The Chinese Reform Process in a European Perspective

Abstract

During the Third Plenum of the Central Committee of the Communist Party in November 2013, China’s political leadership implemented a relatively far-reaching reform program, covering many economic, social and political areas. On paper, the Chinese reform plans appear to be very progressive yet at the same time there are many conflicts of goals inherent in these policy strategies. Finding appropriate preferences for these different conflicts of goals will be difficult.

This introductory description of the paper leads us directly to the need for interdisciplinary research. In this paper an attempt is made to give the most important reform areas a natural interdisciplinary nexus. The objective is to show that China’s economic future cannot be analyzed and predicted without broader analytical tools. It is not mainly an issue of numerical long-term GDP forecasts.

Forecasts about the Chinese economy should focus more on the understanding of the Chinese political, social and the economic system rather than quantitative research. In order to gather some empirical evidence, a survey has been prepared with members of our (LNU’s) China Survey Panel. Hopefully, statistical quality and transparency will be improved during this ongoing reform process in order to stimulate a gradual improvement in the statistical conditions for quantitative analysis.

Some of the main reform challenges are exemplified by the further deregulation of the Chinese financial sector. The academic issue of sequencing seems to be particularly complicated when applied in real life. Can China learn from the Swedish financial deregulation process - and its failures?

There is no doubt that the outcome of the Chinese reform process will also be of great importance for the European (global) corporate sector. There is every reason for Europe, the U.S., and many other countries, organizations, and corporations to optimize their future cooperation with China in line with its necessary and implemented reforms. In other words: Europe (and the U.S.) should be very interested in contributing to a successful Chinese reform process as much as possible and whenever appropriate. Major Chinese reform disappointments would be scary since the European and American economies would not be prepared for such a reversal. This is a mostly forgotten risk.

JEL: F3, G1, N25, O1, O53, P30, Q5   Keywords: China, Asia, Europe, economic reforms, deregulation

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A. Why are major Chinese (economic) reforms urgent?

The famous political leader and strategist Deng Xiaoping proved himself to be the father of China’s enormous economic progress by the implementation of his – then – courageous economic reform and opening-up policy that started in 1978/79. Nothing overwhelmingly exciting could be noted in the 1980s but the 1990s saw a strong push towards a better economic development with a much stronger emphasis on China’s growth model setting exports and investments in the first place, to a great extent driven somewhat later by China’s entry into the World Trade Organization (WTO) in 2001. Furthermore, the move into the WTO happened during a very intensive period of globalization - backed up further by the expansion of IT.

GDP growth achieved on average about 10 ½ percent in the 1990s and the first decade of this new millennium. In recent years, however, China’s economic growth has slowed to about 7 ½-8 percent according to official statistics. This weakening economic expansion can partly be explained by the dampened global demand and by the deterioration of Chinese international competitiveness.

Another explanation may be – with emphasis on “may be” – that China has entered a development or situation which in the literature is known as the “middle-income trap”. Aiyar et al (2013) define the “middle-income trap” as “a phenomenon with hitherto rapidly growing economies stagnating at middle-income levels and failing to graduate into the ranks of high-income countries.” Definitions of what defines middle- and high income countries vary. Both GDP per capita and GNI per capita (GDP per capita plus net income from overseas) are used and can give quite different numbers. The latter, for example, is applied particularly by the World Bank which in its latest GNI per capita classification gave China the status of an upper middle-income country (the range in 2012 starting at USD 4 086 up to USD 12 615 – for China in 2012: USD 5720; but this tells us – by the way - nothing about income distribution). The popular Penn World Tables have different numbers compared to the World Bank.

In a more recent analysis, Eichengreen et al (2013) use critical “modes” for possibly commencing middle-income trap problems at the GDP per capita level of USD 10 000-11 000 and also at the USD 15 000-16 000 range. Thus, Eichengreen et al regard the middle-income trap as a process which can consist of several steps. China could be relatively close to the lower mode when looking at the numbers Eichengreen et al use - but this conclusion is in my view still uncertain. Eichengreen et al also conclude that the verification of a middle-income trap has shown a sustained reduction in the GDP-growth rate/per capita rate for as much as seven years; so far China has – aside from the strong stimulus year of 2010 - noted five out of these seven downsizing years (if we define two years with equal official growth rates as shrinking on trend; the average GDP growth rate declined during 2009-2013 to roughly 9 percent compared to 11 ½ percent during 2004-2008, with statistically no major changes in average credit growth during these two periods – but what do we know about the badly supervised shadow banks?). Furthermore, good education/human capital formation may delay or wipe out the risks of the middle-income trap (Eichengreen et al 2013) – also in China.

But Eichengreen et al have also found some other general characteristics for a middle-income trap – characteristics that so far fit quite well for China and its risk of becoming a country with a potential middle-income trap. They mention in particular high GDP-growth rates before the visible weakening of growth rates, a worsening demographic outlook, very high investment ratios and an undervalued currency. These criteria are very much in line with China’s development in recent years, apart from
the demography problem which is still to come – but these conditions are too short-lived to
determine with any certainty China’s real position with regards to a “middle-income trap”.

Another explanation for China’s recent slowdown is driven by the assumption that manufacturing
exports are usually the easiest and most powerful force to get an emerging economy to take off,
explained by a more limited need for institutional improvements. However, such a growth model can
(almost) never last forever even if an emerging country at a later stage succeeds in moving towards
more innovation and sophisticated manufacturing products for exports.

Sure, a development with a weakening manufacturing export potential may be applicable to the case
of a middle-income trap. However, in the Chinese case, the current slowdown may also be the start of
rebalancing the economy and its growth model towards more private consumption and a
(substantial) increase in the export of services. This would indeed be positive, not negative in a
middle- and long-time perspective. But not managing to “implement” the new growth model could
mean that China de facto could become a victim of the middle-income trap – whatever the definition
of this phenomenon may be.

