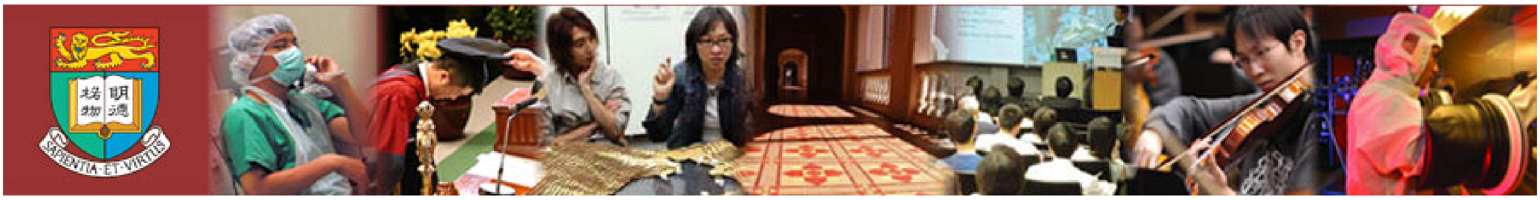

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CHINA’S ECONOMIC TRANSITION:
FROM WORKING DRAGON TO CONSUMING PANDA

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Chapter 1: Introduction

China has transformed from a post-colonial, isolationist developing country into one of the most influential nation-states on the planet. The Chinese economy has experienced incomparable growth in recent decades with an ever increasing influence on global trade, economy, finance, politics, and cultural development. After its economic growth rate peaked at 14% in 2007, the world’s second largest economy now faces an important transition. Until just recently, China's economic 'miracle' has successfully paralleled its drive for modernization based on a Three-Step Development Strategy. According to China’s official policy, the strategy has to be carried out as follows (CIIC, 2014):

“China's overall economic construction objectives were clearly stated in the Three-Step Development Strategy set out in 1987: Step One--to double the 1980 GNP and ensure that the people have enough food and clothing -- was attained by the end of the 1980s; Step Two--to quadruple the 1980 GNP by the end of the 20th century --was achieved in 1995 ahead of schedule; Step Three--to increase per-capita GNP to the level of the medium-developed countries by the mid-21st century--at which point, the Chinese people will be fairly well-off and modernization will be basically realized.”

China is currently in the last, and arguably the most difficult, step in the Three-Step Development strategy. The success of this last step is a determinant not only for ensuring social stability, the core objective of the Communist Party’s authoritarian governance of China, but also for the entire structure of international relations. As the Three-Step Development Strategy shows, this is to be achieved through the continuous improvement of the living standards for the Chinese population. This report provides a comprehensive review of the implementation of the third and last step of the strategy to ensure this objective. To this end, the following question will be answered:

Will China succeed in transforming its economy from a fixed asset investment and export-led growth model to a consumption-based economic model driven by its domestic economy?

Outline

Given that China is the most populous nation on Earth, this report will not give a detailed review of its economic development. The level of diversity from province to province makes a more generalized approach the only feasible option. The report, therefore, seeks to find overall trends in key issues, although with some inclusion of the development diversity factor when essential for analysis quality. Furthermore, this report does not cover all obstacles on the road to China's economic transition. This means that the report will focus less on the social and political consequences for implemented reforms, and more on the key hurdles that the researchers of this report found relevant to China's transition.

These hurdles fall into three sections:

1. The overall macroeconomic and financial framework of China.
2. Major socioeconomic factors and their relationship to China's development.
3. An analysis of the need for reforms in areas supporting China's development.

In each of these sections, an outline will be provided regarding the major problems within these fields after which an analysis will be given on how this will impact China's economic transition. These findings will be combined in the conclusion in which a definitive answer will be given to this report's primary question regarding China's economic future.

Theoretical orientation

This research paper will analyze China's economic policy. Each chapter will be analytically descriptive in order to study the link between policy and its real world impact. The problem with this approach is that each chapter has different criteria for the success or failure of government policies and varying levels of data availability; furthermore, each chapter is quite distinct in nature, making direct comparisons across topic areas difficult. In order to cope with these differences, each chapter will receive its own individual policy analysis, and the success or failure of these policies will be balanced against one another in the conclusion. This inclusive approach toward this research area produces more of a policy study rather than strict policy analysis.

Within the field of policy studies, this research will use a rational model in which the behavior of the state (in this case a unitary actor) is dependent on constraints and limitations (Simon, 1976). In the rational model, the consequences of policy choices are analyzed and compared to alternatives. This is exactly what this research paper tries to do: it looks at current Chinese policy and analyzes the shortfalls against what is actually needed. In short, the policy study will encompass a policy analysis in each chapter that roughly follows the following process: analyze the problem, determine what is needed to solve said problem, and describe China's current attempts at ameliorating the issue. Every chapter, however, structures this approach a little bit differently based on the available data and to enhance the quality of the policy analysis. When each of the policy analyses are combined, the major hurdles or choking points for China's economic transition can easily be deduced.

Research constraints

As stated above, this report uses a very narrow lens with which to analyze China's economic transition. This lens allows for generalizations regarding China's continental economy (a tricky proposition). This restricts the research, however, since even a 70-page research report does not do credit to China's massive economic structure. Important to note, therefore, is that this report looks at macroeconomic policies, financial trends, and other major socioeconomic trends rather than an in depth grassroots analysis.

A problem with this method, however, is that it is a very clinical approach to a very complex issue. No economy exists within a vacuum even though this report treats it as such. Outside factors such as Sino-US relations or other issues beyond China's control are not taken into account in this report. Domestic factors such as the rise of nationalism, which could influence China's policymaking ability, are also left outside of the scope of this research. In other words, this report does not take into account political or social (domestic or international) ripple effects that could influence China's ability to enforce its transition.

The final constraint is that there is a problem with the validity of data provided by the central government. Since data from the Chinese government is often published with a clear political motive, this leads to question the accuracy, reliability, and validity of said data. Since this report is analyzing trends as opposed to a definite economic analysis, this should not be an issue. Furthermore, where possible, data from other more reliable sources will be used to crosscheck the Chinese data. Another aspect that poses difficulty for this report is the vagueness of China's policy and its commitment to formal plans. China as an authoritarian state keeps policy plans abstruse and vague which leaves a lot of room for guesswork.

The combination of these constraints suggest that if the same style of report would be done in, for example, two years, the end result might vary quite dramatically. In order to alleviate this discrepancy, experts from various fields, consultancy companies, and research reports from reputable institutions that provide future projections will be incorporated in this report's research.

Findings

Our research concludes that China will be able to make the economic transition. There are, however, concerns with the quality and sustainability of the post-transition economic model. The government seems to lack commitment to a high quality sustainable growth model in the areas of socioeconomic development and supporting reforms. This leads us to believe that the quality of transition will be low and China's ability to sustain the post-transition model is in question. This opens up new fields of research that could analyze this possible post-transition model as well as the social stability of China's post-transition society.

