

# The Current Status and Problems of the Chinese Economy

**Osamu Tanaka**  
**Executive Vice President**  
**Policy Research Institute**  
**Ministry of Finance**

## I. Structural Problems of the Chinese Economy

### 1. Problems Seen in Economic Indicators for 2012

#### (1) Characteristics of Quarterly GDP

Gross domestic product (GDP) in 2012 stood at 51,894.2 billion yuan with the real growth rate of 7.7%. By quarter, GDP grew 8.1% in January-March, 7.6% in April-June, 7.4% in July-September and 7.9% in October-December. In 2013, GDP grew 7.7% in January-March and 7.5% in April-June. The growth rate for January-June came to 7.6%.

Looking at the growth patterns, the Chinese economy in 2012 seems to have slowed down until September and turned up in October-December, but slowed down again in January-March 2013. But no easy comparison is warranted between China and other countries because China's quarterly GDP growth is computed on a year-on-year basis, not against the preceding quarter as in Japan and other developed economies.

For this reason, the State Statistical Bureau started publishing quarter-on-quarter growth rates beginning in 2012 for reference. You can get annualized growth rates by quadrupling these quarter-on-quarter growth rates. By this exercise, the Chinese economy grew 1.5% in January-March 2012, 2.1% in April-June, 2.0% in July-September, 1.9% in October-December, 1.6% in January-March 2013, and 1.7% in April-June.

These growth patterns show that the Chinese economy had already begun to stagnate in July-September 2012. And the annualized growth rate in April-June 2013 comes to 6.8%, significantly lower than the year-on-year growth China published. It can be considered that the lower growth rate shows the actual conditions of the Chinese economy more accurately.

Quarter-on-quarter growth figures are still unstable and revised every three months, making them no more than just estimates. When comparing China's economic trends with other countries, however, we should pay due heed to its quarter-on-quarter growth rates.

#### (2) GDP Composition by Industry

Looking at China's GDP in 2012 by industry, the primary industry accounted for 10.1% of the total, the secondary industry 45.3% and the tertiary industry 44.6%.

This breakdown indicates that the secondary industry carries a significant weight in China. By comparison, for Japan's GDP in 2011, the secondary industry accounted for 25.9% and the tertiary industry 72.4%, and for the United States, the secondary industry accounted for 17.3% and the tertiary industry 79.6%. In other words, the secondary industry has a disproportionately large share in the Chinese economy, with the tertiary industry yet to be fully developed. This is one of structural problems in the Chinese economy.

### (3) GDP Composition by Demand

Looking at China's GDP in 2012 by demand, final consumption accounted for 49.2%, capital formation (investment) 48.1% and net exports (exports minus imports) 2.7%.

This clearly shows that investment is the primary driving force of the Chinese economy. By comparison, for Japan's GDP in 2011, investment accounted for 19.5% and final consumption 78.8%, and for the United States, investment accounted for 13.1% and final consumption 90.8%. The weight of private consumption comes to 35.7% for China (2012), compared against 59.2% for Japan (2011) and 70.5% for the United States (2011), showing very weak private consumption in China. The heavy dependence on investment with weak private consumption is the second structural problem in the Chinese economy.

What is the reason for weak private consumption in China? It is because of the huge income disparity in China, as described below. Consumption by the wealthy class has already reached the saturation point, with rich people already having everything they want. By contrast, the middle income group cannot purchase what they want because of their weak purchasing power. This income disparity needs to be corrected in order to promote private consumption.

### (4) Income Levels in Cities and Agricultural Areas

In 2012, the average disposable income per urban resident stood at 24,565 yuan, showing the real growth of 9.6% year on year (12.6% in nominal terms), while the average cash income per farmer came to 7,917 yuan, showing the real year-on-year growth of 10.7% (13.5% in nominal terms).

Though the growth of income for farmers topped that for urban residents, there is the income gap of more than three times between cities and agricultural areas. The income disparity between cities and agricultural areas is the third structural problem in the Chinese economy.

### (5) Age Composition of the Chinese Population

The age composition of the Chinese population is as follows:

- 1) 60 or older: 193.90 million, accounting for 14.3% of the total population (up 0.59 percentage point over the end of the previous year);
- 2) 65 or older: 127.14 million, accounting for 9.4% of the total population (up 0.27 percentage point over the end of the previous year); and
- 3) 15 to 59 (working-age population): 937.27 million, accounting for 69.2 of the total population (down 0.60 percentage point from the end of the previous year).

This shows the fast pace of the aging of the population in China, and the development of the social insurance system is failing to catch up with it. The expression of “getting old before getting rich” is often used in China recently. This means that China has reached the full-fledged graying society before the whole nation becomes rich.

The problem goes beyond this. In 2012, the working-age population dwindled by 3.45 million from the previous year, dropping for the first time ever. The working-age population was previously forecast to peak out around 2015. This came three years sooner than expected.

In Japan, the working-age population peaked out in the mid-1990s, and some say that this has led to the decline of the potential growth rate and the long-term stagnation of the Japanese economy. It appears that China has finally got to this stage.