Thus, the above mentioned necessary evolution to a new Chinese growth model is not always
understood, particularly not in our part of the world. However, the new (planned) Chinese growth
model assumes policy changes that imply much greater institutional/social progress and domestic
confidence – i.e. structural changes – than the old/current model of favoring merchandize exports
and government investments did, or still does. At the same time, it should not be underestimated
that this latter growth model has served China well for quite some time.

Consequently, we do not know for sure the answer to the question whether China is approaching or
about to enter the stage of a “middle-income trap” or not. It would nevertheless be very forward-
looking if China could adapt the reasonable economic strategy plans of the Third Plenum as much as
possible. The degree of urgency may be somewhat uncertain – but not the need for China to move
forward, fundamentally and structurally, by using new strategies and reforms in a number of social,
political and economic areas. One should acknowledge that a lot of strategies that are needed for
avoiding the trap of a middle-income country according to modern literature (Agénor et al 2012,
Fromlet 2006), can be found in the 60 different reform subchapters of the Third Plenum from
November 2013. Agénor and his co-writers add in general terms (2012): “The middle-income trap is
avoidable if governments act early – rather than late, when the benefits of cheap labor and the gains
from imitating foreign technology are all exhausted — and decisively to promote innovation.”

One may call the phenomenon of shrinking Chinese GDP growth rates described above as a middle-
income trap (risk) or as something else: it is always crucial to find the reasons for a (gradually)
flattening GDP curve in an emerging economy, regardless of whether there are cyclical, political,
institutional, social or other reasons for such a development, not to forget demographics! In 2013,
China’s working-age population dropped slightly to 917 million people compared to 920 in 2012.

To sum up:
China faces a non-negligible risk of being caught in a kind of middle-income trap – but it is probably
not there yet. China’s envisaged new growth model and the reforms that are needed to get to this
new approach gradually and successfully should be concretely visible in the not too distant future.
Following Agénor’s general advice, there is no time to lose for China’s political leaders.
B. China’s economic reform plans – and their nexus to research

Academic research on the Chinese economy using established or promising models is – as has already been pointed out – continuously undermined by the well-known qualitative shortcomings in Chinese official statistics (Fromlet 2011, 2013). It is, of course, possible to apply quantitative research methods also today in order to see potential qualitative improvements in the models themselves or statistics over time. The intention in this paper, however, is rather to demonstrate that current general economic theory and research can serve well even now - with interesting applications to the Chinese economy. This includes the recently announced new reform policy.

In this chapter, a somewhat different, qualitative approach is chosen in order to underline the importance of interdisciplinary research. The most important points with impact on the economic future that were given by the Third Plenum are integrated in the table below, with obvious links between non-economic research areas and economics (interdisciplinary research). As may be more generally known these days, the Third Plenum is a powerful political institution of the Communist Party in a country where political decision processes obviously have become more complex and complicated compared to the past (Lampton 2014) – which also complicates research on China.

<table>
<thead>
<tr>
<th>Important plans, priorities and strategies from the Third Plenum</th>
<th>Number in the list*</th>
<th>Research area(s) (I = interdisciplinary)</th>
</tr>
</thead>
<tbody>
<tr>
<td>- development of the socialist market economy</td>
<td>2</td>
<td>I -&gt; politics and economics</td>
</tr>
<tr>
<td>- timing of reforms</td>
<td>4</td>
<td>I -&gt; politics, sociology, psychology and economics</td>
</tr>
<tr>
<td>- property rights</td>
<td>5</td>
<td>I -&gt; politics, institutions and economics</td>
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<tr>
<td>- more room for private capital</td>
<td>6</td>
<td>I -&gt; politics, law, institutions and economics</td>
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<td>- modern system for SOEs</td>
<td>7</td>
<td>I -&gt; politics and economics</td>
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<tr>
<td>- good development of non-public economy</td>
<td>8</td>
<td>I -&gt; politics, institutions and economics</td>
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<tr>
<td>- fair, open and transparent market rules</td>
<td>9</td>
<td>I -&gt; politics, institutions and economics</td>
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<tr>
<td>- pricing mainly by markets</td>
<td>10</td>
<td>I -&gt; politics, institutions and economics</td>
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<tr>
<td>- modernization of financial markets</td>
<td>12</td>
<td>I -&gt; politics, institutions, finance and economics</td>
</tr>
<tr>
<td>- improvements of innovation systems</td>
<td>13</td>
<td>I -&gt; institutions and economics</td>
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<tr>
<td>- less incentives based on growth for officials</td>
<td>14</td>
<td>I -&gt; politics, institutions and economics</td>
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<tr>
<td>- streamlining of government structure</td>
<td>16</td>
<td>I -&gt; politics, institutions and economics</td>
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<tr>
<td>- fiscal reform for local/central governments</td>
<td>17</td>
<td>I -&gt; politics, institutions and economics</td>
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<tr>
<td>- healthy urbanization</td>
<td>23</td>
<td>I -&gt; sociology, institutions and economics</td>
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<tr>
<td>- easier for “hukou” (registration) in cities</td>
<td>23</td>
<td>I -&gt; sociology, institutions and economics</td>
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<tr>
<td>- widening of incoming/outgoing FDI</td>
<td>24</td>
<td>I -&gt; politics, institutions and economics</td>
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<tr>
<td>- creation of more liberalizing free-trade zones</td>
<td>25</td>
<td>I -&gt; politics, institutions and economics</td>
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<tr>
<td>- development of “grassroot democracy”</td>
<td>29</td>
<td>I -&gt; politics, sociology and economics</td>
</tr>
<tr>
<td>- deepening reforms of law enforcement</td>
<td>31</td>
<td>I -&gt; law (institutions) and economics</td>
</tr>
<tr>
<td>- new systems for identifying corruption</td>
<td>36</td>
<td>I -&gt; institutions, psychology and economics</td>
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<tr>
<td>- optimizing the income distribution system</td>
<td>44</td>
<td>I -&gt; sociology, psychology and economics</td>
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<tr>
<td>- deepening the reform of the health sector</td>
<td>46</td>
<td>I -&gt; sociology, psychology and economics</td>
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<tr>
<td>- better environmental protection systems</td>
<td>54</td>
<td>I -&gt; sociology, institutions, psychology and economics</td>
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<tr>
<td>- better promotion system for officials</td>
<td>59</td>
<td>I -&gt; politics, institutions and economics</td>
</tr>
<tr>
<td>- encouraging innovation, etc., at the local and grassroots level</td>
<td>60</td>
<td>I -&gt; politics, sociology and economics</td>
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</table>
The list above should be illuminating enough to show that China’s economy in most medium- and long-term perspectives cannot be analyzed without (multi-)interdisciplinary approaches. For example, the system of a “socialist market” economy – still mentioned by the Third Plenum as the system guideline for the future – will continue to allow for many government decisions and interventions and politically influenced economic analysis – often also related to institutional issues. And it is certainly no exaggeration to predict that social developments will have a major impact on expectations and economic stability, at least in the medium and longer run.