Chapter 2: China's Economic Difficulties

The key aspects that would allow China to transition into a consumer based society are reforms in both the financial and macroeconomic sectors. According to the International Monetary Fund (2011a), China's financial sector is generally healthy but facing, "a steady build-up in vulnerabilities," with IMF Deputy Director of Monetary and Capital Markets Department Jonathan Fietcher saying, "China's banks and financial sector are healthy, but there are vulnerabilities that should be addressed by the authorities." Viñals and Singh (2011), their IMF report, included the following risks: "growing disintermediation by shadow banks and off-balance sheet exposures; a downturn in real estate prices; and the uncertainties of the global economic scenario." Not only the financial sector is at risk; China's growth model is also vulnerable during its economic transition. The current system of state-ownership needs to be reformed: labor costs in China continue to rise at 10% annually (Orr, 2014) while the return on assets is less than half of private companies (Budimaan et al, 2009). In order to deal with these rising costs and continue economic transition, the only option is reforming its entire economic growth model to allow for more of a market orientation.

The problem with analyzing both the financial and economic sectors is that China is largely still a planned economy, and is often been seen as a black box. Information given out by government leaders is often intentionally vague and abstruse; a promise made does not ipso facto mean it has to be kept. It is likely only months and years later, after policies have been implemented, that their effects can be seen and policy statements properly interpreted. With that in mind, this chapter aims to open the black box and analyze China's recent economic developments and predict future trends.

Section 2.1: Financial market reform

With China's economy likely overtaking the US' as the largest in the world sometime this century, likely within the next two decades, everyone has kept an eye on recent developments, progress, and possible risk areas within the Chinese financial sector. The drive for financial reforms is a process that has been going on for several decades; Viñals and Singh (2011) analyzed some of China's recent reforms and generally sees them as having a positive effect on China's economic transition possibilities (p. 1). Many of these reforms began after 2003 during the Hu Jintao and Wen Jiabao era. According the Financial System Stability Assessment (Viñals & Singh, 2011), the primary goals during this era were to, "enhance [the] financial sector's resilience," while also, "strengthening . . . financial institutions and improving market confidence" (p. 1).

There are still weaknesses in China's financial sector that need to be addressed in order for China's transition to succeed. The Financial System Stability Assessment (Viñals & Singh, 2011) had a number of recommendations to generally address these weaknesses including the continued commercialization of the financial system, allowing the market to influence money markets, increasing government regulation, creating a stronger financial framework that would be able to withstand normal shocks and corrections, and furthering support for insurance programs among others (p. 1). More specifically, Viñals and Singh (2011) urged Chinese authorities to allow the market to determine both the Yuan exchange rate as well as banking interest rates (p. 18). While there is no overall consensus on the likelihood of China overcoming said financial challenges, it can be agreed upon that there are several obstacles that could impede China's economic transition. Next to these factors, analysts are also concerned about the levels of local debt. This could prove to be a major destabilizing factor that needs to be addressed in China's drive toward economic reform.

The four biggest financial stumbling blocks for China this report has identified are as following: 1) the liberalization of the interest rate; 2) reform in currency and exchange rates; 3) the problem of shadow banking; and 4) local debt.

2.1.1: Interest rate liberalization

The liberalization of Chinese interest rates is seen to be the main solution for China’s financial challenges in general. It is also the most secure and profitable model for Chinese citizens looking to either deposit or lend money. In order to determine how China is approaching this task, it makes sense to visit a few of the financial issues that the country is facing. It is necessary to understand the differences between how China handles its interest rates compared to common financial policy in other countries. When you deposit money in a bank, the bank promises to pay you a certain amount of interest on that money. The bank then lends the money out to others at a higher interest rate. This is part of the bank’s profit margin. In just about every country, the “prime” interest rate is manipulated by a central bank. But in China, all the rates are controlled; both the deposit rate and lending rate. This has made depositing in banks unattractive for major business investments, wealthy Chinese, as well as the average Chinese citizen. This is aggravated by recent high economic growth in China. The following inflation has made the profits on deposits diminish as deposit rates are matched by inflation rates.

Figure 2.1: China's annual GDP growth rate, (www.tradingeconomics.com, 2014)

The decline in China's annual growth has accommodated or dampened the inflation. Still, the rigid interest rates and the expected marginal return make bank deposits unattractive. As the banks have sought to find a way to reverse this trend, the quest for higher interest rates has allowed for the spread of shadow banking. This issue will be analyzed later in this chapter.[1]

The International Monetary Fund's consultation report (2011a) also had quite a few recommendations. For starters, the Chinese government must push for a more modern, more diverse financial system allowing for market-based control over interest rates and other financial figures, and that these changes would require a stronger Yuan (p. 1). Though the IMF was reticent to make any major recommendations, saying, "There is no optimal, predetermined path that financial liberalization and reform should take in China and any plan should be flexible enough to adapt to unforeseen situations as reforms proceed," they in general still recommend, "appreciating the Yuan, absorbing liquidity and strengthening monetary management, improving regulation and supervision, developing financial markets and products, liberalizing interest rates, and finally opening up the capital account" (p. 24). As reported by Xinhua News Agency (2014c), some of the announced reforms by the government include the, "implementation of a proactive

[1] There are two types of shadow banking in play in China. A smaller share falls under the category Microlending. In simple terms, this is non-banks—private people—lending money at high interest rates to other people who cannot get loans from the banks. The potential for systemic harm is smaller than wealth management products; the only loss is to another private person. Since the scope is also smaller, this type of shadow banking is not a focus in this report.

fiscal policy and a prudent monetary policy," also laid out some goals the Chinese government will set for itself during 2014 including, "granting financial institutions more power to set their own interest rates," and "promote the healthy development of Internet finance."

The awareness of the risk in liberalizing the banking sector is evident. After the closing meeting of the second annual session of China's 12th National People's Congress, Chinese Premier Li Keqiang addressed the issue with a metaphor: "We are a developing country, but this is what we have to do, and we cannot let today's stepping stone become tomorrow's stumbling block" (Lui, 2014b). However, the process has clearly begun. In connection with the Congress, Li Keqiang announced that China will establish a deposit insurance system. This is a crucial factor in liberalizing deposit rates as a part of general interest rate liberalization (Lui, 2014a). In November 2013, clues were provided by President Xi Jinping who said that "the core issue is properly handling the relationship between the government and the market" (as cited in: Buckley, 2013). Debates emerged whether these political statements were to be seen implemented (Buckley, 2013). It seems that China is ready to put words into action in order to ensure liberalization by a China-trademark controlled process. Also during the second annual session of China's 12th National People's Congress, the governor of the People's Bank of China, Zhou Xiaochuan, said he expected that the to remove its ceiling on bank deposit rates as early as next year. He stated that this "final liberalization of deposit rates is the last step of interest-rate marketization" (Gough, 2014).