This resulted in the spreading view among China’s leaders and economists that “the high-growth period of China has come to an end.” The question now is whether the Chinese economy will shift to a period of medium growth in a stable manner or slips into a period of low growth at once. It will depend on whether the Chinese leadership of President Xi Jinping and Prime Minister Li Keqiang will be able to solve a host of problems in the Chinese economy described later.

## 2. Problems Seen in Recent Major Economic Indicators

### (1) Consumer Prices

In July 2013, consumer prices in China increased 2.7% year on year. Food prices jumped 5.0%, and non-food prices also rose 1.6%. The trends of consumer prices in recent months are as follows:

Consumer prices: up 2.0% in January → up 3.2% in February → up 2.1% in March → up 2.4% in April → up 2.1% in May → up 2.7% in June → up 2.7% in July.

As these price patterns show, consumer prices in China are fluctuating unevenly, apparently under the impact of movements of food prices. In the Chinese basket of consumer prices, the weight of food prices accounts for over 30%. Thus, prices in China are susceptible to the impact of agriculture.

China experiences cold waves during winter, drought from spring to early summer, and flooding in parts of the country during summer. These weather conditions affect prices of agricultural products, mainly fresh vegetables. China’s agriculture that is vulnerable to weather conditions makes prices unstable.

Aside from this, production levels of pork, developments on the money supply front, price movements of crude oil and other resources, and trends of minimum wages are also affecting consumer prices in China.

### (2) House Prices

In April 2013, selling prices of newly built houses for sale in 70 major and midsized cities across China declined from the previous month in four cities and leveled off in four cities. House prices

increased in the remaining 62 cities, with the highest rise of 2.2% recorded in Xiamen. Year on year, house prices dropped only in one city. House prices stayed flat in no city, but rose in 69 cities, with the highest rate of increase of 18.3% registered in Beijing.

House prices have been on the uptrend in China since 2009, apparently the side effect of large-scale economic measures launched in 2009-2010 in the wake of the Lehman Shock in 2008. The People's Bank of China (the central bank) eased credit policy substantially, and as a result, bank lending in 2009 doubled the 2008 level. The massive amount of money flew into the housing market, touching off the steep rises in house prices.

Former Prime Minister Wen Jiabao came up with a series of countermeasures successively, including the reductions in down payments for and interest rates on housing loans, heavier taxation, restrictions on house purchases and the supply of low-rent public housing. But these measures have yet to produce intended effects, with house prices presenting a major problem in the Chinese economy.

### (3) Trends of Industry, Consumption and Investment

The trends of China's industry, consumption and investment in recent months are shown below on a year-on-year basis:

Industry: up 10.0% in 2012 → up 9.9% in January-February 2013 → up 8.9% in March → up 9.3% in April → up 9.2% in May → up 8.9% in June → up 9.7% in July

Consumption: up 14.3% in 2012 → up 12.3% in January-February 2013 → up 12.6% in March → up 12.8% in April → up 12.9% in May → up 13.3% in June → up 13.2% in July

Investment in urban areas: up 20.6% in 2012 → up 21.2% in January-February 2013 → up 20.9% in January-March → up 20.6% in January-April → up 20.4% in January-May → up 20.1% in January-June → up 20.1% in January-July

These trends show that the increases in these indicators have slowed down in 2013 from 2012, and this is the primary reason behind the slack GDP growth in the first half of 2013.

By contract, the growth of investment in real estate development remains solid, part of reasons why house prices have yet to come down.

Real estate investment: up 16.2% in 2012 → up 22.8% in January-February 2013 → up 20.2% in January-March → up 21.1% in January-April → up 20.6% in January-May → up 20.3% in January-June → up 20.5% in January-July

### (4) Exports and Imports

Exports in July 2013 increased 5.1% over the same month of 2012 to \$185.99 billion, while imports rose 10.9% to \$168.17 billion, leaving a trade surplus of \$17.82 billion, down 29.6%. The recent trends of exports and imports are shown below:

Exports: up 7.9% in 2012 → up 25% in January 2013 → up 21.8% in February → up 10.0% in March → up 14.7% in April → up 1% in May → down 3.1% in June → up 5.1% in July

Imports: up 4.3% in 2012 → up 28.8% in January 2013 → down 15.2% in February → up 14.1% in March → up 16.8% in April → down 0.3% in May → down 0.7% in June → up 10.9% in July

There were suspicions that exports in January-April had been padded. Therefore, the General Administration of Customs scrutinized export statistics in May 2012 onward, and as a result, exports in May onward slowed down significantly.

In January-July 2013, exports increased 9.5% over the same period of 2012 to \$1,238,734 million, while imports rose 7.3% to \$1,113,024 million, leaving a trade surplus of \$125,710 million. By country, while overall exports and imports rose 8.5% in January-July year on year, trade dipped 1.8% with the European Union (EU), rose 6.2% with the United States, dropped 8.8% with Japan and increased 12.4% with the member states of the Association of Southeast Asian Nations (ASEAN). In the same period, China's trade showed no growth with Russia, expanded 15.8% with South Africa, edged up 0.1% with Brazil and dropped 5.0% with India.