Conclusion - interdisciplinary analysis is useful and inevitable for China analysis!

China cannot be analyzed without in-depth interdisciplinary angles; and it takes quite some time to acquire these necessary analytical skills. Attempts to use regular official statistics as the main input into medium- and long-term forecasts must be described as naïve; limitations may even exist for short-term predictions. Understanding China’s complicated political system is particularly essential.

The need for genuine interdisciplinary research on China’s economy should have become more plausible after having studied the above-mentioned examples from the plans of the Third Plenum. Some other interesting angles from theory and research, however, should be applied as well when looking somewhat deeper into financial marketization and deregulation - a reform area that I focus on especially in this paper.

In principle, desirable financial deregulation and other reform processes tend to have special risks. It is fair to say that a deregulating China will also have to meet a number of uncertain consequences without support or input from theory and research. China really is a special country. Despite certain limitations, a substantial number of important general conclusions can be drawn for current and future deregulating countries, including for example the research areas with application to financial reforms listed below. These general conclusions should be useful for China as well – but also the experience from Sweden.

Economic history

Most financial crises with a domestic origin have common financial roots: (too) loose monetary policy, an irresponsible credit boom and psychological exuberance on the real estate market. Charles Kindleberger published the first edition of his book - always worth reading - “Manias, Panics, and Crashes” as early as about 35 years ago (Kindleberger 1978), just to give one example. Unfortunately, Kindleberger was not (sufficiently) read in Sweden.

Experience from Sweden:

Financial exuberance was not really a hot research topic in Swedish research and market analysis in the 1980s. There was simply no domestic experience of deregulation of financial markets – a shortcoming that made things worse.

China should keep in mind that financial markets nowadays react more rapidly and strongly than in the past. Preconditions for financial deregulation are both easier and more complicated than before: easier because a lot of lessons can be drawn from financial deregulation failures in other countries; more difficult because financial markets are much more globalized these days and, consequently, often react more strongly and quickly to policy failures in particular.
**Economics of sequencing and timing of reforms**

The issue of **sequencing** – i.e. putting different reform steps in the right order - can be decisive for the success of a reform process. Edwards (1989) and Agénor (2004) have done important research in this area. The **timing** of economic policy measures with possible effects on financial markets may be important, too. Sometimes flexibility is needed in this respect as well. Too many major structural changes to financial markets within a short period of time may even have counteracting effects. All in all, the issues of sequencing and timing may be crucial. Furthermore, the temperature of the economy can be decisive for the timing of certain financial deregulations.

**Experience from Sweden:**

*Sweden exhibited major failures when it comes to the sequencing/timing of its economic and financial reforms in the second half in the 1980s which partly triggered the economic depression during the years that followed.*

China should really apply the results of research on sequencing and timing before and after its evaluation year of 2020, particularly what regards the issue of financial deregulation and the (complete) opening-up of the capital-account balance. The success or failure of financial reforms will be of major interest to Europe and the entire global financial market development and economy.

**Financial markets and institutions**

Research has shown for many years that well-functioning (political) institutions are crucial to the economic development of a country, as demonstrated more recently by Acemoglu and Robinson (2012) who for this reason are quite skeptical about sustained high growth rates in China. When it comes to financial crises, institutional shortcomings and/or failures are often explained by insufficient financial supervision and central banks that have failed to meet their financial stability mandates. These risks are particularly obvious during financial deregulation processes when different deregulating and supervisory institutions meet a new, unknown reality, and cooperation in this new institutional financial world is not yet well-established - and may even be non-existent (Fromlet 2012).

**Experience from Sweden:**

*Considerable institutional failures in supervision could be found before, during and after the Swedish financial deregulation process in the second half of the 1980s. Supervisory authorities were in uncharted waters. But this should not be accepted as an excuse. Swedish supervisors should have been more vigilant considering all the new financial conditions that were created at that time.*

Reducing institutional problems more visibly means at the same time decreasing risks for financial imbalances during the deregulation process and - in the longer run - positive sources for economic growth. There is, in other words, an obvious win-win situation involved in fundamental, major institutional progress, in all reform areas.

