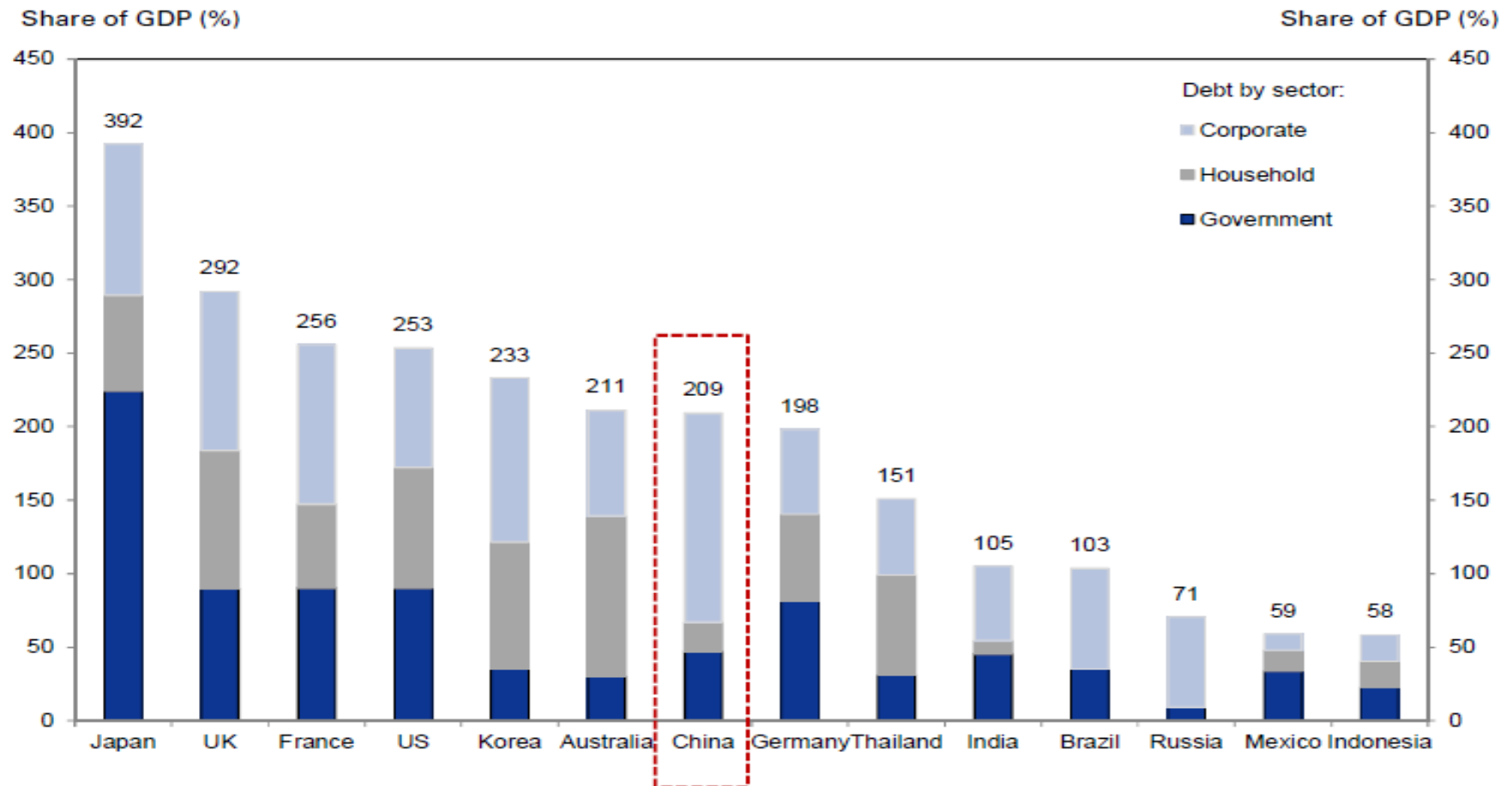
Source: People's Bank of China, GS Global ECS Research estimates.

Rise in Shadow Banking accounts for much of the increased debt



Source: PBoC

Less leveraged than developed more indebted than developing countries



Note: "Corporate" includes all private debt for Brazil and Russia.

