"Likonomics": New Paradigm for Chinese Economy

OM Jung-Myung Research Fellow Samsung Economic Research Institute

I. China's Economic Anxiety

Anxiety is rising in China about its economic prospects. Growth has slowed to the 7% range; investment efficiency has declined, challenging the nation's economic model led by investment and exports; and some economists are warning about implosions of asset bubbles and economic hard landing.

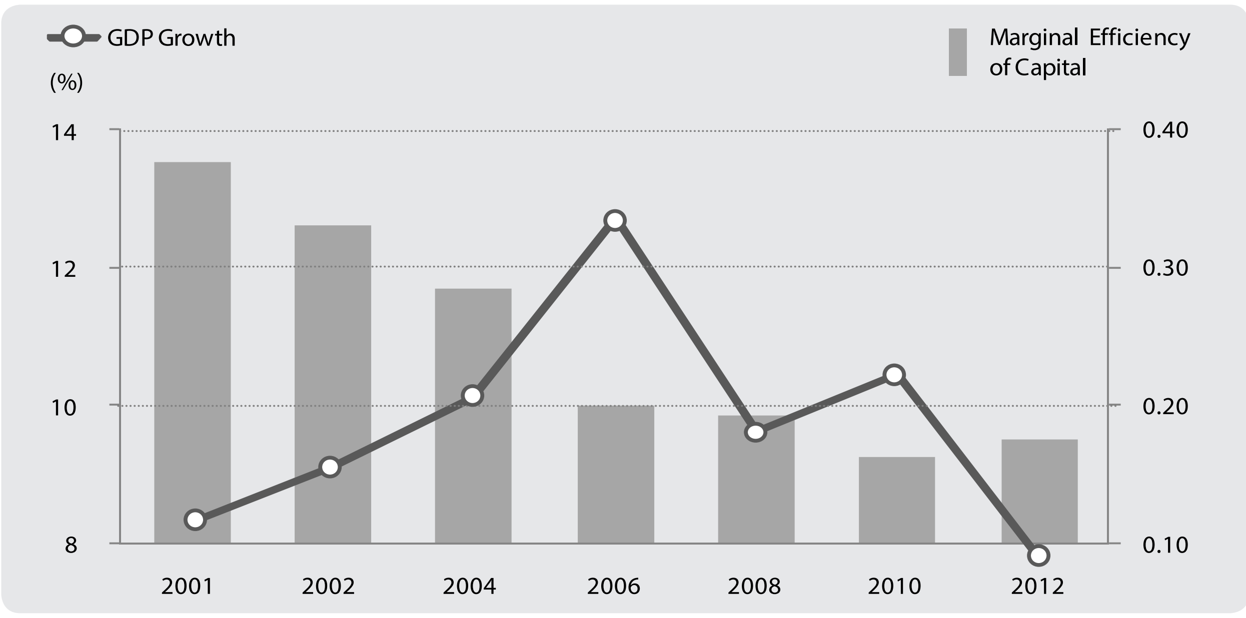
After the global financial crisis erupted in 2008, the Chinese government unleashed massive stimulus to blunt the economic fallout. The economy maintained its fast pace growth, but the government spending along with a flood of state bank lending has resulted in a glut of public infrastructure, housing and factories. Therefore, efficiency on capital investment has declined since 2010; about 10% of its GDP is traced to over investing. The marginal efficiency of capital, a measure of investment efficiency, also has seen a sharp drop, to hit 0.17 in 2012.

Robust wage increases and appreciation of the yuan also has weakened export competitiveness. The goal of the current five-year economic plan is to double average wages by the end of 2015 to encourage domestic consumption and more fairly distribute wealth. Indeed, nominal annual wage growth across China has been 14.9% since 2007. This has led to an increase in manufacturing costs. As for the yuan, it has steadily appreciated due to pressure from advanced countries. In July this year, the yuan/US dollar exchange rate reached 6.18, a 25% rise in value from 8.27 in 2005.

Consequently, export growth, after peaking at 31% in 2010, slowed to 20% in 2011 and 8% in 2012. In the first half of 2013, growth was 10%. As advanced economies continue to limp, China will continue to be compelled to allow the yuan to appreciate further.