To summarize, China desperately needs to liberalize its economy and let market influences take the place of government plans. A report by McKinsey& Company (2006) noted that at that time, "increasing the operating efficiency of China's financial institutions and improving the mix of financing vehicles would boost GDP by $62 billion a year," while allowing more productive investment of capital could add another 259 billion US Dollars. The continued lack of variety in investment vehicles between now and then means that this money is left on the table. Furthermore, letting the market determine interest and exchange rates may, in the short-term, damage China's economy, particularly its slowing export sector, but a stronger Yuan will only help the country advance in an increasingly consumer-based economy that requires more diverse investment to grow. Liberalization of the interest rates is therefore a balancing act that could either launch China's economy into protracted growth, or it has the possibility of derailing China's current economic drive. As with many other endeavors, Chinese leaders seem reluctant to deal with this issue as swiftly as many economists would like, but at the very least, there are signs that this reform will happen in the near future.

2.1.2: Currency internationalization and exchange rates

China’s currency is a hot topic among world leaders. According to Holland and Mason (2014), American President Barack Obama recently, “urged Chinese President Xi Jinping to move his currency toward a more flexible, market-based exchange rate.” Despite external pressures, there is internal tension within China regarding the value and possible internationalization of China’s currency. The IMF’s Financial System Stability Assessment notes that, “the managed interest rate regime and exchange rate system has inhibited financial development and innovation” in China (Viñals & Singh, 2011: p. 18). Although China has made some progress in these areas, the IMF’s assessment program states that the, “intraday movements of the exchange rate of the Yuan against the US Dollar in the inter-bank spot market are limited to ±0.5%” (p. 18). This, along with other government regulated financial policies, in effect, stifle innovation and financial exploration by, “reducing the demand for hedging products,” though it does lower the risk exposure for both the exchange and interest rates (p. 18).

There have, however, been recent developments. The IMF (2011a) states that the international use of the Yuan has grown rapidly, primarily due to the, “expansion of the Yuan trade settlement,” representing, “around 7% of total trade” in 2011 (p. 13). The Yuan’s expansion into Hong Kong has also been noted where the Yuan represents, “8% of the Hong Kong deposit base,” in addition to the growth in offshore Yuan financial products with a growing number, “of instruments, spot markets, and derivatives now available” (p. 13). Clearly China’s Yuan is expanding into the world market, and the numbers suggest solid growth, but the picture is more complicated. The same IMF report (2011a) notes that most of the Yuan used, “for trade settlement remains very one-sided,” with most of the funds covering imports. Furthermore, the instruments mentioned above are still rather limited when compared to the amount of Yuan moving out of the country. This focuses the Yuan into, “the Hong Kong clearing bank” (p. 14). The amount of Yuan moving out in the world is not necessarily as useful as a financial tool as its volume might suggest and does not necessarily allow for the reinvestment of this currency back into the Chinese mainland as the funds find homes in other international products.

The IMF consultation report (2011a) states that this, “one-sided growth,” has put a great deal of, “pressure on international reserves and revealed the tension between achieving a greater global role for the Yuan at the same time as the currency is undervalued" (p. 14). The Chinese government insists that they are tracking the Yuan's use abroad, largely to confirm that these funds are being used in accordance with current regulations and, "only to finance activity in the real economy" (p. 14). The Chinese government, despite the call for Yuan internationalization, continues to manage the Yuan in order to "ensure stability" rather than risk possible, beneficial growth in risky financial adventures (p. 14).

Obviously the exchange rate plays a significant role in China's development. The IMF Consultation report (2011a) notes that the Yuan, "remains substantially below the level," of the optimal exchange rate (p. 18). Though there had been some recent developments in the Yuan against the US Dollar, the IMF notes that, "the real effective exchange rate has depreciated over the past year." Finally, the IMF feels that the exchange rate will continue to hamper the possibilities for investment and savings (p. 18). At the time, Chinese financial authorities largely disagreed with the IMF's findings. Chinese financial authorities stated that China needed more time to, "improve the mechanism for setting the exchange rate," and that the Yuan was continuing, "toward its equilibrium," and that this trend would continue through the near future (p. 19). What some may see as sluggish reluctance, the Chinese government merely sees as prudent financial strategy.

Chinese leaders continue to keep a tight grip on their currency, both in terms of its exchange rate and its internationalization. There is pressure from China's private sector to move toward these goals, but progress has been slow going. Chinese authorities have clearly decided that moving glacially is the correct choice, though this method runs the risk of stifling innovation and profitable investments that would help support China's economic growth. Indeed, it is difficult to know just how slowly China can move without stumbling over its own economic policies. Currency will continue to be at the forefront of a lot of international discussions but China will likely only move forward when it feels its export sector is strong enough to withstand the shock that appreciation will almost certainly bring. Currently there is no clear commitment which leads to the conclusion that in-depth currency reforms might be implemented later rather than sooner.

2.1.3: Shadow banking

The International Monetary Fund has provided a collective definition of shadow banking activity as "all financial activities, except traditional banking, which require a private or public backstop to operate" (Claessens, & Ratnovski, 2014: 1). In China, shadow banking deals with innovative wealth management products in the non-bank loan financial sector. They are issued by the banks as a way to create attractive investment products (Reuters, 2012). By involving systemic institutions, shadow banking poses a systemic risk in Chinese economy by making the Chinese government the implicit backstop guarantee (Claessens, & Ratnovski, 2014: 5).

Normal practice for Chinese banks does not apply if they are not dealing with deposits, but investments. Banks can charge whatever interest rate they want and pay out whatever they want. With such high payoffs, bank customers are demanding wealth management products. And wealth management products seem like a viable option as they are issued and/or backed by the banks or other "credible" actors in the financial sector (Claessens, & Ratnovski, 2014: 5). Although the customers are formally notified about important differences, the banks still present the wealth management products as deposits and not the investments which they in fact are. This is misleading as the customers are not guaranteed the principal, which is the norm. This is not a problem as long as the bank can still pay the principal plus interest to the customers as announced and advertised. Over the short-term, sometimes a few months, the investment has grown substantially. The customers give the banks money, the banks lend the money out, and the customers get their principal plus interest back when they are promised it. But the banks use the money to pay off other debt, effectively repackaged debt. And since the money is loaned to high-risk projects, a certain percentage of the money will be lost. So on top of amassing the funds necessary to pay back principals plus interest, extra money to cover the lacking inflow from bad investments is also necessary. In other words: What started as a snowball is turning into a monetary avalanche (Barboza, 2013). The recruiting for customers of shadow banking started in entities that cannot get cash otherwise. These are institutions, businesses, even occasionally government bodies. The financial gambling inherent in shadow banking is therefore a major threat for the Chinese national economy and the federal bank in the role as backstop. Shadow banking moves money away from the banks, where there are more government leverage and loaner security. If the financial avalanche stops rolling, the financial consequences could be devastating.

Because they are investments and not deposits or even consumer loans, the wealth management products have been flying under the government regulation radar. It is evident that China needs to make bank deposits attractive and stimulate lending diversity in order to shrink shadow banking. Such reforms will be beneficial for the average Chinese citizen through more diverse and safer financial products. This will lead to a greater public trust resulting in positive economic development.

