



China's Fifth Generation Leadership: Growth Policy and Implications

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China's fifth-generation leadership, installed at the National People's Congress (NPC) in March 2012, faces one of the most daunting challenges since the nation's reform and opening began in 1978: restructuring the economy while sustaining solid growth. Some expect the Chinese economy will surpass the US economy around 2030. Others predict it will suffer a crisis and spiral downward, sooner rather than later. In either case, the eventual outcome will likely be set in motion by the new administration's economic policy.

BACKGROUND

Imbalanced Growth from the Third-Generation Leadership

When China's third-generation leaders (1998-2002) assumed power, they confronted a mass of insolvent state enterprises. Nonperforming loans at state owned companies accounted for 60 percent of the country's gross domestic product (GDP), or \$600 billion. Then-premier Zhu Rongji believed that the only way to rescue financial institutions and the real economy was to heighten the profitability of state enterprises. He launched bold reforms aimed at creating economies of scale in China's massive domestic market to help increase price competitiveness for Chinese products and ramp up exports.

In the restructuring that ensued, large state enterprises were merged while small ones were sold to the private sector. Almost all areas were affected, including oil, petrochemicals, automobiles, telecommunications, electricity, metals

and finance. Massive layoffs ensued; with 50 million out of 120 million jobs at state enterprises eliminated. At the same time, the financial sector underwent restructuring. Non-bank financial institutions, including investment trusts, were merged or disbanded and bad banks were created to take over the debt load of mega banks. Mega banks improved their capital structure through injections of government funds or by going public abroad. The large national corporations that emerged from the restructuring expanded their investments, increasing their price competitiveness and exports. This improved their balance sheet, while easing the threat of insolvencies at the same time. The Chinese economy thus became dependent on capital investments and exports.

Although trade and investment-led growth has led to fast-paced expansion, unlike Korea and Japan, China's growth may be unsustainable and result in retrenchment. Side effects have included excessive investments leading to overcapacity; distorted allocation of resources due to government control of the financial industry; limited growth of private firms; and sluggish consumption, and higher precautionary savings due to limited government welfare services. The overarching risk is that an imbalanced economic structure could spark a crisis.

Mixed Results during China's Fourth-Generation of Leadership

The fourth-generation of leadership (2002-2013) under Premier Wen Jiabao retained its predecessors' emphasis on exports and investments, causing imbalanced growth to deepen. At the

same time, conditions at home and abroad delayed reforms needed to resolve the distortions. The domestic economy still needed investments, while robust consumption fueled by housing bubbles in the US and Europe sustained Chinese exports. In addition, the home privatization policy implemented by the third generation leadership took effect during the fourth-generation leadership period, boosting the property market as a major industry and spurring growth.

The 2008 global financial crisis further aggravated the imbalance. A 4 trillion yuan fiscal stimulus program to ride out the ensuing global slump enabled national banks to sharply increase their lending to state enterprises, leading to more capital investments. Consequently, distortion of resource allocation by the government deepened while the portion of investments rose in the economy. Some even believe that the market economy contracted, as state enterprises expanded and private businesses regressed.

At the end of his tenure in 2012, Premier Wen called attention to the economic imbalance and the need for economic and political reforms, but some felt that this was empty rhetoric, as he had little time left for concrete action. Nevertheless, the fourth generation leadership should be

recognized for setting the course for reforms. This shift includes consumption-led growth and attendant urbanization; a more sophisticated industrial structure and development of the nation's interior. The latter is the most significant, and would encompass manufacturing-led growth in China's west, shifting the focus of development from large cities and coastal regions.

ECONOMIC CHALLENGES OF THE FIFTH-GENERATION OF CHINA'S LEADERSHIP

Resolving Imbalance while Maintaining Growth

The overarching economic goal of China's fifth-generation leaders is to double its 2010 GDP and per capita income levels by 2020. Their biggest economic challenge is removing imbalances without sacrificing the overarching goals. As they proceed, they must take into account the heightened political awareness of the general population and the fragile economic conditions that persist abroad. Nevertheless, the burden is unavoidable—and necessary.

Socio-economic inequality is becoming more and more evident. The social contract of the

Table 1 Reform Tasks for China's Fifth Generation Leadership

Tasks	Measures
Reduce investments and expand consumption	Raise the portion of private consumption in GDP
Resolve the gap between rich and poor	Raise salaries and expand welfare spending
Conduct financial market reforms	Liberalize interest rates and allocate resources efficiently
Narrow regional disparities	Continue development of inland and western regions
Increase private businesses	Nurture private companies that create jobs
Promote urbanization	Spur consumption through urbanization
Reinforce social safety nets	Expand welfare services, including medical support and education
Reform the household registration system	Transform the rural population into urban dwellers
Reform the rural land use system	Clarify land ownership

Chinese Communist Party is that it will deliver a better livelihood to everyone in return for continued acceptance of one-party rule and civil obedience. To fulfill its part, the leadership must deliver 7 percent annual growth for the rest of this decade. If that is achieved, China's GDP will reach \$12 trillion in 2020 from \$5.9 trillion in 2010, as per capita income rises to \$8,800 from \$4,400, furthering the shift to a consumption-led economy.

The interconnection of the reform moves will magnify their impact. For example, interest rate liberalization and other financial market reforms will transfer capital that has been disproportionately allocated to state enterprises to the private sector while spurring growth of private companies. Reinforcement of social safety nets and improvement of the household registration system will accelerate urbanization and reduce precautionary savings, thereby bolstering consumption. All these reforms will ultimately ex-

pedite private consumption as the primary economic engine.