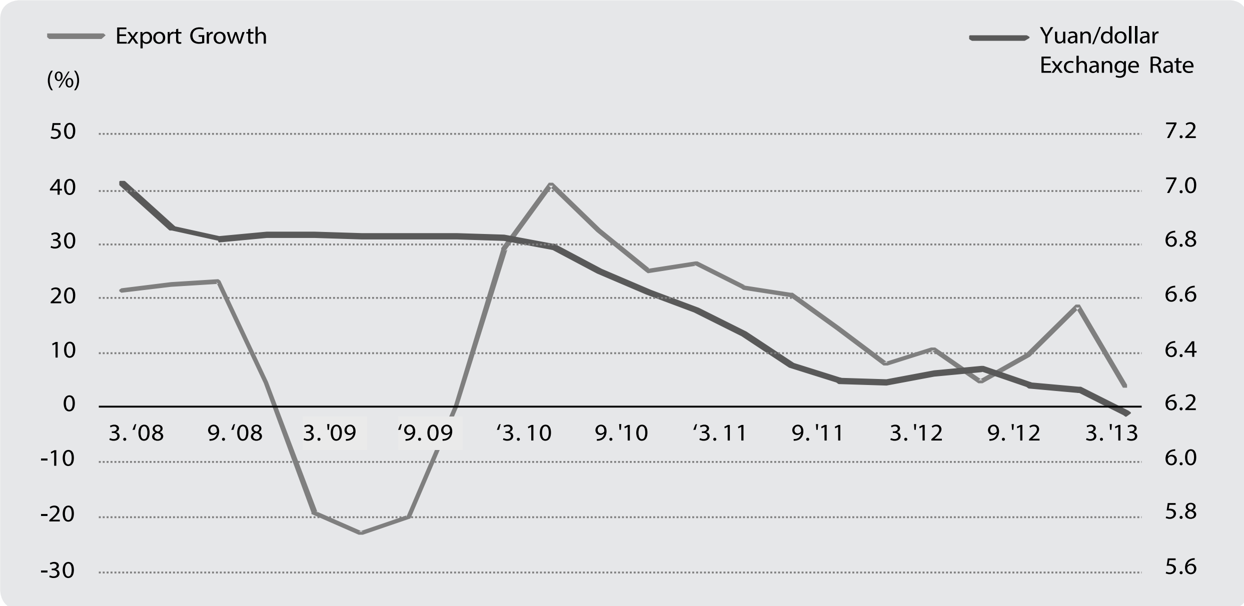
Another concern is mounting corporate debt. The lend-

GDP Growth and Marginal Efficiency of Capital



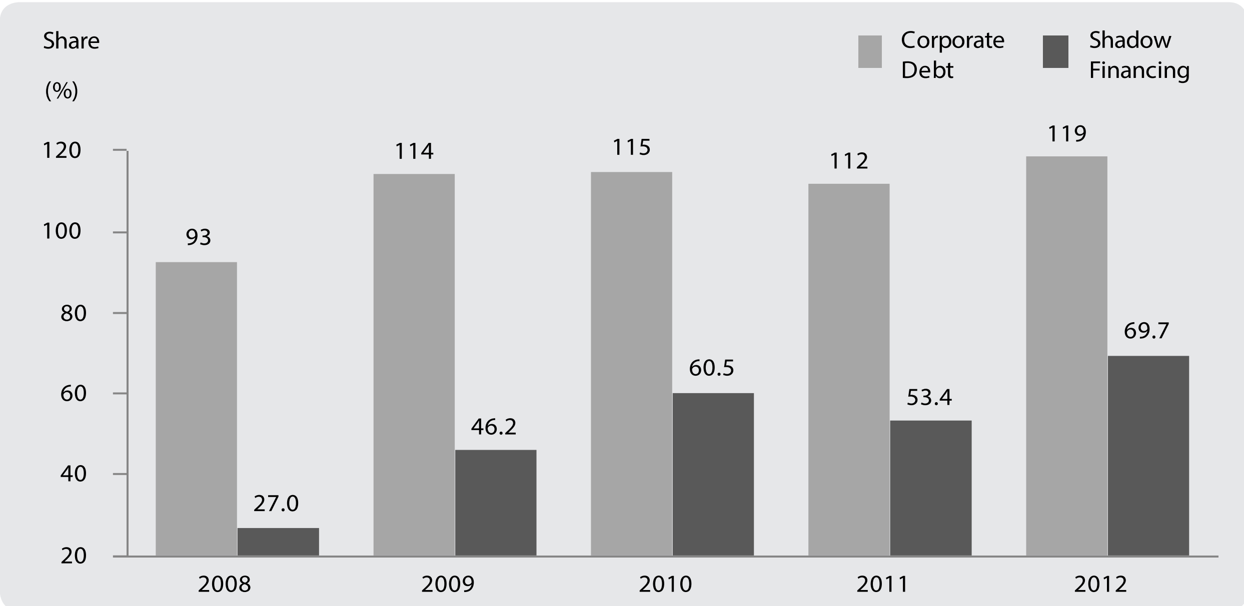
Source: Oxford Economics.

