

# The Chinese Economy From “Likonomics” to New Normal



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Two years ago, when Xi Jinping replaced former Chairman Hu Jintao as China's leader, most Chinese people held great expectations of economic and political reform. Xi promised the people he would realize the “Chinese dream” — even though nobody knows exactly what the Chinese dream is. Some China watchers explained the “Chinese dream” as being the happiness of the people in society. It is true that Chinese society ranked No. 60 in happiness among the global community in 2012. But it is also clear that most Chinese people do not feel happy about their lives, even though official data shows the economy is the second-largest in the world and is still developing rapidly. If most Chinese people cannot enjoy this economic development, how they can feel happy?

During the Hu era China experienced a “lost decade”, as most of the reforms were postponed under his administration. Of course, Hu's administration was very lucky: the economy was driven by the Olympic Games in Beijing in 2008 and the Expo in Shanghai in 2010. The government improved a lot of infrastructure investment related to these two international events. In 2009, Hu's administration announced investment projects costing 4 trillion yuan to counter the damage from the Lehman Shock. Compared with Hu's administration Xi seems not so lucky. There are no international events being staged. The government still wants to improve infrastructure investment, but it cannot pay for it. The only option for Xi's administration is to accept 7% GDP growth instead of double-digit growth.

Two years ago Premier Li Keqiang told the Chinese news agency Xinhua that 7% GDP growth would be acceptable, and the key point here is the implied change in the economic structure, because 7% growth can create sufficient employment opportunities. This was known as “Likonomics”. But over the past two years Likonomics has not succeeded because Li could not take the leadership in reforming the state-owned enterprises. Since the second half of 2014 it seems as if the government has given up on Likonomics. Nowadays Xi has taken the leadership in relaxing financial policies. According to Xinhua and the *People's Daily* newspaper, 7% GDP growth is a new normal situation in China. The announcement means that China is facing difficulties in realizing double-digit growth like that of the Hu era. If 7% GDP growth is the new normal situation, the government doesn't need to take responsibility for the economic slowdown. But nobody can guarantee that 7% GDP growth can be sustained in the coming years. If the GDP growth rate is going to slow to 5% or 6%, it will mean society facing turmoil. Maybe Xi is correct in changing policies to generate more liquidity for the financial markets to avoid financial crises. But here I am concerned about the sustainability of Chinese economic operations.

## End of Deng Xiaoping's Era & Beginning of Xi's

Nobody has given us any vision of Xi's mission to lead China into the future. Deng's policy to improve the country's economic development finished two years ago. He succeeded in economic development, but failed to allocate the income equally. Deng liberalized economic controls, but postponed political reforms. As a result, political leaders and officials went to rot because they were never monitored by the people. It is difficult to imagine how government officials can get millions of yuan in bribes. Some China watchers point out that the anti-corruption campaign is only part of the power game in the country. Every leader and every official gets bribes, although the amounts are different. The problem of corruption is the legacy of Deng's era. Only reforms to create a democratic system can help China establish a clean and transparent

political system.

Under the current political system, however, corruption would be never-ending, and so new leaders would also come to rot. But Xi seems to refuse to build a transparent political system. As leader of the Chinese Communist Party, his task is to maintain the leadership of the party. Of course, he knows that Deng's policy will not be sustainable. Xi is trying to reintroduce Mao's thought. Mao's politics was the cult of personality, and Xi wants to copy him. But the time and situation are different. China was a secluded state in Mao's era, but now it is an open market. Nobody can close the door on the country, not even Xi, definitely. Most Chinese people, especially the young generation, enjoy the freedom to access the Internet. There are over 600,000,000 netizens in China.

Now Xi needs to show his vision of the country to the people. Thirty-five years ago Deng emerged as the new leader after Mao and

told the people they would be rich if they followed him with his reforms. It was a very exciting vision for the people. But most of them are disappointed now, because they are still very poor compared with rich people, especially the political leaders. Deng made the mistake of building confidence in China, but Xi wants to build the rule of law to help the government reassert its authority step by step. Meanwhile, many journalists, lawyers and university professors have been restrained for criticizing the government or political leaders. In China it is still taboo to criticize the government.

