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# China's reform program is far-reaching - and should be implemented quickly

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The announced re-adjustment of the Chinese growth model from an export- and investment-driven to a more sustainable consumption-driven approach by the current political leadership under Xi Jinping is highly welcome . However, given the economic, environmental and demographic challenges ahead the most important questions are whether the planned reform measures are far-reaching enough and whether they will be implemented fast enough.

## Subdued global economic growth

According to the latest statistics, the Chinese economy grew by 7.3 percent in the third quarter of 2014 and for the whole year we expect a growth rate of 7.4 percent after 7.7 percent in 2013. The outlook for 2015 is determined by the ongoing internal reform process in combination with the still rather weak growth dynamics in many industrialized economies and some major emerging markets. Both effects together will probably further dampen economic growth in China to a still impressive 7.0 percent.

The last couple of months have seen some signs of a global economic recovery. The US economy seems to be getting back on track. In November 2014 the unemployment rate has decreased faster than expected and the number of unemployed has fallen to 9.1m, a level that was last recorded in 2008 before the outbreak of the financial crisis. These positive developments on the labor market, in combination with the existing backlog demand, are expected to result in overall GDP growth of 2.3 percent in 2014 and 2.8 percent in 2015.

The outlook for the eurozone is less rosy, with the aftermath of the financial crisis, high budget deficits and postponed but overdue reforms leaving their trace in economic growth. Especially the still high unemployment rates in many southern and eastern European countries above 10 percent and up to 25 percent in Greece and Spain in the course of the persistent economic weakness give reason for concern. Though most of the European countries hit by the aftermath of the financial crisis seem to have overcome the recession, their economic growth rates are still far below pre-crisis levels. The country with the highest GDP growth in the EU in 2014 will be Ireland, recording a plus of 4.5 percent, while Italy is struggling with negative growth the third year in a row. In total, the EU economy is going to grow by 1.4 percent in 2014 after a mere 0.1 percent in 2013. As the falling oil price and moderate wage increases – due to the still high unemployment rates in most countries – should have a stimulating effect, there is a good chance that economic growth in the EU will accelerate further in 2015 to 1.7 percent.

But industrialized countries are not alone in struggling with subdued economic growth. Most Latin American countries are also reporting growth rates far below the figures common in the years before the outbreak of the financial crisis. Latin America's largest economy, Brazil, will grow by a mere 0.3 percent this year, and the 1.3 percent growth expected for 2015 is only a weak echo of the growth dynamic in the years before 2008.

## World trade development still less dynamic

This still rather subdued economic development and a number of downside risks stemming from the current geopolitical situation, especially the uncertainties regarding the political stability in the Middle East and the ongoing tensions between Russia and the Ukraine, have also weighed on global economic trade. As a consequence, the WTO revised its global trade growth forecast for this year from 4.7 percent to 3.1 percent and downgraded its outlook for 2015 from 5.3 percent to 4.0 percent.

China plays a double role in this respect: on the one hand its subdued import growth has added to the slowdown in global import demand, on the other hand as the world's biggest exporter it has been severely hit by the weak demand of the industrialized countries in recent years. Although China's export growth has picked up in recent months, growth rates are more volatile and still markedly below the double-digit rates observers were used to in the past.

Against this background the adopted measures, like the further reform of the state-owned companies and the further liberalization of interest rates, to re-adjust the Chinese economic growth model from export- and investment-driven to a more sustainable consumption-driven one, is essential. However, given the economic, environmental and demographic challenges ahead, the question will be whether the adopted reform measures are far-reaching enough and will be implemented fast enough. The most important precondition for sustainable economic growth is the efficient use of resources.

## Signs for resource misallocation

Functioning markets with competition between market players as well as free prices and interest rates signaling the relative scarcity of goods have proven to be the most effective instruments to channel resources to their most efficient use. The higher the price the scarcer a good or resource, the higher the interest rate for a loan the higher the risk of an investment. The main task of a government is to set the institutional and regulatory framework to guarantee the functioning of the market mechanisms.

When liberalizing prices and interest rates, one can choose between two approaches: either a "big bang", with prices and interest rates liberalized literally overnight, or the gradual approach. The gradual approach smoothes the transition phase and buys the market participants time to adjust to the new mechanisms. However, it entails the risk of triggering further market distortions and resource misallocation by the preservation of outdated structures and technologies if the transition period is too long. The same holds true when interest rates or prices are liberalized only in some sectors or some regions. This may also hamper innovation and dampen sustainable economic growth in the long run.