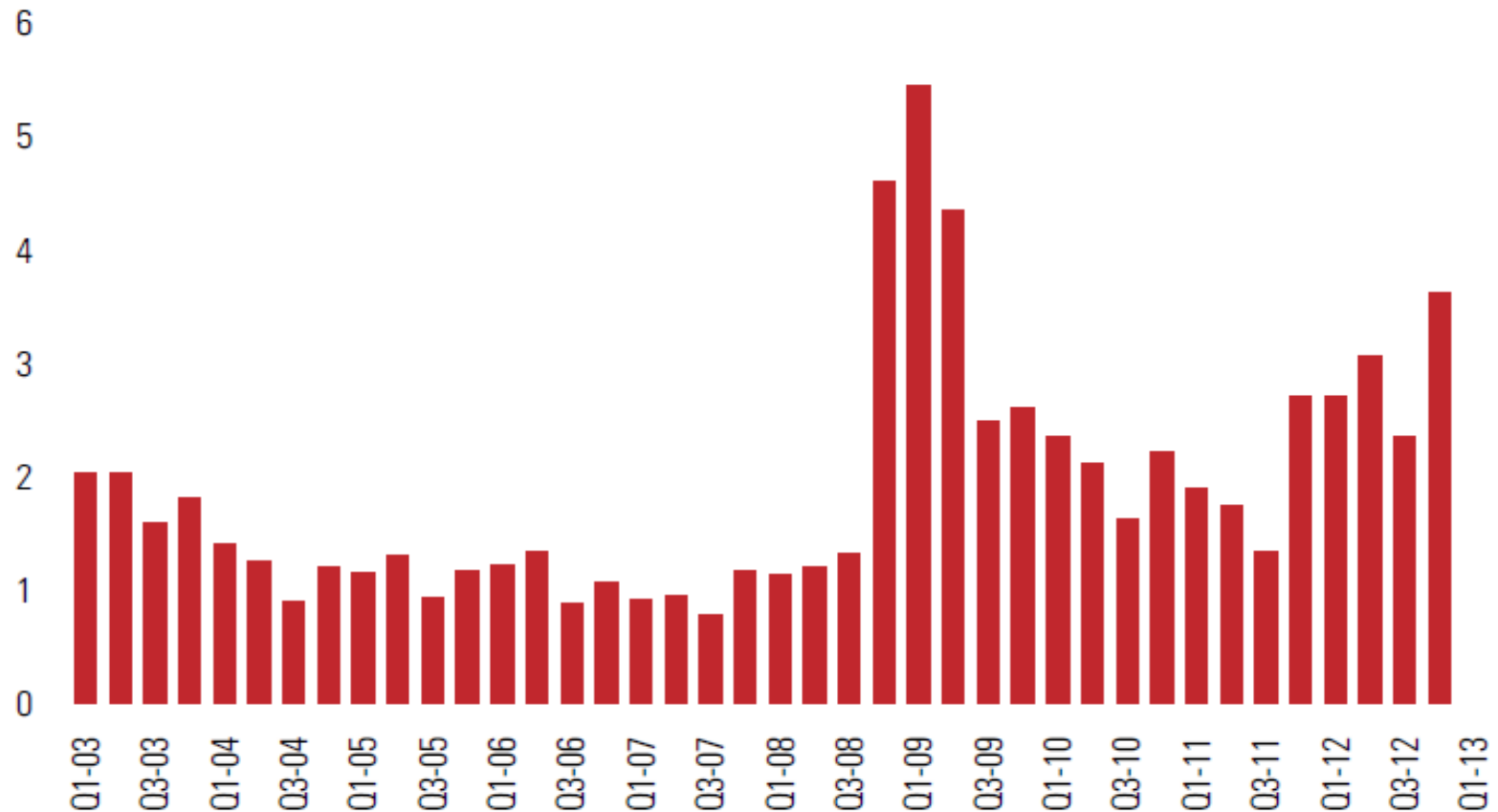
Source: BIS, IMF, National statistical offices, World Bank.

Does China have a debt crisis?