Many people are concerned that Xi is going to lead the country into another Mao era. Conservative groups inside the government have criticized the liberals because they inculcate human rights, freedom and democracy. It seems that universal values will not function in China. I have to say socialism has failed in China; but capitalism is functioning in China gradually. Is there any other framework better than democratic capitalism? We know democratic capitalism is not the best system, but it is better than the alternatives. There is no option for Xi either to continue Deng's policies or to take the people on a road back to Mao. The only correct option available to him is to accept universal values and to act under the rule of law.

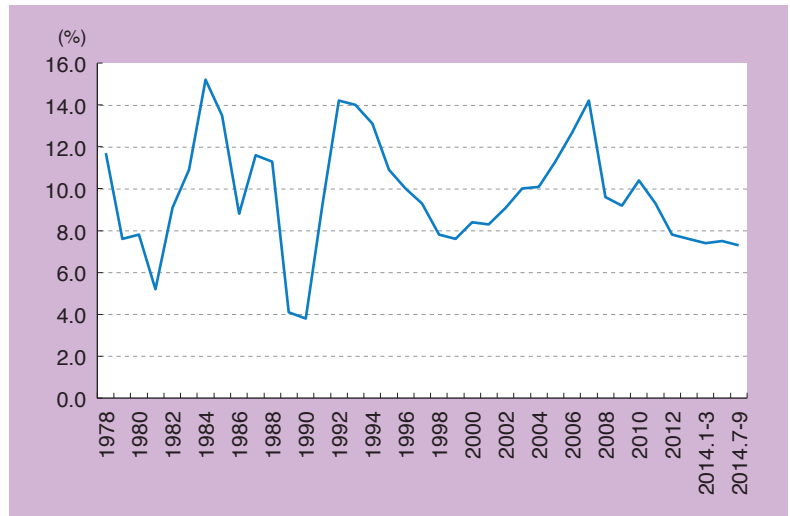
### Chinese Economy in 2015

For China to create a new policy mix would be an important and difficult turning point. The former policies are unsustainable, but they were successful in improving development. The groups that have enjoyed the benefits of the old policies refuse to turn to a new track, so it is not easy for Xi's administration to change the country's economic structure. Meanwhile, when we take a look at the driving force of the Chinese economy, it is easy to find its weakness. The Chinese government announced that from 1998 it would encourage private consumption, but the ratio of consumption to GDP is only 35%, compared with 60% in Japan and 55% in India. It cannot be expected that China can strengthen the consumption ratio in one or two years; indeed, it is impossible.

Another engine of economic development in China is external trade. China started to boost the renminbi from 2005, and the currency appreciated since then by more than 30% against the dollar up to the end of 2014. The appreciation of the currency means a lowering of the competitiveness of the Chinese manufacturing

CHART

### Can China sustain economic growth?



Source: Chinese National Bureau of Statistics

industries. Meanwhile, labor costs have increased 10% annually over the past decade. Labor-concentrated industries are facing difficulties in boosting their competitiveness and expanding business. Some of the small-scale factories established by overseas Chinese have moved to Vietnam and other ASEAN countries. Foreign demand cannot be expected to drive Chinese economic development sustainably. Nowadays fixed-asset investment is still the main engine driving economic development. The National Development and Reform Commission (NDRC) decided to improve expansion of infrastructure from the last quarter of 2014, which means that if a company in China can get a license from the NDRC it can borrow money easily from state-owned commercial banks.

It is thought that policy-making in 2015 will follow that in 2014 to realize a 7-7.5% GDP growth rate (Chart). China has lowered its target of economic growth from 7.5% to 7% from this year, which the government could basically achieve. The US economy is starting to recover considerably, and China could sustain its exports to the North American market. But the European market is still in trouble with the Greek debt crisis, and the Ukraine problem could damage the European Union's relations with Russia. There are a lot of uncertainties about whether China can expand exports to European countries.