The international financial society seems to be clear on how these problems are to be solved. As a highly credible stakeholder, the International Monetary Fund analyzed the impact of China's liberalization of interest rates. While the smaller banks would increase their deposit rates to attract customers, the major banks would lower deposit rates to reduce costs (Feyzioğlu et al, 2009: 8). This will change the stalemate and create increased competition among the banks to the benefit of the customers including average Chinese citizens. In 2011, the International Monetary Fund published an assessment of China's financial stability, based on the Financial Sector Assessment Program (FSAP) exercise for China by the International Monetary Fund and the World Bank. The assessment found that China's regulatory policies on shadow banking needed to be clarified. Also, better coordination, fewer legal restrictions, and more efficient communication between the People's Bank of China and central banks will be necessary to address this issue (Viñals, & Singh, 2011: 39).

In general, the assessment found that "reforms have progressed well in moving to a more commercially-oriented financial system" (Viñals& Singh, 2011: 7). However, it also pointed that China still faced "several near-term risks, structural challenges, and policy-induced distortions":

- "The effects of a rapid crisis-related credit expansion on credit quality
- Growing off-balance sheet exposures and disintermediation
- A reversal in rapidly rising real estate prices, and an increase in imbalances due to the current economic growth pattern" (Ibid.).

The assessment also pointed to a number of areas where reforms would address these challenges, generally following the outline of the 12th Five-Year Plan:

- "Deepening the commercial orientation of banks and other financial firms
- Moving to more market-based means of influencing monetary and financial conditions
- Continued strengthening of the capacity of the central bank on financial stability issues, and that of the supervisory commissions
- Further development of financial markets and instruments to deepen and strengthen China's financial system
- Upgrading the framework for financial stability, crisis management, and resolution arrangement" (Ibid.).

On March 13th, 2014, Chinese Premier Li Keqiang addressed further reforms at the closing meeting of the second annual session of China's 12th National People's Congress. Here is one of his statements: "Concerning financial risks such as shadow banking, we are tightening regulation and have set a timetable for implementing the regulative measures under the Basel III accord" (Lui, 2014b).

Among the purposes of the Basel Committee and the Basel standards is the decrease of capital risk (BIS, 2013). The Basel III accord seeks to further strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage (BIS, 2014). By seeking to comply with the Basel III accord, China sets a course to govern the risk factor within the financial sector. When in place, this will decrease the impact of any stress in the financial markets, which would include those stresses from shadow banking. Though liberalization of the financial sector is not yet evident, China is taking steps to tame the potential shadow banking crisis.

The first fundamental steps have been taken to create a bank sector matching the financial demands of the new growth catalysts in today’s China, especially regarding central issues as liberalization of the interest rates and constructing a stable foundation for the development. But the problems that the reforms seek to avoid are present, which is made obvious by the emergence of shadow banking and other hard-to-regulate financial solutions that are attractive alternatives to banks. They will presumably grow until the effects are implemented. Still, the huge risks of rushing reforms are imminent. Thus, reform of the bank sector is an area in which China cannot compromise. Shadow banking is an issue on a short-term scale for China to reach the goal of continuous growth for the middle class, but if China follows through on diminishing the shadow banking sector, there is a fair chance that this issue can be dealt with in due time.

2.1.4: Local government debt

Another major issue that economists and China analysts have focused on when discussing and predicting the economic future of the country is the amount of debt accumulated by local governments in China. Not only have they grown so much to be a national burden, they have also become an increasing international concern.

China published a national audit at the end of 2013 to measure the levels of local debts in the country. The document revealed that with various debt guarantees added to the total liabilities of local governments in China, their level of debt was equivalent to a third of the national GDP (The Economist, 2014b). However, this is not unmanageable and should not be alarming to anyone, as long as the situation is dealt with swiftly. The central government must implement mechanisms to monitor the situation and prevent local borrowing from matching recent dangerous levels. According to a report from the IMF released in January 2014, "China has already started the reforms to strengthen fiscal management, especially over local government finances" (IMF, 2014).

However, one of the biggest issues will be to change the local officials' mentality. Throughout the period of amazing growth based on the fixed asset investment and export-led model, local officials with the highest growth rate were rewarded and moved up within the Communist Party. This led local officials to support higher spending on their territory, disregarding the significant debt they were accumulating. One way the central government could put pressure on local governments to spend less is by publicly attributing the debt level by province, instead of giving only a countrywide level as it did in its recent audit document. This could prevent provinces like Guizhou from accumulating a level of liabilities to as high as 80% of its GDP over four consecutive quarters. Nevertheless, this remains manageable because under the Chinese model, the central government can assume the responsibility for local government debts. In fact, one of the categories of local debts as stated by the audit report is the "debt that the government may need to bail out," implicitly suggesting that the central government will not let the local governments default. In his report, "China's local government debt," Andy Rothman notes the importance of the link to the CCP on this. He writes: "The loans were made by Party-controlled banks to Party-controlled local governments, to fund construction of Party-approved public infrastructure. (…) There is no independent municipal legal, political or financial structure in China, with all local governments effectively an arm of the Party and the central government. [And] [e]very year, in its budget report to the National Peoples' Congress, the Ministry of Finance states that it will make up for local-level budget shortfalls" (Rothman, 2014). Given this assumption, the local debt level is not a significant issue for the Chinese economy or a major obstacle to the country's economic transition. As can be observed from the graphic below taken from Andy's Rothman's report, when combining the central government debt and the local government debt, the total debt to GDP ratio comes to 53.5% for 2012.

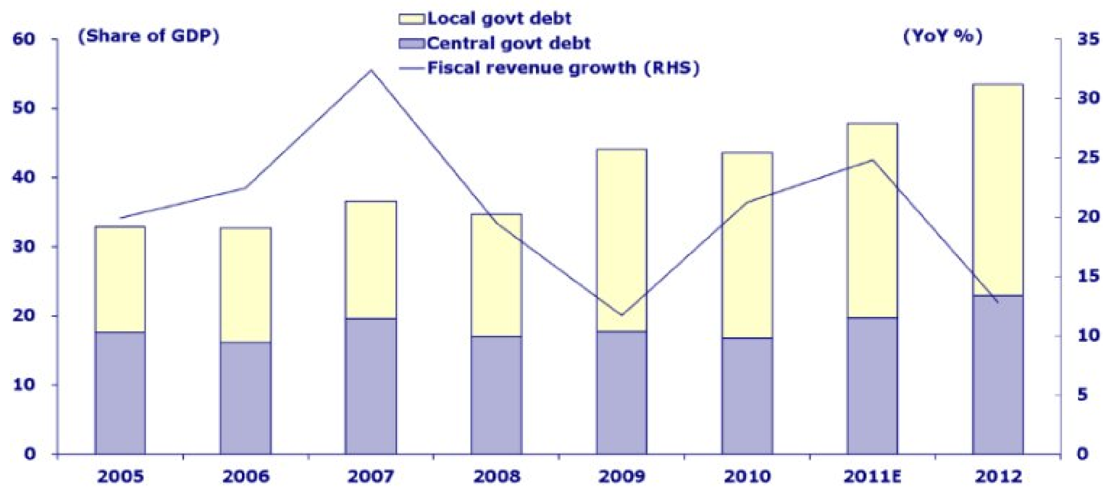

Figure 2.2: Government Debt, (Rothman, 2014)

This is not exceptionally high compared to other developed countries around the world. The next graphic below compiled using IMF data, puts well behind major global economies, including the United States, Germany, and Canada. In addition to this, we must consider that while China's economic growth rate is decreasing, it still remains one of the highest in the world.