- **Rapid debt rise is a serious but manageable concern.**
- **China's debt is largely domestic, backed by enormous reserves and savings and supported by trade surpluses.**
- **Local-government debt needs to be prevented from becoming a major problem.**
- **Shadow-banking needs to be better regulated and contained.**
- **Solution requires sustainable GDP growth of 7-8 percent along with tighter financial policies and fiscal reforms.**

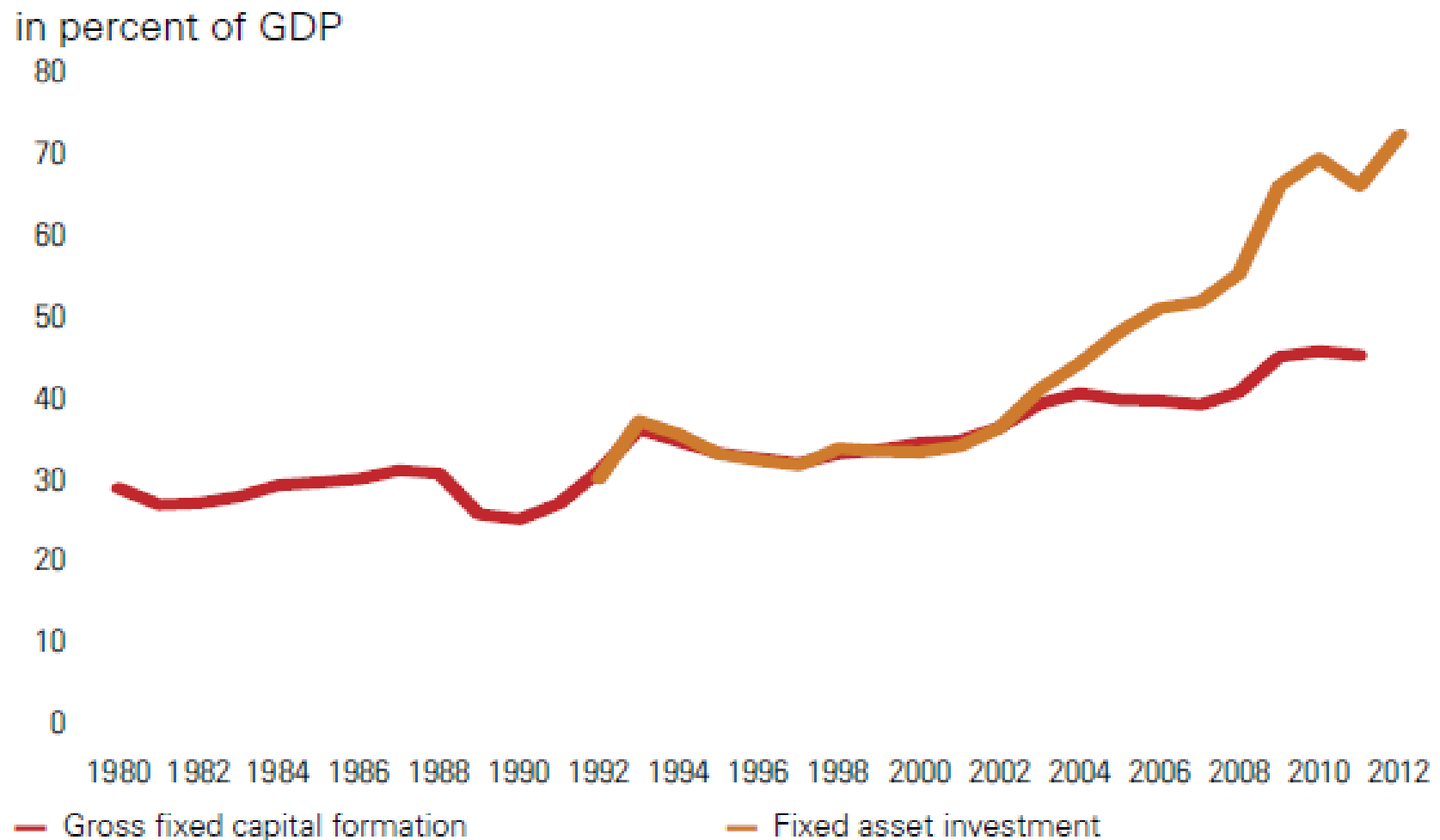
Growth impact of credit has declined

Absolute change in TSF credit divided by absolute change in real GDP, annualized, one-quarter lag