**Behavioral finance**

During the exciting period of major Swedish financial deregulation in the latter part of the 1980s, behavioral economists or psychologists such as Kahneman, Tversky, Thaler and Shiller were about to publish important papers on psychological behavior which also included or encouraged research on reactions in financial markets; but there was – as already mentioned – no broad scientific
recognition of behavioral finance at that time. Their research was contrarian stuff, as was Kindleberger’s. Hopefully, the awarding of the Nobel Prize in Economics in 2013 to Robert Shiller will encourage further cohorts and potential supporters of behavioral finance.

In an earlier article, I made some recommendations regarding the contribution of behavioral finance towards improving the predictability of financial crises (Fromlet 2001). In order to find specific behavior that may have a visible impact on financial markets, one should in particular look at the potential existence of the following phenomena:

preferences for certain news, the psychology of sending messages, anchoring, representativeness by paying more attention to certain circumstances than they initially deserve, overconfidence and control illusion, and, of course, the degree of herd mentality.

It should not be impossible to develop models that give information on strengthening negative trends in these psychological respects which at least in the medium term could be used for financial deregulation or market analysis.

Experience from Sweden:

In Sweden during the 1980s, economists and policy advisors stuck almost entirely to the neoclassical messages of the homo oeconomicus, the agent in the economy who always makes the right decisions based on perfect insight and access to information. However, by applying psychological reflections and conclusions, one could have paid the necessary attention to the overshooting on Swedish credit markets in the late 1980s - and a lot of pain for the Swedish people could have been avoided.

Thus, it is very important for Chinese authorities and research to place considerable emphasis on the psychology of markets during the various difficult stages of financial deregulation. Overreactions on, for instance, the stock markets may easily happen in the case of exaggerated economic growth expectations (herd mentality, overconfidence, control illusion) – or in the housing or commercial real estate sector because of exaggerated price increase expectations. Any trend in such a booming direction – but also the opposite case with gradual price movements downwards from a less booming starting point - could trigger nervous reactions inside and outside China, including Europe.

Finance, financial markets and economic growth

There is as yet little fundamental research available on the connection between distorted or damaged financial markets and the economy as a whole, compared to the opposite approach, i.e. what well-functioning financial markets or structural improvements of financial markets mean to positive economic growth and other macroeconomic components. Schumpeter dealt with the latter issue as early as 100 years ago, by linking the financing of innovation to increased productivity and thus to economic growth. King and Levine took major steps to revive this approach in the 1980s.

Altogether, a positive correlation between financial and economic development is nowadays widely accepted, but does not necessarily include the causation. In my opinion, skeptics could also derive intellectual support from Hyman Minsky. Minsky emphasized - especially in the 1970s - the macroeconomic risks that come from asset price bubbles and other financial overshooting (1972). Having at first been an outsider, Minsky’s views were reconsidered during the American subprime crisis of 2007-2008 and the contagion on the real global economy that followed - with recessions in many developed countries and lower GDP growth in emerging economies.
Experience from Sweden:

Certain academics may have their doubts about the correlation between financial markets and economic growth - or rather about the causality. Reality, however, allows for clarifying conclusions. Sweden had indeed a very disastrous credit and debt accumulation in the latter part of the 1980s with very damaging macroeconomic consequences.

One can conclude that the “Minsky moment” could be observed in the Swedish economy about 25 years ago. Financial and policy mismanagement caused this big crisis. There is enough evidence from Sweden that China - and other countries in the process of deregulating - should not neglect Minsky’s research.

Human capital, education on a managerial level and economic growth

There is a lot of research available on the positive impact of human capital/education on economic growth (Becker, Lucas, Barro, Murphy K., Romer P., etc.), both from macroeconomic and microeconomic angles. However, little research can be found on the reverse perspective, i.e. the macroeconomic risks or distortion that can emerge from insufficient skills or updating on a managerial level regarding economics and linked sciences like politics and sociology. Shortcomings of this kind may finally lead to wrong managerial decisions with serious macroeconomic consequences.

Experience from Sweden:

The Swedish financial crisis in the first half of the 1990s was largely caused by new conditions on financial markets and, thus, could not very easily be recognized in time by financial managers - though it should not have been impossible for psychologically and historically interested or skilled financial leaders. The bursting IT bubble in the year 2000 had managerial shortcomings, too, since very high price/earning ratios were not alarming enough to wake up the Swedish financial leaders with their relatively fresh crisis memories from the early 1990s. Another financial crisis with Swedish involvement - the so-called Baltic-country crisis which started in 2008 - demonstrated quite convincingly how shortcomings in fundamental macroeconomic skills on executive bank levels finally led to tragic economic developments in the Baltic countries, particularly in Latvia. There were obviously no skills or ambitions to regard the Baltic countries’ enormous deficits in the current account as a problem before the eruption of the crises in Latvia, Lithuania and Estonia.

The Swedish experience emphasizes that decision-makers in the banks and other financial institutions continuously have to improve their macroeconomic and macrofinancial skills in line with new (global) developments and new important results from research. Other European countries, such as Finland, Ireland, Spain, etc., have much to relate about their experiences as well. This should be kept in mind in China.

C. Conflicts of policy goals

When looking more deeply into the 16 broader reform areas with its 60 more detailed subchapters from the Third Plenum’s strategy paper, one can quite easily find a substantial number of conflicts of policy goals during the coming, intensified reform process. Conflict of goals mean that certain
envisaged policy steps cannot be optimized because managing the first, positive goal is counteracted by not meeting another one - or that the second objective involves too much risk-taking (Fromlet 2011).

The consequence of such a complicated constellation of (strategic) objectives can only lead to two alternatives: either the cancelation/neglect of one objective or a kind of compromise between the two objectives. In the summary below, the number of practical or theoretical goal conflicts is limited to 20 – but the list could be made considerably longer.