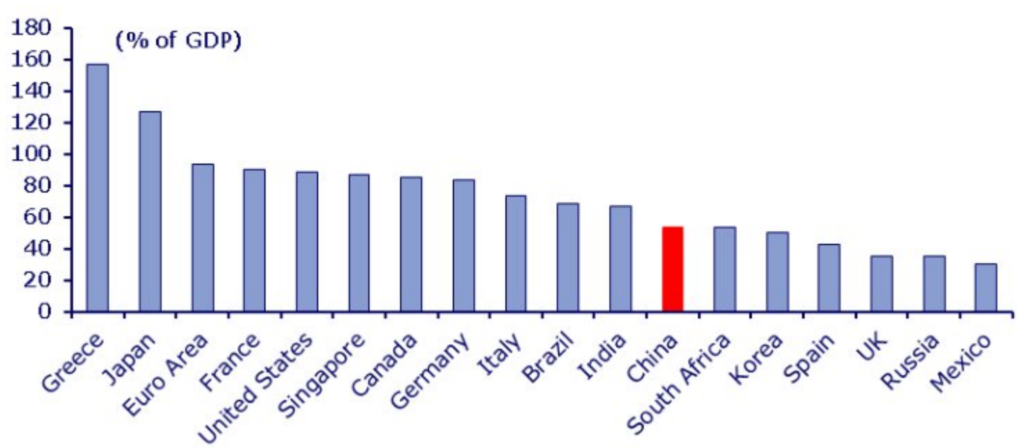

Figure 2.3: IMF general government debt/GDP in 2012, (Rothman, 2014)

Throughout its remarkable economic growth, a major strength of the Chinese model has always been the authoritarian regime that is leading it. With a central government that is running profits and pursuing economic growth, even if more moderate in the upcoming years, it is very difficult to believe that it will allow its local governments to default and jeopardize the success of the whole nation.

However, it is imperative that the Chinese officials act on this now. If the situation continues the way that it has for the past six years for only just a few more years, it may become a much more serious issue. The government is acutely aware of the importance of this issue and we expect to see reforms in the coming years, particularly increased transfers from the Ministry of Finance to local governments. A more recent government working report released by Premier Li Keqiang outlines a willingness to take on additional government debt, and a 13% increase in the monetary supply (Xinhua News Agency, 2014c). Whether this willingness can be transformed into a practical and efficient policy will be one of the key things to look for in 2014. At worst, China will allow a few local governments to default only to send the message that the practice of spending for political promotion is over or that it should not be tolerated when an irresponsible amount of debt is accumulated in the process. According to Tsinghua University Professor and former advisor to the People's Bank of China, Li Taokui, this is likely to happen sooner rather than later. "The only way to solve the local government debt problem is to allow some defaults to take place and to restructure the debt afterwards. This would be something that will surely happen in the second half this year" (Chan, Yu, 2014). However, the local debt issue is unlikely to ever become a systemic crisis for as long as the current political system remains stable. In this case, the Chinese model is actually an advantage for the country because borrowers and lenders are both under the ultimate control of the government. The shadow banking system should remain closely watched as it could come into play and pose an interesting dilemma to the government on this.

Section 2.2: Market orientation

A key element of China's economic transition is the shift to a market oriented approach. A big obstacle in this transition is China's dependency on state-ownership: 43% of China's profits in industry and business are by State-Owned Enterprises (Cary, 2013). The OECD has done research on the dependency on SOE's in country's economies; China tops this list with a score of 95.9 (on a scale from 0-100) (Büge et al, 2013). Looking at the graph shows this score in contrast to other (both developed and developing) nations.

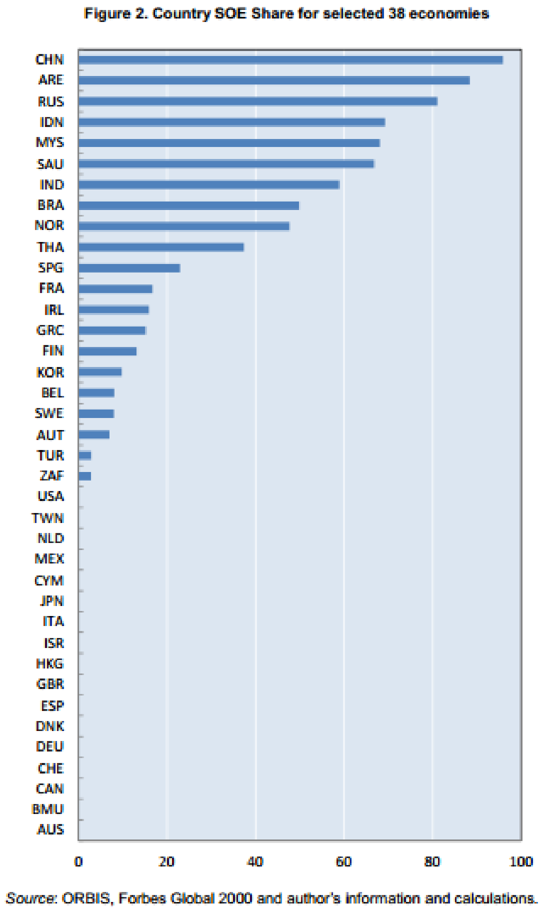

Figure 2.4: Country SOE Share for selected 38 countries, (Büge et al, 2013)

This state-ownership does not limit itself to industry but also extends into the banking system; the current market is therefore organized into a system in which state-ownership is encouraged, private ownership is discouraged, and business is government oriented instead of market oriented. It is clear that China is therefore in a unique position and needs drastic changes in order to follow through with the economic transition.

Where in the past the market played a 'basic role' in China's economy, the leadership has proposed reforms that would allow the market to become the decisive factor (Subler, & Yao, 2013). More importantly, clear deadlines for deep reforms have yet to be established. China is committed to reform and states in its Third Plenum that it wants to "set competitive business free" and eliminate sector monopolies (CCP Central Committee, 2013). Its strategy in establishing this is: 1) diversification of ownership 2) banking reform; and 3) market pricing of resources.