China is trying to create free trade agreements (FTAs) with regional neighbors and is also very interested in the Trans-Pacific

Partnership led by the United States. Although Xi met with Japanese Prime Minister Shinzo Abe at the APEC summit in Beijing last November, it was just because China wants to build a new cooperative relationship with Japan. The two nations are still arguing about issues of history and about sovereignty of the Senkaku Islands (Diaoyu in Chinese). Such problems are difficult to solve. Deng suggested freezing them and letting future generations try to solve them. Given that the Chinese economy is going to slow down, China needs to cooperate with Japan. There are about 25,000 Japanese companies invested in China directly. These contribute to creating 10 million employment opportunities, and also transfer their technology to their business partners in China. Japan, meanwhile, also needs the Chinese market. Under Abenomics the yen has depreciated from 76 yen to 120 yen to the dollar, strengthening the competitiveness of Japanese exports. The most hopeful market for Japanese companies is China, so cooperation between these two nations is a win-win game.

### Chinese Dream

If we look back at the Deng era, we see that the keyword was *development*. According to Deng, economic development is everything. Everybody expected the country could develop and they would benefit from it, but now many Chinese people find they cannot enjoy economic development. Only a small number of Chinese people, especially the political leaders and business leaders, can benefit from economic development. So now the people have come to doubt what the government tells them. Most Chinese people support Xi's anti-corruption campaign, but they are also shocked when they learn that the political leaders gained such huge amounts in bribes.

Two years ago Xi told his people that he was going to lead them to realize the Chinese dream, even though nobody knew what that dream was. Development was the dream in Deng's era, but nowadays many Chinese people are disappointed because they have failed to realize the dream. The low-income class wants Xi to make them rich, but to redistribute wealth equally Xi will first need to promise to disclose politicians' private assets — otherwise nobody will feel that income is being reallocated equally.

Another hot issue is the environment. In China *per capita* income has increased rapidly in the past decades. But it is not enough to claim that Chinese people are happier than 30 years ago, because the environment is much more seriously polluted now. Air pollution is damaging people's health in urban areas, while about 97% of the

rivers are polluted in China. Meanwhile, northern China is facing serious water shortages, and the government has invested in a big project to distribute water from the Yangtze River (Chang Jiang River) to the Yellow River for supply to the people in Beijing and Hebei Province. Another environmental problem is that the land is also severely polluted. In rural areas the farmers have used too much pesticide and chemical fertilizer, and as a result the land has become polluted with heavy metals.

Basically the environmental problem is a moral hazard problem. First of all, the government is irresponsible about protection of the environment. Secondly, companies only want to maximize their profits and do not want to pay the costs of environmental protection. Thirdly, individuals are also irresponsible about protecting the environment. In China the government never discloses the real data on pollution; the reason is that it is worried about social instability. This kind of attitude can only postpone the resolution of the problems; it cannot solve them.

Xi promised to realize a dream, but he must show the people what the dream is and how it can be realized. In the past decades, especially in the Mao era, the government demolished traditional culture. It simply expected to control people's minds by controlling the mass media. In Mao's era Chinese people didn't have any freedom of speech. Nowadays the *People's Daily* has started calling on people again never to believe foreign news agencies' reports, only the government's propaganda. Even some leftwing intellectuals hope the government can control Mao's critics on the Internet.

In a country like China the leader needs to show a vision to the people to gain their support for the government. It is the same as the American dream. But the Chinese dream cannot simply be propaganda for the government to control the people: it must be a promise that society is going to be freer, fairer and more global. The government must not ask people simply to believe it and ignore foreign news agencies. If the government wants the people to believe it, it must be believable. But when something significant happens in China, lawyers and journalists only gather at home to discuss it, such as with what happened in Tiananmen Square; and some of them were then arrested by the government illegally. According to the Chinese constitution, citizens have freedom of speech. So such behavior by the government is obviously unacceptable. If control of speech is the Chinese dream, I believe nobody in China would follow the leader in trying to realize such a dream.