China's trade with the EU fell sharply since 2012 under the impact of the economic crisis in the EU. In addition, its trade with Japan has been shrinking in the aftermath of the confrontation over the Senkaku Islands since the autumn of 2012. The slowing of emerging economies has also made China's exports unstable.

#### (5) Utilization of Foreign Capital

The amount of foreign capital utilized in July 2013 stood at \$9,408 million, an increase of 24.13% over the same month of 2012.

(Reference) Down 3.7% year on year in 2012 → down 7.3% in January 2013 → up 6.32% in February → up 5.65% in March → up 0.4% in April → up 0.29% in May → up 20.12% in June → up 24.13% in July

The amount of foreign capital in January-July came to \$71,392 million, up 7.09% year on year.

Looking at foreign capital utilized in January-July by country, foreign capital from the EU amounted to \$4,637 million, up 16.72% year on year, from Japan \$5,181 million, up 9.57% (up 14.37% in January-June), and from the United States \$2,184 million, up 11.44%.

Direct foreign investment kept the negative growth since November 2011, but turned up again from February 2013, and these funds may be flowing into the real estate market.

#### (6) Money Market

China's M2 at the end of July 2013 grew 14.5% over a year earlier, with the year-on-year growth picking up by 0.5 percentage point from the end of June. The trends of M2 in recent months are shown below:

M2: up 13.8% in December 2012 → up 15.9% in January 2013 → up 15.2% in February → up 15.7% in March → up 16.1% in April → up 15.8% in May → up 14.0% in June → up 14.5% in July

The recent developments show the accelerating growth of M2 despite the stagnating trend of the Chinese economy. This may indicate that extra funds are flowing into the real estate market to push up house prices. The People's Bank of China slightly tightened its grip on the short-term money market in June in order to bring the M2 growth into line with its annual target of 13%. As a result, liquidity tightened at the end of June, leading to a sharp temporary rise in short-term interest rates. Following this development, the central bank eased its credit grip somewhat in July. Going forward, money supply trends require a close watch.

#### (7) Public Finance

China's fiscal revenues in July 2013 stood at 1,184.9 billion yuan, up 11% over the same month of 2012. Fiscal revenues for the entire nation in January-July came to 8,043.9 billion yuan, up 8% over the like period of 2012. The trends of fiscal revenues are shown below:

Fiscal revenues: up 12.9% in 2012 → up 7.2% in January-February 2013 → up 6.1% in March → up 6.1% in April → up 6.2% in May → up 12.1% in June → up 11% in July

In January-July, China's fiscal expenditures amounted to 6,906.9 billion yuan, an increase of 8.9% year on year.

The Finance Ministry attributes the two-digit growth of fiscal revenues in June and July to special factors, and sees it difficult to expect sharp increases in fiscal revenues going forward, given such factors as the slowdown of industrial production expected going forward and larger tax reductions. When China continued to mark the double-digit growth of GDP, fiscal revenues showed substantial growth of 20-30%. With the high-growth period coming to an end, however, the growth of fiscal revenues is slowing down significantly.

#### (8) Social Power Consumption

China's social power consumption in July 2013 increased 8.8% over the same month of 2012. Social power consumption in January-July rose 5.7% year on year. The recent trends of power consumption are shown below:

Social power consumption: up 5.5% in 2012 → up 5.5% in January-February → up 2.0% in March → up 6.8% in April → up 5.0% in May → up 6.3% in June → up 8.8% in July

As power consumption is closely related to industrial activities, it is an important indicator for estimating the trends of the Chinese economy.

### 3. Issues Related to Marketization

China's decision in 1992 to shift from the planned economy to the socialist market economy was the inevitable choice for the long-term development of the Chinese economy. Nevertheless, the marketization is still the target of various criticisms. Needless to say, the market economy is not a panacea for everything. For the market economy to function effectively in China, it seems necessary to have a clear understanding of the following matters.

## (1) Clarification of the Roles of the Government and the Market

The market cannot solve all economic problems. The government must solve on its own things that cannot be left up to the market. However, there have been criticisms that the government 1) has been doing what it should not be doing; 2) has not been doing what it should be doing; and 3) has been doing wrong things.

Regarding 1), oft-repeated criticisms are leveled against the interference by local governments in investment decisions by state-owned enterprises and lending decisions by financial institutions. Such interference is apparently the legacy of the planned economy, and the advantages of the market economy would not come into full play unless this is put out of the way. Furthermore, China's industrial policy that leads to the excessive concentration of key industries in the hands of huge state-owned enterprises or enterprise groups would block the development of the non-public ownership economy.