Export Growth and Yuan/dollar Exchange Rate



Source: CEIC.

Share of Corporate Debt and Shadow Financing in GDP



Source: Estimated based on CEIC data.

ing by state-owned banks to the corporate sector to stimulate investments has lubricated construction of housing and related infrastructure to urbanize most of China's 1.4 billion residents. But it also has produced a long list of state enterprises who over borrowed. As a result, their debt-to-GDP ratio rose to 120% in 2012 from 93% in 2008.

Adding to worries about the health of the financial system is "shadow financing." When the government reined in excess lending by state banks, private companies in particular turned to non-conventional lenders. Shadow financing has significantly higher chance of turning sour compared to bank loans due to its high-risk, high-return characteristics. Shadow financing in China refers to loans from non-bank sector, trust loans, bank-guaranteed commercial papers and private financing. It reached 36 trillion yuan, or 70% of GDP, in 2012, up from 8.4 trillion yuan, or 27% of GDP, in 2008.

II. Likonomics" and China's Economy

Under Premier Li Keqiang, a new economic strategy is emerging. “Likonomics” has two goals. One is "growth led by consumption." It is facilitated by urbanization and further growth of China’s middle class. The other is “restructuring industries.” It involves resolving over-investment and corporate debt problems while fostering high value-added industries.

1. Likonomics policy

A. Goal 1: Consumption-led growth

Li wants domestic consumption to replace investments and exports as the primary engine of the Chinese economy. Further urbanization and higher salaries are imperative to the new economic model. In 2012, per capita income and spending by urban residents was three times that of rural residents.

Investments totaling 40 trillion yuan (around US$6.5 trillion) are to be poured into a “new” urbanization program with a 2020 completion date. The effort will focus on constructing a "smart city," promoting "green growth," and an urbanization that "puts people at the heart" by allowing rural-to-city migrants to enjoy the same benefits as city dwellers.

Likonomics also aims to increase the urban population by reforming the rural land and household registration (hukou) systems. New arrivals in cities will be eligible for the same benefits as urban residents, which will help facilitate their consumption. Meanwhile, land use rights, currently under collective ownership, will be privatized and selling private land rights will be allowed to facilitate the migration of farmers to cities.

B. Goal 2: Industrial restructuring

Restructuring of industries will involve the integration of companies that have excess capacity, which will help contain high corporate debt’s risk to the economy and enhance profitability. Other efforts call for the government to foster large enterprises in high value-added industry.