## Xi's Foreign Policy

China has positioned itself as a developing country during the past decades. China is an emerging economy, yet it is also the second-biggest economy in the world. Some economists in America recalculate normal Chinese GDP by purchasing power parity (PPP), and they point out that it is bigger than that of the US. That means China has become the biggest economy in the world. China's political leaders always emphasize that China is rising peacefully and will not be a threat to the world, especially to its neighbors in East Asia. Actually such announcements are meaningless, because no country would ever say its development would damage the world; all leaders in all countries usually tell us they will contribute to global peace and prosperity. But any country's development will imply a change in the current world order, especially if it feels uncomfortable about it. Britain and the US have historically both changed the world order. Japan challenged it in World War II. China never had a chance to challenge international rule during the past centuries, but now it has the potential to challenge it by force.

First of all China has trouble with its neighbors, such as Japan, Vietnam and the Philippines, over ownership of islands. Actually this issue is one of natural resources. China is a big country with a huge population; it is facing shortages of resources such as crude oil and natural gas. In this regard, China's expansion strategy is understandable. But challenges by force will not be acceptable to the global community. Dialogue would be more helpful in solving the problems peacefully, and the global community could play a positive role in the coordination and creation of a framework and mechanism for such dialogue.

East Asia needs a peaceful and constructive situation to integrate the region's nations into working together. Over the past couple of decades the ASEAN countries have created the ASEAN Free Trade Area to improve free trade in the region. In 1997 and 1998 the region experienced currency crises, the lesson from which was that Asian countries could not maintain economic development merely by relying on exports to the US. China brought a more positive attitude to create a free trade framework with ASEAN countries by promising to open its domestic market to its neighbors, including its agricultural market. The interdependence between China and ASEAN countries effectively helped them to create a free common market.

Japan has been the economic leader of this region historically. Direct investment by Japanese companies has contributed to industrial division in the region since the 1970s. Although China is now the biggest economy in the region, the economic power of

Japan is still the strongest in terms of technology and knowledge, despite the lost two decades after the economic bubble burst at the end of the 1980s.

In 2014 China changed its attitude to push for a new relationship with Japan. Chinese political leaders recognized that China can play an important role with Japan as co-leader in the region, even though there are still some problems the two countries need to solve, such as views on history and island ownership. Xi shook hands with Abe during the APEC summit in Beijing — perhaps symbolic of a potential new relationship.

The issues of history and island sovereignty are very difficult to solve, but the real reason that the two nations' relationship has become strained is that they have positioned each other wrongly during the past decade. Abe has emphasized that Japan is prepared to build a strategic win-win relationship with China — a constructive message on creating new ties. But I still want to ask Abe how he will position China in Japan's diplomatic strategy, while Xi also needs to make it clear how China will view Japan.

In Chinese diplomatic strategy there is no doubt that America is the most important stakeholder. The US is the biggest export market for China, while China is the biggest investor in American debt. Although the values of the two countries are completely different on issues such as freedom of speech and human rights, they need to maintain a dialogue between their governments on strategic issues. Such dialogue contributes to mutual understanding. The US wants to see China integrated into the international community so that it will act in accordance with international law. Of course, the US understands that China cannot change into a democratic country in the short term and still has a long way to go to reform its political system. For China, only gradualism is feasible as a means towards political system reform. Given all the uncertainties in China, we cannot expect a sudden regime change and a soft landing together. But Xi has no other options if he refuses to reform the political system. Gradualism will not stop reform.

Finally, 2015 could be the year for Xi to start reform of the state sector and local government. But there are still many concerns about overall governance. Will Xi try to make himself a new "King" in China? Will the people be allowed to play a role in monitoring government officials? Such factors will be important in defining Xi's politics from now on.

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