As for 2), solutions of environmental problems, redistribution of income and public welfare problems, as well as the development of infrastructure for the market economy are the roles the government should be taking up by the nature of things. Up to now, however, the deterioration of the environment has become a very serious problem, the economic disparity has widened, and medical care expenses, educational expenses and house prices have risen sharply. A delay in solving public welfare problems has helped raise the savings rate among Chinese people, weakened consumption and created the structural imbalance between investment and consumption. For the redistribution of income, it is essential for China to raise the labor share, strengthen efforts to improve and implement the individual income tax, introduce the progressive inheritance tax and develop the social insurance system. They are problems that cannot be solved by the market by the nature of things. As the government has failed to fully perform its role in these areas thus far, criticisms against the marketization reform have erupted.

Moreover, the government should be taking the lead in the development of infrastructure for the market economy. At the top of the agenda was an early enactment of the Property Law and antimonopoly law. But the enactment of these two laws lagged far behind China's decision in 1992 to make a shift to the socialist market economy, resulting in a delay in bringing in standard market orders.

Regarding 3), the typical example is the practice of local governments to forcefully purchase land from farmers for cheap compensation and sell it off to developers to raise fiscal revenues. Also, "projects for political performance" and "image-building projects" may be counted in such examples.

## (2) Problems of the Market and Information

For the market to function efficiently, all market participants should have access to necessary

information. When there is a big information gap among market participants, it gives rise to speculation and ultimately creates a speculative bubble.

Similar problems could arise in the transition from the planned economy to the market economy. The planned economy, by nature, is the system where the command division of the government manages information in an integrated manner. When the marketization goes ahead without the decentralization and sharing of information, it makes it possible for people in the command divisions of various levels of government and their relatives to monopolize important information and use it to amass enormous wealth. The uneven distribution of information appears to be behind the widening gap between the rich and the poor at present and the rise of super-rich people in China.

However, this is not the problem that can be ascribed to the market mechanism, but the problem associated with the legacy of the planned economy. It can be solved if market participants are allowed to share and utilize necessary information by thoroughly pushing ahead with marketization and anti-corruption efforts, strict restrictions on the monopolization of information and proactive disclosure of market information.

### (3) Problems of the Market and Ethics

The market economy, by its nature, does not function efficiently unless market participants comply with rules, because the market where market participants do not abide by rules would become a savanna ruled by the law of the jungle. People who participate in the market need to have a sense of justice and the spirit of fair play.

However, when people can get larger gains in the short term by not abiding by the rules than by abiding by the rules, or when people can get larger gains in the short term by deceiving counterparties than by faithfully performing contracts, it would not be absolutely easy to lead market participants to abide by the rules. Some form of ethical motivation would be needed to make market participants willing to abide by the market rules.

## II. Macroeconomic Policy for 2013 in the Report on the Work of the Government

On March 5, 2013, China convened the 12th National People's Congress (the equivalent to parliament), where then Prime Minister Wen Jiabao delivered his last Report on the Work of the Government (hereinafter referred to as the "Report"). The Report is an important document that spells out the basic economic policy for the coming year.

### 1. Problems in the Domestic Economy

The Report listed a host of remaining problems as described below:

#### (1) Unbalanced, uncoordinated and unsustainable development

The Chinese economy are confronted with a host of problems, including economic disparities



between urban and rural areas, between regions and between individuals, the uncoordinated state of economic development and social policies (for example, development and improvement of sanitary facilities and the minimum medical security system), the uncoordinated state of economic development and resources, energy and the environment, the imbalance between investment and consumption, the imbalance of the industrial structure (secondary and tertiary industries), and the extensive growth formula (massive input of resources, energy and labor).

The “Scientific Outlook on Development” and the “Transformation of the Economic Development Mode” advocated by former Communist Party General Secretary Hu Jintao sought to solve these problems for sustainable growth. But the Hu Jintao government failed to make much of the achievement in this area, leaving most of the problems to the new leadership of Xi Jinping and Li Keqiang.

#### (2) Growing conflict between downward pressure on economic growth and excess production capacity

The excess production capacity for steel, cement, electrolytic aluminum, sheet glass, coke, photovoltaic power generation and wind power generation poses serious problems, resulting in the spread of loss-making operations. This can be traced to the substantial addition to capital spending under large-scale economic measures in 2009-2010, making the industry reorganization a major challenge.

#### (3) Coexistence of enterprises' increasing operating costs and their weak capacity for innovation

Since 2010, minimum wages have been raised by more than 20% each year. The increases reflect the government's policy to raise income of low-income earners and promote personal consumption and are thus expected to continue going forward. It may be said that the era of China's low cost has been brought to an end.

However, unless wage increases are accompanied by the enhancement of productivity, the Chinese economy's international competitiveness would be significantly undermined. Chinese enterprises are confronted with the urgent tasks of strengthening their innovation capacity independently and fostering and bolstering their own brands.

#### (4) Conflict between the slowing growth of government revenue and increasing fixed government expenditures

While fiscal revenues are declining in tandem with the slowdown of the economic growth, fixed government expenditures in social insurance and other public welfare-related areas, putting widening pressures on China's fiscal deficits. Structural problems found in Japan's public finances are beginning to emerge in China as well.

