Chinese Industrial Policy & Economic Development

By Long Ke


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China's open-door policy, which started 34 years ago, succeeded in improving economic development and has realized about a 10% growth rate annually during this period. The keywords of Chinese economic development over the past decades have been liberalization and deregulation. Under the central planning economy, the government controlled almost all resource allocations and economic operations through its economic plan. As a result, resource allocation is very inefficient; economic growth was limited by the central planning system in the Mao Zedong era. Thirty-four years ago, the Chinese economy was in a very dangerous situation when Deng Xiaoping took over the administration from Mao. If Deng had continued with the same policies as Mao's, it would have resulted in China's bankruptcy. The only solution to China's problems was to reform its institutions and improve economic development. Deng's challenge was obviously very risky for the Communist Party, but it eventually was repaid with a high return.

However, China is a big country with a large population, and it is difficult for the Chinese government to change the country with the same shock therapy which was applied in Eastern Europe in the 1990s. The Chinese government adopted a "Gradualism Strategy" to reform the economic system gradually and postponed reforming the political system in order to maintain social stability. For all Chinese political leaders, stabilization of society eventually means that the party must maintain leadership through economic development, and so the monopolistic political system is not allowed to undergo reform.

Here I want to point out several changes in China's economic structure over the past decades. First of all, the state-owned enterprise (SOE) sector has been downsized sharply from 34 years ago. Under the Jiang Zeming administration, Premier Zhu Rongji privatized almost all of the small-sized SOEs in 1998 but could not downsize the large ones. Since then, such reforms of SOEs have resulted in rapid economic development. Secondly, the Chinese government has promised to protect private assets since the 1990s. As a result, the number of private companies has increased over the past decades, although the business environment for private companies in China is still very inhospitable; for example, the formal financial system refuses to generate liquidity for private companies. Most private companies have to get finance in the informal financial market, known as the "Shadow Bank", where the interest rate is much greater than that in the formal financial market. Nevertheless, private companies have still increased very rapidly over the past decades. Thirdly, the manufacturing industry has been the main driving force of the Chinese economy. During this period, China lowered the share of agriculture in its GDP to about 10% in 2012 and strengthened the manufacturing industries. Now China is trying to strengthen its service industries.

What's the Problem with the Industrial Structure?

Every country needs to rationalize its industrial structure during different periods of economic development. When Deng started to open the door to foreign companies and reform the economic system, China faced many difficult problems such as a shortage of foreign currency and weak technologies. Deng liberalized control of the economy by the government and promised foreign companies would be able to invest in China freely. Foreign direct investment was the frontier on which Deng's open-door policy would be able to accelerate economic development. Small companies from Hong Kong and other Asian countries and areas invested in Guangdong and Fujian and created many thousands of employment opportunities. Japanese companies invested in Chinese coastal areas and transferred their technologies to their Chinese business partners, most of which were SOEs. It is obvious that foreign companies, especially Japanese companies, have contributed greatly to China's economic development and industrial structure upgrade over the past decades.

China is a large country with a large population, and it is difficult for the government to develop the whole economy in a short period. Deng decided to develop the coastal areas first by encouraging FDI. Compared with inner China, the coastal areas were given priority for infrastructure development and human resource allocation. Some provinces, such as Guangdong, Fujian and Zhejiang, have a lot of resources from overseas Chinese connections. In fact, Chinese living abroad were the main players in investing in their homeland and played a very important role in helping China catch up early in the Deng era.

In the Jiang era, China had promised to open all of its markets, including the service industrial market, to foreign companies, especially after it joined the WTO in 2001. Since then, China has played an important role as a global manufacturing center, while at the same time becoming a global market. We find that most of the FDI flowing into China in the 1980s and 1990s was in the manufacturing industries, but since 2001 more and more modern service industries, such as distribution and information technology, and financial service industries have invested in China. The Chinese information technology outsourcing industry has grown to become the biggest in the world.

According to the "Flying Geese" model, China learned its development model from Japan and succeeded in catching up by improving its export manufacturing industries. Chinese labor costs were the most competitive in the world and the skills of its laborers were excellent, and as a result the labor-intensive manufacturing industries developed very rapidly in the first period of the open-door policy. In the first two decades, the Chinese government maintained labor costs at a low level in order to improve the labor-intensive industries' development. But the government cannot maintain labor costs at low levels forever. The key point that the government should focus on is how to strengthen the productivity of industries.