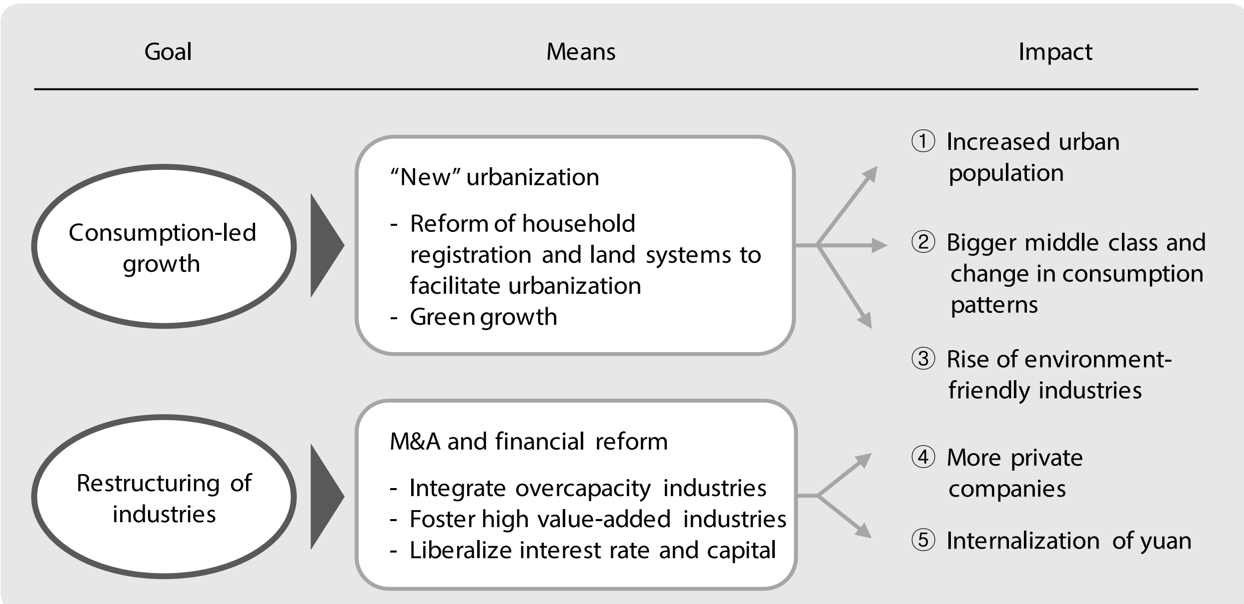
In January 2013 the Chinese government released guidelines for M&A and restructuring in the country's core industries. Between 2013 and 2015, M&A will be pursued in industries that have serious overcapacity problems. They include steel, cement, shipbuilding, aluminum, rare metals, automobiles, electronics, agriculture and pharmaceuticals.

Financial reform also is under way to invigorate M&A activity. To facilitate equity capital increase, debt-equity swap, acquisition and sale of bad loans, liberalizing interest rates and capital transactions are crucial. In July, Li liberalized lending rates and will soon liberalize deposit rates.

2. Economic changes ahead

A. Accelerating urbanization

Likonomics and China's New Economic Strategy



Number of Cities 2012-2010

	Below 500,000	500,000- 1.5 million	1.5 million- 5 million	5 million- 10 million	Over 10 million	Total
2012	597	168	69	12	14	860
2020	501	270	108	20	21	920
Increase	-96	102	39	8	7	60

Demographic projections foresee 250 cities with population exceeding 1 million and 60% of the country's population in cities by 2020. This would involve the number of cities increasing to 920 in 2020 from 860 in 2012, among which cities with more than 10 million people will increase to 21 from 14. A case in point is the areas surrounding Xi'an, a capital in ancient China and now the government seat of Shaanxi Province. China's urban population is forecast to rise 2.7% annually to 850 million by 2020, or 61% of the country's total population, from the current 700 million, or 51% of the population.

B. Expansion of middle class and change in consumption patterns

Assuming no major economic upheavals, the Chinese middle class will expand rapidly and it will alter consumption patterns. The rise will be driven by higher income; reform of the hukou system and changes in the business landscape. The number of middle-class households -- households earning 110,000 yuan to 230,000 yuan a year -- will soar to 170 million in 2020 from 14 million in 2010. As the hukou reform removes the entrenched barrier that encumbers resettlement in cities, the consumption of rural-to-urban migrants (nongmingong) will increase. Meanwhile, the growth of high value-added and service industries will help urban residents' income rise. Consequently, consumption by the middle class is expected to reach US$4.5 trillion by 2020, outstripping US' US$4.3 trillion.

Consumption trends will also change. Most notably, the share of spending on daily necessities, including food, will drop to 20% from 28% of total consumption, and that on leisure and culture will increase to 18% from 12%. The proportion of quasi-daily necessities such as clothing, health insurance and daily supplies, will edge down to 41% from 42%.