## (5) There are potential risks in the financial sector

There are three risks in the financial sector.

### 1) Debts of local governments

Large-scale economy-boosting measures implemented in 2009-2010 brought large fiscal burdens on local governments. As local governments in China are barred from borrowings, fiscally-strapped local governments one after another established dummy companies (called “financing platforms”). Financing platforms procured massive amounts of funds from banks, but repayments of such funds began to fall into arrears from around the end of 2010, bringing to light hidden debts of local governments. Based on the audit conducted by the central government’s auditing body, debts of local governments stood at 10.7 trillion yuan at the end of 2010. Their debts continued to grow subsequently, and total debts at present are believed to have swollen to top 20 trillion yuan, with their repayments posing a major problem.

### 2) Real estate-related loans

Funds are rapidly flowing into the real estate market, and if house prices nosedive, it could shake the entire financial system.

### 3) Private-sector finance

Since private-sector enterprises have low creditworthiness and often find it difficult to obtain loans from banks, they borrow money from loan sharks. In particular, Wenzhou in Zhejiang Province was known as the place that had many well-developed private-sector enterprises and private-sector financings. When the economy was booming, private enterprises were able to repay their high-interest borrowings. After exports turned sour, however, private enterprises there went bankrupt one after another around September 2011, followed by a string of bankruptcies of loan sharks that lent money to them, with many loan shark operators also skipping town or killing themselves one after another. There occurred sort of regional financial panic in Wenzhou. This panic was calmed down by the government’s efforts led on the spot by Prime Minister Wen Jiabao. But the supervision and regulation of the private-sector finance remains as a major challenge.

In addition, a large number of trust companies and other entities are incorporating high-risk, high-return bonds issued by financing platforms to raise funds and selling them a wide range of investors and depositors as high-return products for speculative investment without adequately disclosing risks involved. As many issuing financial platforms face growing financial problems, the safety of these financial products is being called into serious question.

## (6) Unbalanced industrial structure and the weak agricultural foundation

As stated earlier, the services industry is developing only slowly, while agriculture remains vulnerable to weather conditions.

## (7) Economic development increasingly in conflict with resource conservation and

environmental protection

While air pollution by PM2.5 drew keen attention recently, water contamination and soil contamination have also become serious problems in China.

(8) Large development gap between urban and rural areas and between regions, and large income disparities between individuals.

These gaps represent not only the bottleneck for an expansion of private consumption but also the source of spreading public discontent, making it an urgent task to narrow the gaps through reform of the income distribution structure.

(9) Marked increase in social problems, and many problems in the areas of education, employment, social security, medical care, housing, the environment, food and drug safety, workplace safety and public order affecting people's vital interests and having some people still lead hard lives

These are exactly public welfare problems in China, and inadequacies in all of these areas are heightening people's discontent. When people see inadequacies in public welfare, they feel uneasy about present conditions and the future and increase savings, leaving little room for private consumption to grow. Thus, the security and improvement of public welfare has been placed at the top of the Chinese government's agenda since the Hu Jintao administration.

## 2. Macroeconomic Policy for 2013

### (1) Goals of Macroeconomic Policy

While China's macroeconomic policy goals for 2012 were "steady and rapid economic development and maintaining basic stability of overall prices," the goals for 2013 were set to promote "sustained and healthy economic development" with the "focus on improving the quality and performance of economic growth." The new goals show that following the end to the period of high growth, China has come to attach importance to the quality, efficiency, sustainability and soundness of the economic growth, rather than the speed of the growth.

### (2) Growth Target

The growth target for 2013 was set at "about 7.5%," as for 2012. Explaining the reasons for the target, the Report said that 1) "we must ensure that economic growth is in accord with the potential economic growth rate, the ability to supply factors of production, and the bearing capacity of resources and the environment" and 2) "we should guide all the people to shift the focus of their work to accelerating the change of the growth model, adjusting the economic structure and improving the quality and performance of economic growth, so as to promote sustained and healthy economic development." Thus, the Chinese government has acknowledged the considerable decline in China's potential growth rate, and is trying to bring the growth target more into line with the actual economic conditions and promote the adjustment of the economic structure.

### (3) Public Finance

The Report said the Chinese government will “continue to implement a proactive fiscal policy.” It projects a deficit of 1.2 trillion yuan, 400 billion yuan higher than the restrained budgeted figure in 2012. The increase in the deficit in 2013 will bring the deficit-to-GDP ratio to about 2%, up from around 1.5% in 2012.

The Report said the government will continue to give priority to spending on “education, medical and health care, social security and other weak areas that are important to people’s wellbeing,” while public investment will be mainly made in government-subsidized housing projects that have the nature of social insurance, infrastructure projects related to agriculture, water conservancy and urban utilities networks, social programs, energy conservation and environment protection-related areas. As the structural tax reduction policy, the government will accelerate the pilot project for the services industry, launched in FY2012, to replace business tax with VAT, extending the projects to more areas and sectors in a timely manner.