Former Chinese President Hu Jingtao suggested undertaking "scientific development" instead of intensive economic development. What is this scientific development? Hu himself never made the definition clear. It is likely that this scientific development would be sustainable, economical and more efficient. That means that the original economic development model is not sustainable. There is no doubt that this is the case, but the problem is how to realize scientific development? The Hu administration, at least, was unable to realize this scientific development.

Changing the Industrial Structure

It's safe to say that most of China's leaders understand that the original export-dependent development model is not sustainable, but the government seems to have no other choice but to sustain economic development under the current situation. First, the government needs to improve the development of high-technology industries while maintaining some labor-intensive industries as well. Second, China is facing a shortage of well-educated business managers. Third, local governments seem uncooperative when it comes to upgrading the industrial structure. Almost all of the provincial governments want to maintain a full industrial structure, including labor-intensive industries. As a result, China has developed into the second-largest economy in the world, even though Chinese companies seem not to be aggressive enough in innovation.

How could the Chinese government, including local governments, maintain the industrial structure over the past three decades while still sustaining economic development? The key point here is that the government refused to raise workers' salaries. These workers come from rural areas, and under the current system, people from the countryside cannot get registered status in urban areas because of the "Hukou" household registration system. This means that they are not covered by social services in the urban area. Low wages and no social services means these laborers are in fact slaves of the export manufacturing industry in modern Chinese society. Of course, this was obviously the source of the strong competitiveness of the Chinese labor-intensive industry during the country's economic "catch up" period.

In the future, however, China will likely reduce the competitiveness of its cheap labor costs. It is clear that the government cannot keep laborers' wages at such a low level. In fact, most local city governments in coastal areas started to raise the minimum wage by 10% annually 10 years ago. Furthermore, the People's Bank of China, the country's central bank, started to cause the renminbi to appreciate in 2005. Since then it has appreciated approximately 30% against the US dollar, which is weakening the competitiveness of export manufacturing industries. The conclusion here is that the government has to change the industrial structure.

The New Phase of "Made in China"

The original industrial model of 34 years ago has driven economic development over these past decades, but the "Made in China" model is now considered unsustainable. Why is this original model unsustainable? First of all, the labor-intensive industry has gradually lost its competitiveness. For the government to maintain labor costs at low levels is no longer an option; if it does, it will be unable to stabilize Chinese society. Secondly, Chinese companies are generally negative towards innovation. The cheap cost of labor actually contributed to the labor-intensive industry's development, but such development without innovation is not sustainable. China is now the largest prospective market in the world — for example, vehicle sales in China have been No.1 for the past four years. Also, China's smartphone market is the largest in the world. But it is apparent that the main manufacturers in such hi-tech industries are all foreign companies: VW, GM, and Japanese and South Korean car makers are the main players in the vehicle market. To improve industrial development, the key lies in how local Chinese companies can strengthen innovation in order to create an original Chinese brand.

China is now an open market not only for local companies, but for foreign companies as well. But an open market never means easy competition. Competition in the market means the companies with the ability to innovate will win. Why then are Chinese companies so negative towards innovation?

Any kind of innovation, especially fundamental research and development, could be a serious hurdle for Chinese companies, because the cost of R&D would lower the companies' profits initially. In many cases, R&D entails only risk, but no return, for some companies. This problem relates to proper application of R&D. Another problem holding back local companies from undertaking R&D is the government's protection policy towards SOEs. For most of the SOEs it is not necessary to engage in R&D because they are protected by the government. Chinese companies need original technology and an original brand. To realize this goal, the Chinese government needs to liberalize the control and protection of SOEs. Privatizing SOEs would be the most efficient reform to improve market competition and innovation.

Leading Industries of the New Era

Early on after the adoption of the open-door policy, labor-intensive industries like textiles and toy manufacturing played an important role in creating employment opportunities and driving economic development. At the end of the 1990s, information technology (IT) industries came to be the key industries in China. Meanwhile, the urbanization movement improved the development of property markets. The real estate sector is still a strong engine driving China's economic development. Ordinary households are concerned with post-retirement lifestyle, which has led to an overly high savings rate in China. The national savings rate has reached 50%, but there are few investment instruments in the financial market. While the property market is still the best investment market for ordinary households, it tends to form bubbles because of over-liquidity. Not only individuals, but private funds and institutional investors are seeking to rent in the market, too.