The fifth-generation leadership will also take largely the same economic course taken by the fourth-generation leadership and complement some policies that existed in name only. The inherited policies¹ include urbanization, reinforcement of social safety nets and nurturing of the service industries, all of which are aimed at promoting domestic demand led growth. Fostering new growth engines, including IT and new and renewable energy, and restructuring overbuilt industries like steel, petrochemicals and automobiles are remaining initiatives.

However, China's fifth-generation leaders have two new economic policies of their own. The first, announced by Premier Li Keqiang in March 2013, is to invest 40 trillion yuan (\$6.4 trillion at current exchange rates) for urbanization over 10 years up to 2020. This investment,

Table 2 Mergers in Nine Key Sectors

Sectors	Goals by 2015
Automobiles	- Increase the top 10 carmakers' industrial concentration to 90 percent - Nurture 3-5 car makers with core competitiveness
Steel	- Increase the top 10 steel companies' industrial concentration to 60 percent - Nurture 3-5 large companies with external influence
Cement	- Increase the top 10 cement companies' industrial concentration to 35 percent
Shipbuilding	- Help the 10 largest shipbuilders produce more than 70 percent of all ships domestically - Nurture 5 shipbuilders which rank within the top 10 globally
Electrolytic zinc	- Help the top 10 producers account for 90 percent of all electrolytic zinc - Nurture 3-5 large companies with global competitiveness
Rare earth	- Integrate large companies' resources through M&A and restructuring
Electronics & information	- Nurture 5-8 leading large companies with more than 100 billion yuan - Nurture 3 large companies with more than 500 billion yuan
Pharmaceutical	- Help the 10 largest pharmaceutical companies take up more than half the market - Help the 20 largest basic drug makers to account for 80 percent of the market
Agricultural	- Nurture large companies through M&As and restructuring

¹ In 2011, per capita consumption was \$2,425 in cities, 1.75 times that of provinces. As such, deepened urbanization would likely increase private consumption. Expanded social welfare services lower precautionary savings, spurring consumption. Expansion of the labor-intensive services industry would lead to more private disposable income and spending.

The hope is that urbanization will propel private consumption until value-added industries can take the lead. If the strategy succeeds, China will be able to avoid the middle-income trap and enjoy sustained growth.

equivalent to 80 percent of China's 2012 GDP, is for building infrastructure and urban homes, and includes social welfare services for 250 million migrant workers who live in cities, but who are excluded from services due to China's "hukou" system². The second, released in January 2013, is to promote mergers in nine key sectors by 2015. The goal is to nurture high-tech industries and expand economies of scale in traditional industries, thereby increasing industrial concentration.

IMPLICATIONS

The long-term goal of China's fifth-generation leadership is development of value-added industries, which will require considerable time to bear fruit. This is why government investments will target urban infrastructure and development in the mid-term. The hope is that urbanization will propel private consumption until value-added industries can take the lead. If the strategy succeeds, China will be able to avoid the middle-income trap and enjoy sustained growth.

Sustaining Growth of 7 Percent or More through Urbanization

China should be able to keep growing through government-led infrastructure and urban development because the nation's per capita capital stock remains low, leaving ample room for further growth. China's per capita capital stock³ is only 13 percent of that of the US, 4.7 percent of that of Japan and 23 percent of that of Korea. Urbanization is expected to raise the country's annual average growth by 4 percentage points if the government spends 4 trillion yuan annually

² China's "hukou" or family register system, makes it difficult for migrating workers and their families to receive educational and social benefits outside their region of origin.

³ Based on the US dollar in 2005.

Table 3 Capital Stock per 1 Million People

(Unit: \$1 billion, based on 2005 price levels and the US dollar)

	Korea	US	China	Japan
2011	27.7	47.4	6.4	135.3


Source: Oxford Economics.

for 10 years (as Premier Li plans), with the balanced budget multiplier estimated at 1.0. Moreover, the Chinese government's investment in infrastructure will increase the utility of land, pull up property prices and stimulate materials industries like steel and cement. The country's real estate industry is already in overdrive with revenue surging 26 percent on average since 2000. Revenue grew from 451.6 billion yuan in 2001 to 4.4 trillion yuan in 2011.

Government-led investment, including infrastructure development and urbanization in Western and inland regions and relocation of manufacturing businesses into those regions probably will sustain economic growth.

Companies in finance, telecommunications, steel, cement and automobiles have become larger thanks to domestic demand. In 2012, 70 Chinese companies were ranked among the Fortune 500. However, only three of these were in value-added industries.⁴ Though the government has nurtured high value-added industries since the 1990s, results have failed to meet expectations. China's industries have increased their exports but foreign-funded companies in China represent more than 80 percent of the high value-added industries. Value-added industries still need government support to ex-

pand.

Companies with technological competitiveness are imperative in the growth of value-added industries. At present, financial resources are allocated mainly to state enterprises, limiting job creation and the development of private companies with competitive technologies. It has been demonstrated that government-run corporations are barely profitable if financial privileges are excluded.⁵ Accordingly, further reforms in the financial sector and the real economy are necessary to ensure that the private sector can sustain economic growth. 

Translation: BYUN Ha-Na

Keywords

China's fifth generation leadership, Wen Jiabao, Li Keqiang, urbanization, economic reform

⁴ Huawei, Lenovo, China Electronic Corporation (CEC).

⁵ Giovanni Ferri and Li-Gang Liu(2009). *Honor Thy Creditors Before Thy Shareholders: Are the Profits of Chinese State-owned Enterprises Real?* (HKIMR Working Paper No.16/2009). HKIMR.

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