### (4) Finance

The Report said the government will “continue to implement a prudent monetary policy.” But the target for growth of M2 for 2013 was set at about 13%, somewhat lower than the 2012 target of 14% and the actual 2012 growth of 13.8%.

Regarding the allocation of financial resources, the Report said the government will “guide financial institutions to increase financial support for structural adjustments to the economy, especially for agriculture, rural areas and farmers, small and micro businesses, and strategic emerging industries, and satisfy funding needs for key national projects under construction or expansion,” and tighten management of financial risks. The government also said it will “steadily carry out reforms to make interest rates and the RMB exchange rate more market-based” and proceed with the phased liberalization of capital transactions.

### (5) Expansion of Domestic Demand

While noting, “The difficulty in and key to expanding domestic demand lie in consumption, and that is also where the potential lies,” the Report said that as personal consumption cannot be expected to rapidly expand anytime soon, “In the current stage, the role investment plays in promoting economic growth cannot be underestimated.” But it added the government will pay close attention to the accurate direction of investment (for example, housing, schools, hospitals, agriculture, rural areas, farmers, urban infrastructure, the Great Western Development, and energy-saving and environmental protection), optimization of investment structure and the enhancement of the quality and performance of investment, noting that investment often gets overheated immediately after the Party Congress. The Report also said that “we must further relax controls over market access for nongovernmental investment and stimulate it.”

## (6) Urbanization

The promotion of urbanization is the key element of new Prime Minister Li Keqiang's policies. China is now in the transition from high growth to medium growth, but the progress in urbanization will underpin China's economic growth over the medium term as it helps expand consumption and employment, promote construction of urban infrastructure and develop the services sector. In this regard, the Report said that China "should accelerate reform of the household registration system... register eligible rural workers as permanent urban residents in an orderly manner; progressively expand the coverage of basic public services in urban areas to all their permanent residents."

However, urbanization could also risk wanton development, deterioration of urban problems such as the excessive concentration of the population and going slum, and the decline of agriculture due to reduced farmland. Since there are already early signs of wanton development, such as spiraling house prices and the rapid expansion of investment in property development and real estate-related lending, close attention should be paid to developments going forward.

## III. Macroeconomic Policies for the Present

Following the announcement of the GDP growth for the April-June quarter, General Secretary Xi Jinping presided over a meeting of the Politburo of the Communist Party's Central Committee, called on July 30 to review the economic situation in the first half of 2013 and consider China's economic policies for the second half. The results of the Politburo meeting are outlined below:

### (1) Review of the Economic Situation

Major economic indicators for the first half are well within a reasonable range of the targets set for the full year and the socioeconomic development has made a generally favorable start. The economy has maintained moderate growth, overall price levels are basically stable and the employment situation is largely stable. Production of grain crops and edible oil during summer is abundant, the development of the services sector continues to accelerate, the accomplishment of scientific and technological innovation is emerging constantly, and we further strengthened energy-saving efforts and reductions in emissions of pollutants. The streamlining and decentralization of powers of the government has moved ahead proactively, reform and the opening gained further ground and social projects have been strengthened.

### (2) Problems in Macroeconomic Policy

At present, China's development is in the period of an important strategic opportunity where it can still make a major contribution, and the fundamental conditions for sustained and healthy economic growth are in place, with the Chinese economy as a whole still expected to maintain moderate growth.

At the same time, we need to recognize that the global economy is in the middle of a major adjustment, and the domestic and international environment is highly complicated. We need to be

well-prepared for any eventualities, and we not only need to prepare for all kinds of complicated and difficult situations, but also firmly grasp the opportunity for important adjustment, proactively achieve results and seek a further advancement through innovation. We need to stick with the integrated planning for stable growth, structural adjustment and promotion of reform, stabilize macro policies, activate micro policies, underpin them with social policies, and strive to realize the organic unification of the three tasks.

### (3) Basic Macroeconomic Policy for the Second Half

The economic policy for the second half must uphold the pursuit of progress while maintaining stability, uphold the focus on improving the quality and performance of economic growth, uphold the continuity and stability of macroeconomic policy, enhance the appropriateness and coordination, proceed with the preadjustment and fine-tuning in a timely and appropriately manner in response to changes in the economic situation, and show successful results amid stability.

We need to plan stable growth, structural adjustment and promotion of the reform integrally, proactively expand effective demand, and step up the promotion of the switchover and upgrading. We must also constantly deepen reform and the opening, lay emphasis on the security and improvement of people's wellbeing, and ensure the accomplishment of major tasks for the year's socioeconomic development.

Each local government and division must bring their ideologies and behaviors into line the party's analysis of and judgments on the economic situation as well as its policy decisions and arrangements. We must consolidate our confidence, make extra efforts to achieve results and strive to steadily implement policies for socioeconomic development.

### (4) Major Policies for the Second Half

We should grasp the direction, intensity and rhythm of macro-controls to keep the economic performance within a reasonable range.