20 Conflicts of policy goals - referring to the political leaders’ Third Plenum *
(no ranking, underlined goals specifically mentioned by the Third Plenum in November 2013)

- “Decisive role of the market vs “socialism with Chinese characteristics”.
- “Private ownership and market economy” vs public ownership (still called the “main body”).
- “Healthy development of the non-public economy” vs interests of the SOEs.
- Market economy (“promoting the survival of the fittest”) vs “socialist democracy”.
- “Well-working property rights” vs political and institutional traditions.
- “Fair, open and transparent market rules” vs traditional institutional impediments.
- “Price determination by (predominantly, own comment) markets” vs different social and political interests.
- “Further improvement and opening up of the financial industry” vs the interests of the SOEs and politicians.
- “Opening up the financial industry” vs hitherto major shortcomings in transparency and political interests.
- “The complete (premature) opening-up of the capital balance” vs the risks of speculation against the RMB.
- Creation of “service-type government by basing its functions on the law” vs the traditional political style.
- Providing more possibilities for local taxation vs certain interests of the central government.
- “Healthy urbanization”, “reform of the hukou system” (for urban household registration) vs traditionalists.
- Further opening-up for FDI to and from China vs less opening-up minded people in the CPC’s leadership.
- “Boosting the judicial system of human rights” vs specific traditional interests.
- “Establishment of a fairer and more sustainable social welfare system” vs fiscal (budgetary) restrictions.
- “Deepening of the medical and health care sectors” vs fiscal (budgetary) restrictions.
- “Optimization of governance and service platforms at the grassroots levels” vs central influence.
- “Reforms of environmental protection” vs promoters of industrial growth and/or short-term perspectives.
- “Improvement of a system in which officials can be demoted or fired for poor performance” vs many benefitees from the old or current system.

* These conflicts of goals are at least theoretically or partly possible; the order of the goal conflicts follows the official order of the subchapters set up by the Third Plenum’s summarizing document.

Obviously, a large part of the reform package that was launched by the leadership of the Communist Party of China (CPC) deals with the improvement of the market economy which previously was given a “basic” role in the Chinese economy – and from now on a “decisive role”. These plans are, of course, positive but the open question remains to what extent such a forward-looking development can be verified in the coming six years. One may say that a number of previously sensitive issues have been brought up in this official Plenum document – issues that are not only beneficial strategies for the economic future of China but also for a number of important social and organizational political changes.
It should also be noted that the Third Plenum claims that “political reform should evolve around the Communist Party of China” which “must strengthen and improve its leadership in such a way to become a Party that learns, innovates and serves the people”. A high degree of historically-based political influence apparently remains in place. What the document is looking for can rather be described as a kind of organizational modernization or renewal of the CPC.

**Conclusion** - goal conflicts mean uncertainty about the outcome of the Third Plenum’s visions.

The above-mentioned goal conflicts indicate that it won’t be easy to bring China onto a solid path towards long-term growth and social harmony, including a considerably better environment. Europe’s future economic development will be increasingly linked to the economic, institutional, political, social and environmental trends in China.

In other words: China should find the appropriate priorities and/or compromises to move itself forward – but also for the sake of the global community. Whatever choice will be made in Beijing and on local levels, the environment (anti-pollution policy and clean water) must be given extremely high priority during the coming six years until the evaluation day of the Third Plenum’s objectives. Placing strong priority on the environment is also necessary in order to achieve a better social balance and, thus, achieve a more promising outlook for the new growth model towards a higher share of private consumption related to GDP. Such a new trend assumes a declining savings ratio of private households (not considering unrealistic wage hikes). But this can only be achieved by improving social standards, including the environment, certain kinds of social benefits and new insurance solutions.

**D. LNU’s “China Panel Survey” on the planned economic reforms**

As already mentioned, there are real difficulties when it comes to conducting quantitative research on the chosen topic – not only because of shortcomings in many statistical series but also because of the marked lack of transparency. However, considerable theoretical and general research can be applied to future Chinese reform policy. On the other hand, it may sometimes make sense to come to a kind of numerical compromise by trying to gather data from surveys with direct links to the topic of the paper. In March 2014, we therefore asked experts from the U.S., Europe and Asia to give their views on China’s economy policy strategies that were decided during the Third Plenum, looking forward as much as six years. We received close to 20 answers – not really bad! - but would have appreciated some more on this difficult topic. A summary of LNU’s recent survey looks as follows:

**Survey with LNU’s China Panel on Chinese Reform Policy after the Third Plenum - Linnaeus University, Kalmar / Sweden, March 2014**

I. Do you think that the main economic and social reforms that were set up by Chinese leaders at the Third Plenum in November 2013 can be implemented roughly successfully by 2020 – the year of the planned evaluation by Chinese leaders?

- yes: 59 %
- no: 41 %
Almost 60 percent of our China experts believe that China’s reform plans and decisions can be implemented roughly successfully by 2020. This is, of course, quite a vague answer - both with regards to the single reform steps and the time frame. Without a doubt, it would be much better for China to finalize a certain reform, for example, by 2022 or 2023 in a proper and stable way rather than accelerating by taking unnecessary risks in order to push through the same reform ambitiously in time by 2020. A reasonable guess, however, is that during the whole reform process the Chinese political leadership will work for stability in all areas as much as possible – no matter what the reform aims at.