SOE dividend payouts	Increase dividend payout ratio for SOEs to 30% by 2020, from the current 5-15%
Market entry for private firms	- Implement franchise operations, and "formulate specific measures for non-public sector enterprises to enter into franchise business" - Abolish "unreasonable regulations" and "hidden barriers" for non-public sector enterprises - Separate infrastructure management from transport operation
Modify ownership of some state assets	Encourage "interlocking shareholding", esp. non-public sector stakes in SOEs
Separate government from enterprise	Separating government agency from enterprise and assets in naturally monopolistic industries
SOE reform	- Organize state-owned capital investment and operation companies - More public disclosure of SOE finances - Perfect the enterprise bankruptcy system
Simplifying approval procedures	- Reduce the number of items that require administrative approval - Replace "certification before license" with "license before certification" - Replace license for paid-in capital with registration of subscribed registered capital
Price reform	Price deregulation for energy and resource inputs, electricity, and telecoms -- retain price controls only for public utilities and services

Source: Decision on Certain Major Issues Concerning the Comprehensive Deepening of Reform

Figure 2.5: SOE reforms, (Koch-Weser& Salidjanova, 2013)

2.2.1: Diversification of ownership

What follows is a key element of the Third Plenum: "We must unwaveringly consolidate and develop the public economy, persist in the dominant position of the public ownership, give full rein to the guiding function of the State-owned economy, incessantly strengthen the vitality, control power and influence of the State-owned economy" (CCP Central Committee, 2013). This shows that even though China is committed to macroeconomic reform in the SOE and private sector, this reform will be severely constrained since SOEs will remain a pillar of the Chinese economy. Another constraint to SOE reform listed above is that the agency that implements these reforms has already outlined several limitations that are sector specific. The State-Owned Supervision and Administration Commission (SASAC) has stated that the sectors vital to national security will remain 100% state-owned. Furthermore economic 'lifeblood' industries will remain majority controlled by the state (Silk, 2013). While SASAC has not outlined criteria to what SOE belongs in either one of these categories, it shows some restraint in liberalizing the Chinese economy.

That these constraints could still provide a working model is proven by the success of Singapore's commercially oriented Government-Linked Companies. Indeed sources within the Chinese government outlined that Singapore's use of a government investment corporation to structure will be used as an example for China's reform process (The Economist, 2013).The diversification of ownership in China's SOE heavy economy means a two pronged approach: 1) encouragement of private shareholders in SOEs; 2) the stimulation of the private sector.

2.2.2: SOE private shareholding

"Reform towards fully mixed ownership will increase, in such areas as petroleum and petrochemicals, power and telecommunications," said Zhang Chunxiao, an adviser at the State-Owned Assets Supervision and Administration Commission (SASAC) which is responsible for guiding SOE reforms (as cited in: Miller, & Zhu, 2014). In order to evaluate SASAC's commitment to this reform, policy changes since the Third Plenum have to be analyzed. One of the energy sector policy changes is the increase in private shareholding in Sinopec, a super-large petroleum and petrochemical enterprise listed on New York, London, Hong Kong, and Shanghai stock exchanges ("About Sinopec", n.d.) Sinopec announced it would sell 30% of its marketing arm in a move towards fully mixed ownership in accordance with SASAC reforms (Miller, & Zhu, 2014). Even though the markets interpreted this as a commitment of China to SOE reform, other analysts are less convinced and expect Sinopec to use the revenue of asset sales to buy assets from its parent companies (Lim, 2014). The market is therefore highly skeptical of China's ability to evolve into a mixed-ownership economy.

It needs to be taken into account, however, that the Third Plenum's proposed reforms are still quite young and that at this point it is too early to draw conclusions due to a lack of policy changes.

2.2.3: Separation of government and enterprise

Even though the reform agenda calls for separation of government from enterprise, this point on the reform agenda dates back to 1993. This is followed by the formation of SASAC in 2003 which would separate direct state control and leave it to a state controlled agency to guide SOE reforms. The problem with these reforms is that it does not address corporate governance issues; SOE management is directly appointed by SASAC based on political considerations and power is highly centralized within these SOEs. The Third Plenum could result in drastic changes, however: not only has i announced a more market oriented approach for SOEs, the establishment of a board of directors i every SOE is also a clear sign that corporate governance in SOEs is changing (Bin, 2013) Furthermore the crackdown on corruption is expected to reach bureau level cadres in 2014 which wil mean a shift in leadership of the local SOEs (Keohane, 2014).

In order to increase the efficiency of SOEs, long-term incentive and control mechanisms will be implemented. Strengthening of investment accountability requirements and possible ways to disseminate more information to the public are also developed in order to increase market orientation (Steptoe & Johnson LLP, 2013).

Market orientation also involves forcing corporate governance to be more risk aware. China is notorious for bailing out companies that are on the verge of default; indeed, in China's modern economic history, no company has defaulted on its domestic bonds. Allowing defaults is vital in letting risk factors contribute to the pricing of resources and services; it will contribute to making companies in both the private and public sector more market oriented, which will increase the quality of China's growth model. It seems ironic that in order for China to show it is committed to market oriented reform, it needs to let parts of its economy fail. This creates a situation in which the default of a company means an increase in investors' trust in the economy. The first default of a major Chinese company occurred when a major solar-panel manufacturer could not make payments on its domestic bonds (Rankin, 2014). That the company is based in Shanghai is interesting since it shows that China is testing the default in a zone that can be classified as China's testing ground, to see what impact it has on the economy. Analysts are divided on the possible impact of defaults to the Chinese economy; while analysts of Barclays claim that the default reduces the risks of moral hazards and will create a healthy credit market, Bank of America analysts said default could be "China's Bear Stearns moment"[2] (as cited in: Gittleson, 2014). Since default is now an actual risk for investors, bonds will become more expensive, which can cause severe problems for companies in China (Desai, & Wilday, 2014). Allowing defaults, even though vital in China's process to become more market oriented, therefore has the potential of derailing China's economy. This means that 2014 will be the pivotal year in which China will successfully step in either the direction of a competition based economy, or a financial crisis.

2.2.4: Private sector

China's commitment to a more market oriented approach and the opening up of sectors that are dominated by monopolies means easier access for private enterprises into areas that were previously off limits to them. The touchstone of China's economy needs to be studied in order to see how China is structuring the opening up of monopoly industries. Shanghai is now regularly used as a pilot schem in which reforms are tested before being introduced to a wider range of cities. The governmen announced that it will open up seven telecommunication service providers to foreign capital in th recently established Free Trade Zone (Xinhua News Agency, 2014). Furthermore, they announced a the beginning of 2014 that it will enable Wholly Foreign-Owned Enterprises (WFOE) establishment i

[2] With "Bear Stearns moment" these analysts mean that it could trigger a market panic due to the default of a major enterprise

the Shanghai FTZ (China Briefing, 2014). The success of the Shanghai FTZ will influence China's commitment to reforms and determine the depth and width of these reforms. Even though this means that China still takes a very gradual approach to economic reform, the setting of a 2020 deadline means that more structural reforms will have to be implemented. A positive note in the reform debate is that the private sector has been steadily growing in the previous decade while SOE size has remained a constant. Furthermore, the contribution to GDP growth from the private sector outweighs the SOE contribution to the total GDP which means that the private sector is becoming more and more important for the quality of China's growth (Ying, 2013). The new diversification of ownership commitment in the Third Plenum will speed up the existing trend of private sector growth which will increase the quality of China's growth.

2.2.5: SOEs and banking

The emergence of shadow banking, outlined earlier in the financial chapter, demonstrates the necessity of reforms in the Chinese banking system if further economic development is to be supported and facilitated by the financial sector. If the right financial products are not available, the financial market is locked out of development, and the banks do not support the private sector, where development supposedly happens. Reforming the banking sector is therefore a key element in the diversification of ownership in China's economy. Currently the Chinese banking system gives preferential treatment to the SOEs, providing them with easy credit (Cary, 2013). As outlined earlier, these SOEs are a lot more inefficient than private companies. It has led to a disproportionate amount of non-performing loans. Indeed this 'easy credit' has been systematically granted to SOEs with a high default risk (Huet al, 2005).