- 1) We will continue to implement a proactive fiscal policy and a prudent monetary policy, make full use of stocks, optimize the flow, emphasize the enhancement of the efficiency of use of fiscal funds, strengthen financial support for the real economy and use money where it is needed.
- 2) We will proactively draw out effective demand, promote the upgrading of personal consumption, maintain reasonable growth of investment, proactively and prudently promote the new type of urbanization with people at its core, and promote a prudent and healthy development of the real estate market.
- 3) We will maintain the stable development of agriculture, consolidate the foundation of abundant food production, steadily produce supplementary food, and steadily implement disaster-prevention and disaster-reduction measures.
- 4) We will further bolster up the vitality of enterprises, strengthen policy support and services for

small and micro businesses, consolidate expenses and reduce burdens further, and open up the channels of fund procurement for enterprises.

- 5) We will accelerate the promotion of industrial structural adjustment, promote the conversion and upgrading of traditional industries, proactively foster and develop strategic emerging industries, accelerate the development of the information industry, focus on energy-saving, environmental protection and the development of the new energy industry, and promote the development of the new services and livelihood-related services industries.
- 6) We will thoroughly implement the overall strategy for regional development and implement and develop regional development plans and policies.
- 7) We will strive toward stabilization of external trade, develop policies and services, cultivate export channels, proactively increase imports, effectively respond to trade frictions, and encourage overseas investment by well-prepared enterprises.
- 8) We will continue to withdraw or delegate items requiring administrative approval, thoroughly promote reforms of the fiscal, tax and financial systems, proactively and prudently promote the reform of prices for resources and the environment, and steadily implement overall reform-related tests.
- 9) We will stabilize overall price levels, strengthen the linkage between production, supply and sales of important products, and strive to mitigate the impact of price rises on people's livelihood.
- 10) We will lay stress on the security and improvement of public welfare, continue to develop and improve support policies for employment and the startup of businesses, integrally plan the building of social security systems for urban and rural areas, appropriately make arrangements for people's production activities and livelihood in disaster-affected areas, promote the development of projects related to education, health care, culture and sports, strengthen and overhaul social management, and maintain social harmony and stability.

#### IV. Economic Policy of Prime Minister Li Keqiang (“Liconomics”)

Recently, Prime Minister Li Keqiang's economic policies are occasionally referred to as “Liconomics,” as those of Japanese Prime Minister Shinzo Abe are called “Abenomics.” The Liconomics is said to be the term coined by three economists at Barclays Capital, and in this author's view, the Liconomics is rich in content. Its full picture is described below.

##### (1) Promotion of New Type of Urbanization That Puts the People in the Heart

The first pillar of the Liconomics is the “promotion of a new type of urbanization that puts the people in the heart”.

Citing reasons why the promotion of urbanization is necessary at his inaugural press conference,

Prime Minister Li said that urbanization will unleash enormous consumption and investment demand and create many job opportunities and “More directly, it can enrich farmers and benefit the nation.”

China’s working-age population dwindled for the first time ever in 2012, and the recognition that China’s high growth period has been brought to a close has set in among many party and government leaders. For the Chinese economy to go on the stable path of medium growth, it needs a new engine of growth and urbanization is considered to be that engine.

First of all, urban residents consume much more than farmers. If farmers turn into urban residents in massive numbers, total consumption is likely to grow. Urbanization requires infrastructure development. Urbanization will also help develop the services industry and should also lead to increased employment. The promotion of urbanization is the key to sustained growth of the Chinese economy.

Then, what does “human-centered” urbanization mean? Currently, the urbanization rate in China stands at 52.6%, but this figure is interpreted to show the “false urbanization.” Some 260 million migrant farmers are working in urban areas, but they are markedly discriminated against resident with urban household registration in their access to such basic public services as social insurance, housing and education of their children. If the ratio of the population with access to basic public services in urban areas represents the genuine urbanization rate, China’s urbanization rate stands at just around 35%. This is why China’s urbanization is called the “urbanization of the population,” not the “urbanization of people.”

To realize the genuine urbanization, it is necessary to reform the household registration system and turn migrant farmers-workers into urban residents who can receive basic public services on an equal footing with present urban residents. However, these steps would inevitably increase fiscal burdens on cities. Particularly because the government is pushing for the relocation of farmers to mid-sized and small cities instead of large cities, it would be necessary to drastically reform the local finance system to bolster up the fiscal bases of mid-sized and small cities.

Furthermore, summarizing what Prime Minister Li has stated, the “new type of urbanization” means urbanization that reasonably deploys large, medium-sized and small cities, avoids the urban malaise such as traffic congestion, environmental degradation and going slum, and is aligned with the advancement of agriculture and rural areas.

As described above, Prime Minister Li has the very lofty vision of urbanization. But local governments are poised to expand investment in real estate development on the pretext of urbanization. It does not seem to be an easy task to push forward urbanization in a healthy and stable manner while avoiding wanton development seen in 2003-2004.

## (2) Transformation of the Government Function

The second pillar is the “transformation of the government function.”