The conclusion here is that China needs to create some other leading industries to drive economic development. The manufacturing industries are still the key industries in China, especially hi-tech and industries related to smart cities. Secondary leading industries are related to environmental protection. Air and water pollution in urban areas is very serious. PM 2.5 has at times reached levels of 400 in cities like Beijing and Shanghai. According to the ministry of national environmental protection, approximately 90% of rivers in urban areas are seriously polluted, and the groundwater of over 60% of cities has been polluted. Environmental protection industries could be key industries for China in the next decades.

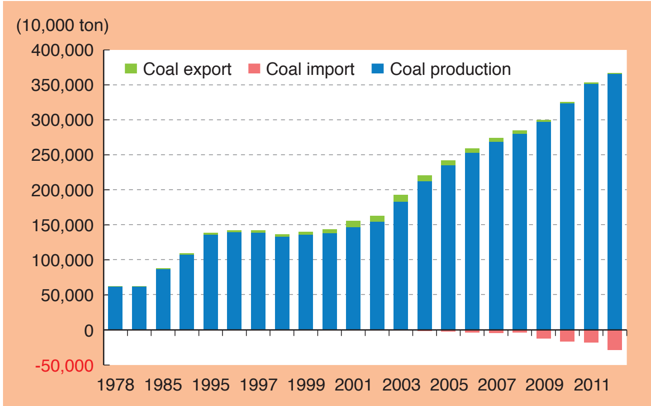
Another key to China's future is changing its industrial structure. China cannot sustain its economic development only by depending on the manufacturing industries and exports. China needs to improve the development of its service industries and strengthen household consumption. To realize this goal, the Chinese government needs to increase efforts to reform and rebuild the social safety net and promise to raise up the low income classes. Convincing households to increase consumption is key to changing the economic and industrial structure.

The Hu era is now over. Under the Xi Jinping administration the government needs to reform the political and economic systems in order to reallocate resources from the SOE sector to the private sector, otherwise China will be unable to strengthen productivity due to the monopoly of the SOEs. Premier Li Keqiang emphasized that he would increase efforts to build a real market economy. To realize this goal, the government needs to liberalize its control and improve the transparency of market transactions and market rules. Deregulation will be critical for strengthening the service industry, but in today's China the local government usually protects local companies; such tendencies prevent service companies from creating a service network.

Furthermore, how should resources be reallocated? The government will play an important role in the process, but the real engine for improving resource reallocation is the market. The conclusion here is that China needs to reform the regulatory system

CHART 1

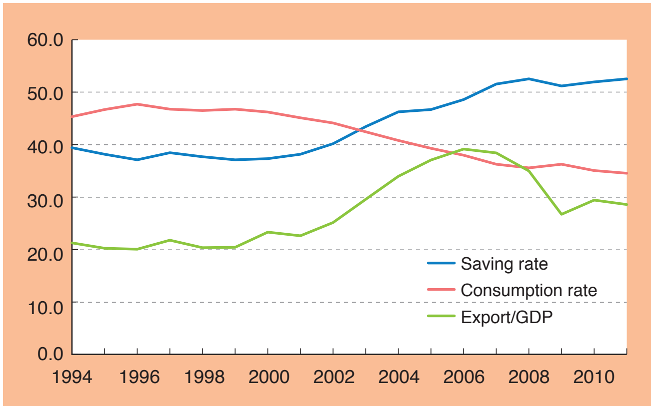
Coal production & coal trade volume



Source: The State Statistic Bureau

CHART 2

Saving rate & consumption rate



Source: The Key Indicate, ADB

and improve deregulation. Of course, deregulation in China will not be easily realized. A monopolistic political system makes strong regulation possible, but at times regulation turns into direct control of the economy by the government.

The Chinese government has announced again and again that a Western-style democratic system is not acceptable in China and that China will walk the path of a Chinese-style democratic system. But a monopolistic political system invariably means a monopolistic economic system. The roadmap for China to create a new and productive industrial structure is clear. First, it must reform the political system and create a democratic one. Secondly, it must reform the economic system and create a real market-oriented economy. Thirdly, it must privatize the SOE sector and strengthen the private sector.

Finally, the Xi administration is trying to reform the administrative system to create a small government. This is a very important endeavor and an important step toward a market-oriented economy. JS

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