Non-performing loans from the major banks are still a big problem, especially with regards to the lack liquidity options for a broader group of medium- and small-sized enterprises and private people. China needs to act in order to prevent a money flow out of the balance sheets of banks and into other sources of financial growth, as the emergence of shadow banking illustrates. China needs to take control of banking development by offering liquidity to a wider segment of society, rather than see non-bank financial sector establish a market of innovative business models that assume the role of banks. That might lead to the desired opportunities for growth of the middle class, but it is more difficult to regulate and contains risks for the situation to spin out of control (Barboza, 2014).

A McKinsey projection suggests "that the structure of China's banking market will continue to chang at an unprecedented rate as business opportunities shift from large state-owned enterprises to smal and midsize businesses and the newly enlarged ranks of middle-class consumers" (Liao et al, 2013) The 2011 International Monetary Fund assessment of China's financial stability hold recommendations towards a more market-based system that can facilitate this development. It point out a number of areas of policy reforms that will be needed to promote financial stability while supporting continued balanced growth (Viñals& Singh, 2011: 8p):

- Improved management of systemic liquidity
- Greater use of market-oriented monetary policy instruments, e.g. interest rates
- Broadening financial markets and services
- A reorientation in the role and responsibilities of government
- Replacing the use of the commercial banking system to pursue broader policy goals
- An upgrading of the financial infrastructure and legal framework.

The assessment stresses that these reforms are to be implemented at a pace that does not jeopardize stability. The foundation should be created through “functioning legal, regulatory, supervisory, and crisis management framework” before streamlining the banking sector for market introduction (Viñals& Singh, 2011: 9).

The World Bank also sees a strong effect and a long-term sustainability of China’s economic growth if the obvious reforms are implemented in China (The World Bank, 2014). The World Bank stresses that it would enhance incentives for private investment, especially in currently monopolized or concentrated sectors by (Ibid.):

- Removing entry barriers
- Simplifying approval procedures
- Reducing regulatory and administrative burdens
- Consolidating the business tax with the value-added tax will lower the tax burden and promote investment in transportation and financial services.

The World Bank has promoted a policy that would make more land available for commercial activities, thereby improving service sector growth. Still, The World Bank expects and acknowledges the reform process as to be “gradual, with more specific follow-up implementation plans expected as the year goes on" (Ibid.). Reform in the banking sector is intertwined with both SOE reform and the liberalization of interest rates, exchange rates, and shadow banking. Whatever happens in these fields will determine how successful China is in implementing reforms in the SOE banking sector.

2.2.6: Market pricing

Price regulation reform allowing for the market determination of prices is one of the reforms that wil affect the way SOEs can do business. It will enable SOEs to become internationally more competitiv since it is no longer constrained by domestic policy. Sinopec, for example, had some difficulty sinc the Chinese government outlined domestic energy prices instead of taking into account marke fluctuations (CNN Money, 2011). Deregulating the prices for energy and resources is a key aspect in providing incentives for SOE management to force SOEs to adjust for domestic and international competition. Price reform will also allow fair competition for private enterprises in a previous state monopolized sector. China's National Energy Administration has announced that it would allow private access to its pipeline system in order to let the market determine the allocation of resources (Ling, 2014). This proposed deregulation of prices will make it possible for private and foreign enterprises to be more competitive in the energy sector while also making SOEs more market oriented.

Chapter 3: Socioeconomic Developments

This report’s goal is to determine the future direction of China’s economy. As such, much of this report focuses on the economy itself as seen in chapter two regarding China’s economic difficulties. There are, however, other sectors of Chinese society that impact its economy. The Chinese government has made pulling the population out of poverty one of their top goals. China’s rapid growth from a developing country to the second largest economy in the world in just a matter of decades has been called a miracle. But GDP graphs and growth projections cannot tell the whole story. China’s population can be seen as an important, if not one of its greatest resources. With that in mind, it is important to step back from the direct analysis of China’s economy and analyze what role China’s citizens have played in China’s economic growth. Looking forward, China will attempt to transition from an export-led growth model to a consumption-based growth model. This requires new policies that will strengthen China’s growing middle class. These efforts are supported by a long running push toward urbanization which is regulated through China’s hukou system, or household registration system. This chapter deals with some of the socioeconomic issues tied to people and places as well as their impact on the future of China’s economy.

Section 3.1: Domestic consumption

Ensuring that citizens benefit from China’s transformation is the core strategy of China’s overall economic development. Simply put, this is where China must succeed. First and foremost, perceptible progress continuously legitimizes the CCP’s leadership within China. Secondly, increased wealth among the Chinese will itself act as a key catalyst for future growth.

Strengthening domestic consumption in China can be promoted through several different factors. For instance, trust in social stability and security will allow citizens to pull some of their capital out of savings accounts and aid economic development through other investments. This exact issue is covered in Social policies reform section of this chapter. This is the case with many other factors contributing to the total framework of strengthening domestic consumption.

3.1.1: Enriching households

The level of socioeconomic development throughout China varies widely; it is extremely complex, if not impossible, to give a nationally accurate definition for the middle class in China. This can be seen in China’s definition of range of middle class income according to the National Bureau of Statistics (Wang, 2010). Household annual incomes range from 7,250 US Dollars to 62,500 US Dollars, a testament to the difficulty in determining who is and who is not included in the middle class. It perhaps makes more sense to look at how a general increase of the middle class is being facilitated. The term “increase” applies to both quantity and annual income for households relative to current figures. It then becomes a question of a widespread boost of domestic consumption.

Domestic consumption is, in this case, defined as private consumption, which refers to the spending power of private households in China. If the household income share of China's GDP can be increased, this will lead to higher consumption. Such a development will support the transition of China's economy. It will promote an economy where domestic financial circulation will dampen the dependence on primary and secondary sectors of the economy to create growth. Even tertiary sectors of the economy will be boosted to accommodate rising consumption. This development will create jobs and also generate taxes.

With that in mind, the objective of this section is to investigate how skillfully China is at increasing the volume of private households that have sufficient spending power to contribute to the strengthening of domestic consumption. This socioeconomic group is universally defined as the middle class. Furthermore, this section will also investigate how China manages to increase spending power within the middle class. Finally, it will analyze how China creates more jobs for the ever increasing number of China's educated middle class.

3.1.2: Chinese consumption – not as bad as it looks

In the midst of China's economic growth, household consumption has not been able to keep up a proportional share of GNP. In 2005, household consumption fell below 40% of GNP. Numbers showed that this tendency could not only be explained by an increase in savings (Aziz & Cui, 2007: 3).

However, this is not necessarily an unsettling development. As Figure 3.1 shows, China's consumption is alive and well. It is merely the tremendous overall economic growth that dwarfs an impressing consumption growth. Still, measures can be taken to increase consumption's contribution to GDP. Thus, China has a strong incentive to facilitate higher spending by middle class households relatively to the future total economic growth.