At the inaugural press conference as described above, Prime Minister Li stated that the “transformation of the government function is to redefine the relations between the government and society and between government and the market.” He added, “Frankly speaking, let the market and society decide what they are capable of accomplishing. The government should manage affairs well in what it is supposed to do.”

What he has stated is designed to limit the roles of the government and means the streamlining of government functions, promotion of deregulation and utilization of the private sector’s vitality. Prime Minister Li pledged to the nation that 1) he will not allow construction of new office buildings, public halls and guest houses by the government; 2) he will reduce the government’s payrolls; and 3) he will cut back on entertainment and overseas business trips at government expenses and the purchase of official vehicles. He also stated that he will slash more than one-third of over 1,700 approvals and licenses now being administered by the departments and divisions of the State Council during his term of office of five years. The State Council, at two sessions of the executive meeting has already decided to abolish or streamline a total of 133 approvals and licenses. He also came up with measures to introduce private-sector capital into the railroad and financial sectors.

The extensive administrative reform like this resembles the administrative reform carried out in Japan in the 1980s under the Cabinet of Prime Minister Yasuhiro Nakasone. The slogans at the time were also the utilization of the private sector’s vitality, promotion of deregulation and reform of Japanese National Railways. But then Prime Minister Nakasone in Japan and Chinese Prime Minister Li find themselves in the quite different positions. The administrative reform under Prime Minister Nakasone had the strong backing of the business community. In China, the business community means groups of massive state-owned enterprises, which themselves are the target of administrative reform.

The bold administrative reform in China pits the government directly against the business community and represents no easy task. If Prime Minister Li looks for any force that would lend its support to administrative reform, he could only find it in the ruling Communist Party. Unless he secures the strong backing of General Secretary Xi Jinping, the “transformation of the government function” he advocates could end up as empty slogans.

### (3) Maintenance of Economic Stability within a Reasonable Range

The third pillar is the “maintenance of economic stability within a reasonable range.”

Prime Minister Li unveiled his basic stance on macroeconomic policies at a conference on China’s current economic situation held on July 16. He said that a major task of macroeconomic control is to avoid sharp fluctuations and keep economic growth within a reasonable range, adding, “The lower limit is to stabilize economic growth and maintain employment, while the upper limit is

to prevent inflation.” He thus indicated that the government will place an emphasis on the transformation of the growth model and structural adjustment when the economic management is maintained within a reasonable range, while the government’s macroeconomic policies focus on stable growth or prevention of inflation when the state of economic management approaches the upper limit or the lower limit.

While specific figures of the upper limit or the lower limit have not been revealed, most economists believe that the upper limit is the inflation target of 3.5% for 2013 and the lower limit is the average growth rate target of 7% for the duration of the 12th Five-Year Plan.

As seen above, Prime Minister Li is negative toward the re-invocation of large-scale economy-boosting measures implemented in 2009-2010 right after the Lehman Shock, but stands ready to respond to a major downward risk of the Chinese economy, paying a measure of heed to those who give priority to economic growth.

However, the current problems confronting China, such as the excessive production capacity, huge debts of local governments and the problem of “shadow banking,” are all the after-effects of the economic measures introduced in 2009-2010. It is no easy task to flexibly manage macroeconomic policies while mitigating the potential risks of these problems posed to industry, public finance and the financial sector.

#### (4) Return of the Reform Bonus to People

The fourth pillar is the “return of the reform bonus to people.”

Prime Minister Li routinely states that “reform is the biggest bonus,” and expounding on what it means at the press conference on March 17, he said that reform can further liberate the productive forces and that “there is a huge potential for the benefit of all the people, there is a huge space for reform dividend.”

At the press conference, Prime Minister Li cited the content of reform as 1) reform of the fiscal and budget systems, 2) market-oriented interest rates and exchange rates, 3) liberalization of the services industry, 4) reform of the income distribution system, 5) reform of the social security system, and 6) the entry of private-sector capital into the finance, energy and railways sectors, among others.

It should be noted that while Prime Minister Li acknowledged that the reform has already entered the difficult stage of conflicting with vested interests, he demonstrated his resolve to push ahead with the reform by saying that “it is about the fate of the country, the future of the nation,” adding that the reform “takes courage, wisdom and toughness.”

#### (5) Future Challenges

As discussed above, whether it is the transformation of the government function or further

promotion of the reform, Prime Minister Li will face a lot of difficulties ahead and the realization of the reform essentially hinges on the support of the ruling Communist Party, in particular the support of General Secretary Xi Jinping. In this respect, General Secretary Xi made worrisome remarks at a round-table conference on the thorough deepening of reform and the opening, held in Wuhan on July 23. He stated that research and studies are necessary before pushing ahead with the reform and that it is important that reform of the economic system should take into account a strengthening of the development vitality of the state ownership economy. These remarks run counter to the tone of Prime Minister Li's public statements.

General Secretary Xi may have made these remarks intentionally out of consideration for both the conservative and leftist forces within the party, or he may be taking a cautious approach to the further deepening of the reform. Either way, General Secretary Xi's stance is likely to significantly influence the success or failure of the Liconomics.