II. Which three envisaged reform areas will be the most difficult ones to implement successfully? (Ranked)

1. Financial reforms (deregulation of the capital account included)
2. Fiscal reforms
3. Transition to consumption-driven economy, balance between cities and rural areas, environment

Comment:
The ranking above is not surprising, apart from possibly the strong doubts about future fiscal reforms. Other difficult reform areas that are mentioned by the panel include corruption, income distribution, social reforms (the hukou system included) and reforms of the SOEs. All in all, the reform process set by the Third Plenum will not be easy to manage, according to our panel.

III. Which are the five most important reform areas for a future stable economic development in China - with decent and appropriate economic growth in the longer run? (Ranked)

1. Financial system
2. Environment
3. Fiscal system
4. Balance between rural and urban population
5. Public governance and other institutional areas (corruption, transparency, law, hukou)

Comment:
Looking at the reform areas that are judged as the most important ones by LNU’s China Survey Panel, one may note immediately that these reform areas for sustained and reasonable GDP share are not easy to change or improve. By adding some other frequently mentioned reform areas like marketization as such, SOEs and income distribution, the reality of the forthcoming reform process may appear even harsher. One can also recognize various conflicts of goals (see more in chapter C). In this context, indebtedness and a number of major imbalances on credit markets may be clearly underrated problems. The problems of Chinese shadow banking cannot even be roughly estimated.
All in all, China must work hard to avoid the so-called middle income trap and/or worrisome GDP-growth problems five to ten years from now.

IV. Where do you see the three major challenges to the reform process to come from? (Ranked)

1. Political resistance from certain groups to a number of far-reaching reforms
2. Environment vs economic growth
3. Financial sector (risk for bursting asset price bubbles included and speculation against the RMB).

Comment:
Despite the substantial topics of reforms that were selected for improvement in the Third Plenum, our China experts still feel uncertain about the stability of the new reform course. The goal conflict between economic growth and the environment is ranked highly by the panel as well. And that reforms and improvements of the financial sector will not be easy to handle, will be explained in the next chapter.

V. Considering your answers, where could Chinese potential GDP growth roughly be in the year 2020 (in %)?

5 ½ - 5 ¾ %

Comment:
Most answers on potential growth six years from now – i.e. when the reform program from the Third Plenum will be evaluated – showed between five and six per cent. Such a result would be relatively satisfactory – but below the potential that seems to be achievable when looking at the opportunities of the entire reform package of the Third Plenum. Furthermore, one should later also consider the quality of future GDP growth, i.e. the development of private consumption, the environment, social conditions, etc. – and not only pure (and uncertain) GDP numbers.

VI. As how important would you grade the success of China’s new reform policy until 2020 (scale 1-5, 5=very important)?

1. for Europe: 3.6
2. for the U.S.: 3.4
3. for the global economy: 3.6

Comment:
Our China Survey Panel considers a successful outcome of China’s new reform package as quite important – but still not as very important. In my own view, this result underestimates (somewhat) China’s future role in the world economy. The focus appears to be on China’s current global status. It is logical that China currently means more to emerging countries as a group than to the advanced
countries (which is not analyzed separately in this survey). One should also consider the fact that all
the Chinese reform plans are still not transparent enough, and that many details have yet to become
more concrete. My own guess is that the three numbers given above about China’s geographical
impact will be higher one year from now and more obvious in the longer run – especially in the case
of serious accidents and failures. Anyway, it will be hard to maintain current potential GDP-growth
rates of approximately 7 ¼ -7 ¾ percent at the end of this decade. The main risks should be on the
downward side when regarding the complexity of the whole reform process – possibly also
compared to our China Survey Panel’s estimate of potential GDP growth. But – once more – the
quality of future Chinese GDP growth has to be considered as well.

Summary:
The experts in LNU’s China Panel are not pessimistic about the verification of the comprehensive
reform plans that were set up by the Third Plenum in 2013. But they still have their doubts about the
der degree and quantity of concretization of the 60 reform points – which is understandable at this stage
of the intended reform policy. The estimated potential GDP-growth rate at about 5 ½ - 5 ¾ percent in
2020 seems to be in the lower or medium range of what may be regarded as acceptable six years
from now – but is in line with the answers to the other questions and the foreseeable gradual
slowdown of productivity growth. 6-6 ½ percent would be better, of course, if China at the same time
could be able to protect the environment much more efficiently.

E. Case study: Chinese financial deregulation
– and some lessons from the Swedish example

One of the most important policy objectives for the (relatively) new Chinese leaders is the
deregulation and marketization of financial markets. Chinese financial markets are lagging behind in
almost all respects compared to Western standards. This is true of public policy and financial
supervisory institutions and their transparency, the bank themselves, insurance companies, credit
and capital markets, financial products (particularly for retail customers), etc. There are still too many
old-fashioned regulations affecting Chinese financial markets, for example when it comes to deposit
rates and cross-border financial movements. And there is an urgent need to reduce or abolish the
priority that is still clearly given to state-owned enterprises (SOEs) on both credit and capital markets – a phenomenon that can even be found on the Shanghai and Shenzen Stock Exchanges.

According to the Third Plenum (Resolution from November 2013, subchapter 12), the following
abridged strategic plans for financial markets are mentioned: “Improve financial markets. Further
open up the financial industry. Allow private capital to set up financial institutions. Promote reform
toward a registration-based stock-issuing system and increase the proportion of direct financing.
Improve market-based exchange rate formation mechanisms for the renminbi. Accelerate interest
rate liberalization and capital-account convertibility. Build a deposit insurance system and complete
the market-based exit system for financial institutions.”

Subchapter 12 from the Third Plenum obviously points out quite a number of expected changes in
the Chinese financial system, such as the new establishment of private banks, reduced influence of
SOEs on financial markets, more volatility for the currency, the renminbi (RMB), an accelerated way
to increased or even full capital-account convertibility, and – surprisingly – the “market-based exit system for financial institutions”. In particular the plan concerning the capital account may be very risky and assumes a very stable economy both before, during and even a long time after the complete deregulation of the capital account. In this specific context, some valuable lessons can be learned from the Swedish example in the second half of the 1980s.