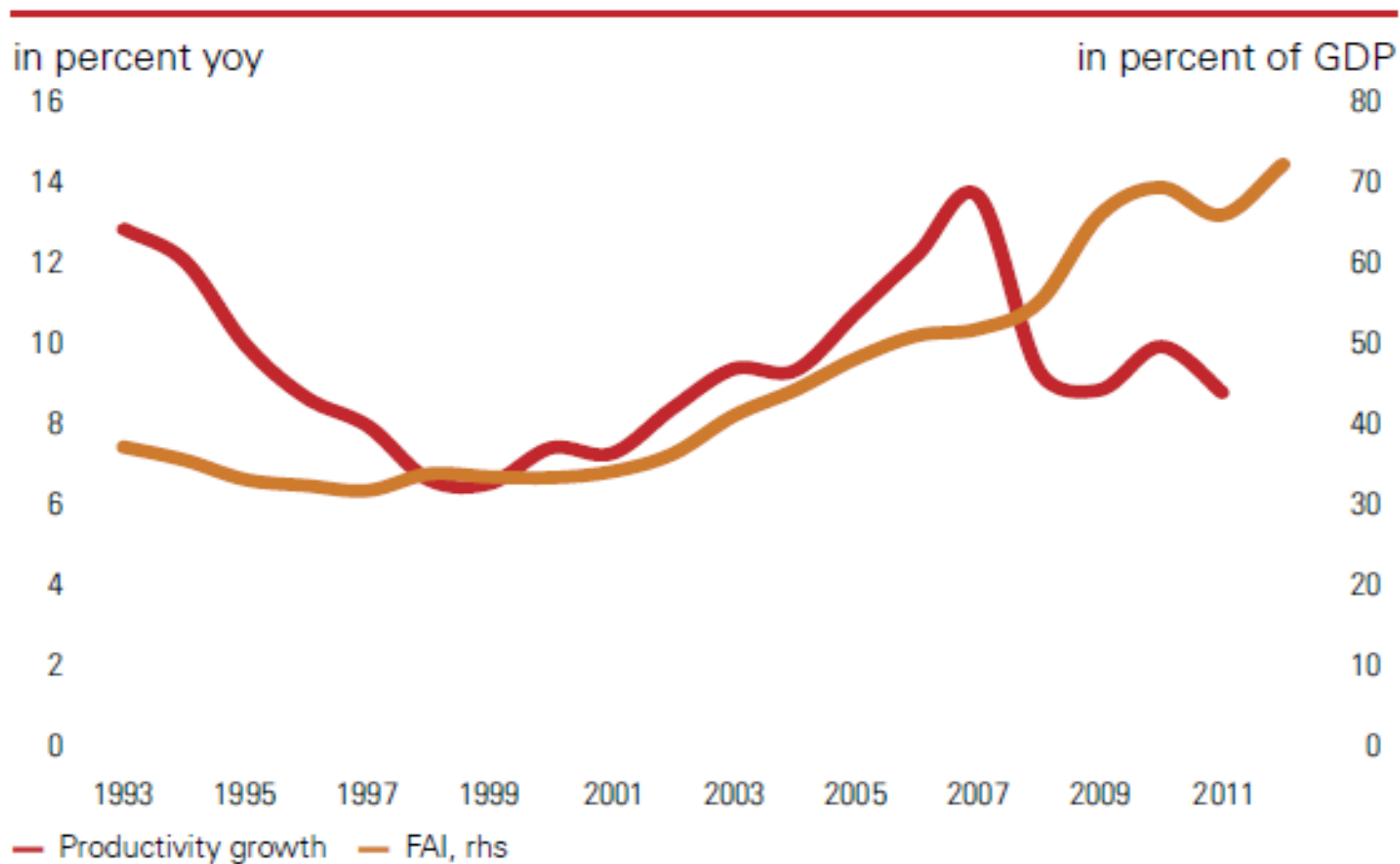
Source: World Bank staff estimates.

Divergence between investment and GFC explains why credit is not producing as much GDP growth



Source: CEIC and Haver Analytics.

Must restore pre-stimulus productivity growth



Source: Haver Analytics and CEIC.

Note: Productivity=output per employed person.

If implemented Third Plenum reforms will increase productivity and growth

- 1. Shift of resources from state to private investment**
- 2. More efficient urbanization process**
- 3. Restructuring regional investment strategies**

These actions could add 1-2 percentage points to current underlying growth of 6.5 percent.

**Projected GDP growth : 2014-2015 – 7.5
2016-2018 – 8.0**