C. Rise of environment-friendly industry

The "new" urbanization drive, as it emphasizes green growth, will spur the growth of environment-friendly industry. Pollution in China is the severest in the world, with seven Chinese cities listed among the top 10 most polluted. The Chinese government plans to foster related industries and launch massive investments for environment conservation. Over the next five years, it will spend 1.7 trillion yuan on combating air pollution and 2 trillion yuan on water pollution.

Meanwhile, the government will foster high value-added industries in cities in order to reduce traditional industries that consume high amounts of energy and pollute. Li said that he would provide policy support for labor-intensive companies in central and western regions if they shift to environment-friendly businesses.

D. Rise of private companies due to financial reform

Interest rate liberalization will stimulate competition among financial institutions and growth of private companies. Currently, 70% of state-owned banks' lending flow into state enterprises, and most private companies raise funds through shadow financing. As competition intensifies, deposit rates will rise and lending rates will decline, thus reducing the deposit-lending rate gap. Profitability at financial institutions will fall as a result. In response, they will expand lending to private companies to which they impose higher lending rates than state-owned companies. This will spur the growth of private companies.

In addition, capital market liberalization will spur foreign capital inflow, which will lead to weakening of government influence on the financial industry as government will have limits in providing state lending support. Ultimately, profitability at state-owned companies will decline. This is because companies that are state-owned will have difficulty in raising funds in the financial market because foreign investors, who search for sustained corporate profitability, will shy away from them. China is planning capital opening by establishing free trade districts in the north, south and southwest with Tianjin, Guangzhou and Chongqing, respectively, besides Shanghai.

Meanwhile, private companies will likely acquire low-profit state enterprises at an increasing rate.

Taiwan Companies That Succeeded in China's Inland Areas

▷ Kunming Group that opened department stores in 16 inland cities

- To tap rising middle-class income, it expanded luxury brands at its department stores in inland areas in central and middle regions while upgrading store interiors.

- It is expanding stores in inland areas where the middle class is increasing.

▷ Dennis Company that became a retail firm in Henan Province

- Responding to changing shopping habits of the middle class, it expanded from large retail stores to shopping malls and then to large department stores.

- Based on its retail business, it also entered warehouse and processed food industries.

E. Accelerating internationalization of the yuan

Capital market liberalization will help accelerate internationalization of the yuan. China wants to reduce reliance on the US dollar by internationalizing its currency. But due to weak capital liberalization, cross-border yuan trade settlement is mostly conducted through Hong Kong. China also allows only in limited manner bringing in yuan earned from international trade. The inconvenience of having to conduct cross-border yuan clearance in Hong Kong and a few other areas is an obstacle to currency internationalization. Hong Kong accounted for 80% of offshore yuan transactions in the first half of this year.

If yuan can freely flow back to China, yuan internationalization will facilitate as the currency can be managed through investment in the Chinese financial market and various yuan products.

III. Implications

Foreign companies entering the Chinese market need to customize their marketing according to regions, which have per capita GDP differences of up to 4.8 times. There is also an uneven distribution of middle-class households, which account for only 6-8% of all households in China. For example, foreign companies can note that consumption is gathering pace in China's middle and western provinces, but those regions have relatively lower middle-class populations. Consumers there still prefer practical, mid-to-low price products.

In devising tailored strategies, there should be enough flexibility to prepare for an increase in middle-class residents. This is the approach that Taiwan companies apply in China's inland provinces.

In high value-added industries such as electronics and telecommunications, China entry should focus on strengthening R&D to satisfy consumers who want a variety of durable, high performance and unique design products. They should also prepare for more intensive price competition by Chinese companies, which are scaling up through M&As.

In environment and service industries, China entry could be promoted through alliance with local companies or through stake acquisitions. In the environment industry, alliance with Chinese companies that have good communication with the Chinese government will help gain a competitive edge. China's environment sector benefits from the government's green-growth policy and leading global companies already have presence there. Possessing a differentiated competitive edge is thus crucial. In service industries, foreign companies can consider an alliance with Chinese counterparts or stake acquisitions, since some industries, particularly leisure and culture, have high growth potential but government barriers on direct foreign control. SERI