In my opinion, China may run the risk of pushing through certain financial reforms too rapidly. One historical experience seems to be certain, i.e. that marketization and institutional improvements have to be in place before China opens its capital balance completely, particularly for the short-term capital movements. Here we return to the important issue of sequencing, of making the deregulation steps as predictable as possible – and putting them in the right order! Domestic efforts and improvements of financial markets are initially most urgent – improvements that also can be linked to the development of science and technology systems and the legal and financial support of innovators. This is all about the supply side and medium-/long-term growth - summarized in subchapter 13 of the official resolution: “Deepen science and technology system reform...Perfect a market-based system that encourages technological innovation. Strengthen intellectual property application and protection...Improve the venture capital system”.

These points of reform are, of course, also important from a European perspective since they reflect some of the main preconditions for sustained, reasonable economic growth in China without major distortions.

*One could add once more: all the reforms that are necessary to keep China’s economic growth on track also contribute to more stable European growth conditions. But – again – this should happen without reducing the environmental improvement needs in the Middle Kingdom. Europe would, of course, benefit from a better environment in China, too. This is another obvious “win-win” situation.*

Some possible reactions on global financial markets that originated from uncertainty in China may already have been seen recently. Certain signals about (possible) GDP weakness in China were not very well received on global financial markets, for example the weakening of the monthly Purchasing Managers Indices (PMI), worries about exports and the stability of the banking system - and the role of the Chinese shadow banks. Already today the global financial markets – though the Chinese economy is still considered to be reasonably in place – look very carefully at economic statistics and special news from China. Taking into account at the same time the growing importance of China for the world economy, it does not seem complicated to figure out what a significant derailing of the Chinese (economic) system at some point in the future would mean to Europe and the entire global economy. The rest of the world would most probably not be prepared for major economic disappointments from China. This insight is frequently neglected.

We know very well from history that financial deregulations – as now envisaged by China – may trigger financial crises when these reform steps are not taken in an appropriate manner. The Swedish case is very telling. Consequently, China should be careful and avoid unnecessary risk-taking. In general terms, one may stress particularly that the complete opening-up of the capital balance should always happen from a position of good fundamental health in the economy. This was not always the case in Sweden about thirty years ago, as has been described earlier in this paper. Serious mistakes were made during Sweden’s financial deregulation – mistakes that China, with better
knowledge from research, could avoid. But today and tomorrow, of course, new traps and pitfalls have to be found in time and tackled.

**Conclusion – the Swedish financial deregulation provides some lessons for China.**
The deregulation and marketization of Chinese financial markets contains a lot of pitfalls. Quite a number of them can be taken from economic history, to a great extent from the negative Swedish financial deregulation examples in the second half of the 1980s. Among them we find the neglect of the “sequencing” of the reforms and of behavioral finance. There is no need for China to open its capital account too rapidly since cross-border speculation might increase financial risks very dramatically in times of major financial turmoil at home for whatever reason or because of global distortion with possible contagion in China; and certainly not before the necessary structural improvements have been made in China’s domestic financial markets and in other policy areas that may be important to the success of financial deregulation in China.

**F. What Europe could do – and what it should do!**

There is no doubt that China’s economic influence on the global economy has increased dramatically during the past two decades or so. More recently, China’s influence on global politics has been growing, too. China’s position as a global superpower will be strengthened further in the future. This is a very predictable development, also with regards to China’s further strengthening economic influence – for better or for worse.

Good economic times in China have already proved positive for Europe and the rest of the world. In recent years, China has contributed around one third to global GDP growth. One can imagine that the opposite development in China with major economic distortions could do a lot of harm to the global economy - Europe included – not least because of what are probably increasing negative multiplier effects compared to today and yesterday. It is worth mentioning that such a – at least imaginable – development might be worsened by psychological overreactions.

Consequently, China is placed in the same boat as Europe, the U.S., Japan and the rest of the interlinked (emerging) world - or in the longer run – rather vice versa, with China at the steering-wheel more frequently. China will also catch up visibly as a new innovation powerhouse, even if the speed and the strength of this process remain uncertain – but it will most probably happen (Chaminade et al 2014). The same can be said about China’s still lagging cross-border trade of services, in 2013 adding up to around USD 540 billion, amounting to about 5 percent of the total global volume – or only half of the Chinese share of global merchandize trade. A “decisive” role for the market economy in future China should also mean much more room for mutual exports and imports of services between China and the EU (and the rest of the world).

*A positive future reform policy and medium-/long-term trend of the Chinese economy would be beneficial for Europe and all the other continents in the global economy. Economic distortions in the Middle Kingdom would cause real problems also in a global context. For this reason, there is no other economic way forward for Europe or the EU than to optimize Sino-European relations wherever it seems realistic and appropriate - and to learn as much as possible about China. It is important to*
clarify that “optimizing” does not equal “maximizing”. Anyway, too many European decision-makers and students still know by far too little about China. This should be changed.

After the Third Plenum, important areas for concrete (better) cooperation between the EU and China/China and the EU could be ...

- … holding more frequent EU-China summits, biannually (16 as so far) – instead of annually as so far
- … areas that improve the environment, including systems solutions and urbanization in China
- … more joint technological development on both macro and micro (corporate) levels,
- … further institutional progress in China with regards to cross-border merchandize trading,
- … further progress in the cross-border trade of services and in the deregulation of services per se,
- … China’s increasingly influential representatives/delegations in international organizations,
- … sharing experience from European financial crises and European shortcomings in supervision,
- … increasing co-operation between the People’s Bank of China and the ECB
- … even more open doors for joint research in many areas,
- … the promotion of mutual tourism and exchange of students, including language students,
- … improved institutional FDI conditions in China, better cooperation with China’s investors in the EU,
- … technical improvements in Chinese statistics.