Reports about growing numbers of vacancies in newly built cities and the surge of the debt to GDP ratio hint at an ongoing resource misallocation in China. The debt ratio of the public and the private sectors increased from 148 percent in 2008 to 220 percent in 2013. Main borrower is the company sector, while the debt ratios of private households and the central government have so far remained comparatively low. But not only the borrowers also the lenders give reason for concern, as the rather strict control of the state-owned banking sector triggered the development of so-called shadow banks. These institutions are difficult to control and might become a destabilizing factor in times of crisis.

Another sign of the building up of overcapacities that may harm lenders sooner or later is the increase in the non-performing loan ratio, though the overall level reported by the commercial banks of 1.16% is still moderate. Loan interest rates that reflect the creditworthiness of the lender and the profitability of the financed projects can help to prevent future misallocation of resources and the development of bubbles. This also implies a strict separation between the tasks of development banks and commercial banks. Recent reports about a sharp rise in commercial bank loans to the agricultural sector as well as to micro- and small-sized enterprises reflecting the government's reform priorities raise some doubts whether this separation is actually being practiced.

## Environmental pollution and demographic change are challenges for future growth

Nevertheless, additional efforts to support the agricultural sector and environmental protection are urgently necessary, as air and water pollution as well as the waste of resources might become a growth stopper in the near future. The agricultural sector and industries needing fresh water struggle with the quality of water and air pollution already causes up to 500,000 premature deaths ever year. The costs of air pollution alone amount to USD 300bn every year according to a joint report by the World Bank and the Development Research Centre of the State Council. Internalizing the costs caused by pollution by levying taxes on companies and taking fees from consumers could not only educate the waste producers to become more environment friendly, but could also help finance the necessary facilities for environmental protection like sewage treatment plants.

A further challenge is demographic change. As an upshot of the one child policy, the number of people in working age between 15 and 59 has already started to decline. As a consequence, wages in some sectors have started to rise. Fostering migration from the inner provinces to the prospering coastal areas and reforming the hukou system will help to alleviate the looming shortage of workers in the eastern part of the country. However, there is also a downside to this development. Though the inner provinces have become more attractive due to ongoing state development programs, the brain drain from west to east China hampers the development of the inner provinces in the long run. This entails the risk that the regional disparities, i.e. the income and wealth gap between the eastern and western provinces, might persist and widen even further. At the end of 2013 GDP per capita in Tianjin was still five times the GDP per capita in Guizhou and the per capita deposits of a Tibetan amounted to a mere 13 percent of the deposits of an average inhabitant of Beijing.

Furthermore, it exacerbates the question of who will care for the elderly left behind in the inner provinces. Within the next 20 years, the number of people aged 65 and older is going to more than double. In 2035, there will be 282m people in this age group. That means that in China there will be more people in retirement age than in the European Union and the United States together. More than 12 million of them will probably be in need of care. With the family structures splitting up, there will be an increasing need for formal care and nursing-care homes.

However, given the ongoing urbanization process, China has the chance to become a role model for barrier-free and age-friendly urban development. Architects and developers should take the aging of the population into account when planning the future cities to realize the projected urbanization rate: Barrier-free housing and access to public buildings, easy-to-reach medical and day care facilities, supermarkets and shops as well as public transport, help the elderly to stay independent.

## Need for private old-age provision

A further question is how the pensions of the increasing number of elderly will be financed. If the retirement age is not increased gradually, there would be 62 persons aged 60 and older for every 100 persons in working age between 15 and 59 in 2050; with an increase of the retirement age to 65 years, the old-age dependency ratio will be only 39 percent. Today there are 100 people aged 15 to 59 for 22 persons aged 60 and older. Taking into account the rapid aging of society and the so far still low coverage of the public pension system, private provision is inevitable to prevent old-age poverty in the future. Incentives like subsidies and tax exemptions could help to make private old-age provision more attractive.

Furthermore, savers need access to a broad range of products, including deposits, securities and insurance in order to build up a broad portfolio mix. With an increasing need for private old-age provision and the coverage of longevity risks, the demand for life insurance will increase further. In the course of this development, China is set to become the second largest life insurance market in 2020 behind the USA.

Against this background, ensuring the stability of the financial system and the market players as well as consumer protection are absolutely vital. Providing a level playing field and fostering competition by means of efficient regulation would be beneficial for consumers. This also implies the opening up to foreign competition, fostering the know-how transfer between domestic and international companies. Given these challenges ahead, the timing of the implementation of announced reforms becomes a decisive factor for the Chinese government. An ambitious program seems warranted. While it is true that major changes always create new risks, any delay with the reform program would have major adverse effects on the Chinese economy.