Conclusion – China’s increasing role as an economic superpower should be accepted!

Europe and the EU should accept China’s rapidly increasing role as an economic superpower. There is no alternative to this view. This outlook urges European cooperation with China wherever possible and appropriate. The EU has no choice but to accept China as an economic superpower – and its steadily increasing global economic and political influence.

G. Final conclusions – for China and the EU

- New or modified reform strategies from the Third Plenum touch upon a large number of areas that are crucial to China’s political, social and economic future development, both in the medium and the longer run. Many areas are nowadays brought up and discussed openly in mainland China – areas which Chinese leaders did not even talk about a decade ago.

- However, we still have to see to what extent president Xi Jinping and prime minister Li Keqiang can create strong power positions in the Standing Committee of the Politburo, which is the real political core powerhouse of China, and within the CPC. It is not until 2017 - at the 19th Party Congress – that political power reality will become sufficiently transparent. Currently the Standing Committee is still mainly supported by leaders who represent the faction of former president Jiang Zemin. When considering current retirement traditions, only Xi and Li will be full-term members of the next Standing Committee. The other five members will most probably have been replaced due to reached retirement age in 2017. Then we will know much more definitely how the political power of the fifth generation of political leaders will be distributed and what it will look like.

- Considering the importance of politics for the Chinese economic development, the obvious need for interdisciplinary economic analysis and research should be singled out once more. Chinese
politics are much more complicated than many Westerners believe. Also within the EU, its commissions, members of the European Parliament, etc., the opportunity should be taken to continuously learn more about the ever-changing country of China – not just in order to try to find the right answers to future challenges from China but also to explore new promising cooperation with what will be – sooner or later – the largest economy in the world.

There already exists a forum called the “EU-China Dialogue” with an annual top summit. The EU could try to give the large number of topics that tend to be discussed during this summit a concrete connection to the subchapters of the Chinese Third Plenum – subchapters that seem to be relevant in a European perspective. In the future, the EU-China summit should be organized twice a year.

The only answer to China’s very complicated future path to economic health and stability must be the acceptance by the U.S., Japan and the EU that China inevitably will increase its political and economic importance – and that the rest of the world is better off when dealing with a prosperous rather than a troubled China. Future financial and economic risks in China should definitely not be underestimated. They really exist and may even show up unexpectedly.

All in all: the EU should help China in its efforts to establish a well-functioning economic and social system whenever and wherever possible. China should be treated as a strong commercial partner - even when views on specific questions might vary quite a bit. The EU is currently China’s biggest trading partner - and China the EU’s largest source of imports. This should be a good base for even closer trade relations.

The commercial ties between China and Europe mentioned above mean, however, specific conclusions not only for China – but also for Europe itself, including from the risk perspective. Europe has to increase its potential GDP growth again despite future negative demographic trends - also when considering future European resilience if GDP developments in China should become critical in the next five to ten years or even later.

It seems to be a realistic assumption that it would be good for China/EU-relations if both China and the E(M)U countries became even more active in stabilizing or improving their financial structures. China has to reform its financial markets considerably – but everything possible should also be done in our part of the world to improve the medium- and long-term conditions of the euro, in particular when it comes to fiscal policy in certain countries. Both China and the E(M)U area would benefit from a fundamentally strong euro.

All the conclusions and possible scenarios above also mean that there is an increasing need for foreign/European companies to improve their skills and understanding of China. Successful business people from abroad should develop a well-based feeling for what’s going on in China. Otherwise future commercial opportunities and risks will be missed or not observed. There is no room anymore for what Nobel Prize winner Shiller calls “overconfidence ”, i.e. that people think that they know more than they really do (about China, my own additional remark).

There is no doubt that China must act more harshly against corruption and the violation of property rights – intentions which also are integrated in the subchapters of the Third Plenum’s strategy document. Here we can see an urgent precondition for steadily progressing FDI in China which also is regarded as an important reform area by the current Chinese leaders. Major progress in this highly
institutional FDI respect would help China a lot - and also create new opportunities in China for European companies and companies from the rest of the world.

A good, more general comment on the opportunities of the future was made some time ago by the OECD (Gurria 2012). This organization of international cooperation – China will hopefully join in the not too distant future – wrote in the winter of 2012/2013:

“The information revolution has changed the way our economies function and laid the foundations of a knowledge-based world... In today's knowledge-based economy, wealth comes more and more from ideas and innovations embedded in products and services. ... which depends on cooperation.”

This should be taken seriously in both China and the EU.

China was at the frontline of the first global information revolution by inventing the printing machine around 1000 years ago according to their own historical understanding (which might be questioned by many Germans and Indians). What kind of informational or technical breakthrough with strong global impact will come from China at some point in the future?

All in all, future Chinese-European economic cooperation should increasingly be influenced by the perspective of innovation. European corporations must see the structural changes and modernization in future Chinese demand, the need for new products and for production itself – if not, the consequences for the lagging European companies with an interest in China and/or competition with Chinese companies could be disastrous later on (Langhammer 2014). And China needs improved innovation systems adapted to its own preconditions.

The opposite – lagging – development in China and/or Europe would be sad – but still cannot be ruled out. Strategic and practical efforts have to increase further in both China and Europe. Not only China but also Europe/the EU countries need to strengthen their domestic economic structures in order to improve mutual trade and GDP-growth contributions.

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