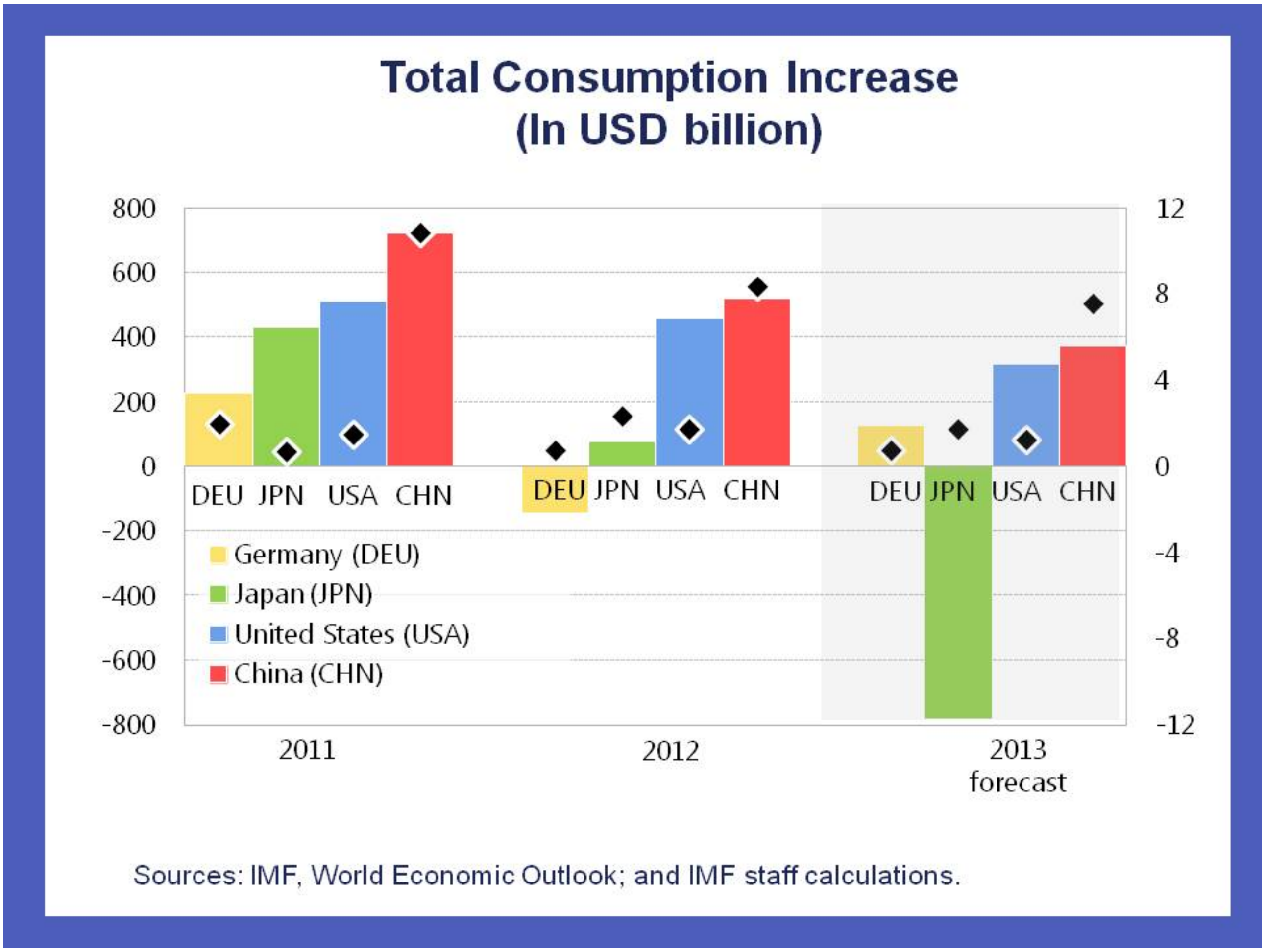

Figure 3.1: The bars show the increase of consumption in China and other major countries in USD. The dots show the real growth in consumption, (Barnett, 2013)

Household consumption contributes a low share of China's GDP especially when compared to countries with a similar GDP per capita, as Figure 3.2 shows. Even though soaring saving rates are blamed, this is not a sufficiently comprehensive answer.

Figure 3.2: China's private consumption compared to GDP per capita, relative to other countries, (Barnett et al, 2012)

3.1.3: Translating wages into purchases

In spite of rapid growth and economic development, poverty and income equality are still key issues in relation to the growth of the middle class (The World Bank, 2014f). The middle class's contribution to domestic consumption is impeded by an overall decrease in labor income. While wages themselves have grown faster than productivity, the employment rate has struggled to increase at a pace expected for sizeable GDP growth as in the case of China (Guo & N'Diaye, 2010: 7).

At the Third Plenum of the Chinese Communist Party's 18th Congress in 2013, President Xi Jinping outlined economic reforms that would allow market forces to play a pivotal role in the allocation of resources (Hui, 2013). This would result in drastic changes in the Chinese labor market. As wages increase, capital is to be invested in machines rather than manual labor to create the effective production that market forces stimulate. This will lead to much needed efficiency improvements in th primary and secondary sectors, with agriculture representing an important sector (Guo & N'Diaye 2009: 10). The following lower employment intensity of future growth is a major challenge that need to be overcome in order to boost the number of Chinese middle class citizens with money to spend.

Following this development, it is crucial to create new types of jobs for the large numbers of Chinese people that do not have a higher education. For this population group, the increase of employment must come from less conventional jobs in the future. Though a driver for GDP growth, the export-led secondary sector of the economy, manufacturing, has failed to create the employment opportunities necessary to facilitate a quantity increase in household income with middle class status (Guo & N'Diaye, 2010: 7p).

There is a need for political measures that will encourage employment growth in the tertiary sector, services, and the non-tradable sector overall[3]. China has been struggling to create a growth in the tertiary sector relative to the primary and secondary sectors. Great potential lies within the strategy of transferring low-educated labor force from the primary and secondary sectors to the more labor-intensive tertiary sector.

3.1.4: No jobs for brains

In order for this to happen, people first have to spend. Thus, it is a development that might have to be pushed from elsewhere. For this, look no further than the growing population group with a higher education; a high level of education ought to lead to a high income level to use for consumption.

China faces major obstacles for enabling the reliance on present and future higher education graduates to facilitate a consumption boost. Unlike with health care reform, education reform is not a problem the government can solve by just throwing money at the situation (Barnett & Brooks, 2010: 11). Well-funded schools and universities are important, but it is more a matter of developing a robust job market for the highly educated. In 2011, China had more than 30 million students enrolled in higher education, an increase of 35% compared to 2005. In 2010, the gross enrollment rate in China's higher education reached 27%, an increase of nearly 6% compared to 2005 (People's Daily Online Reports, 2011).

[3]The non-tradable sector is defined as the sum of the tertiary sector and construction in the secondary sector (Guo & N'Diaye, 2009: 4).

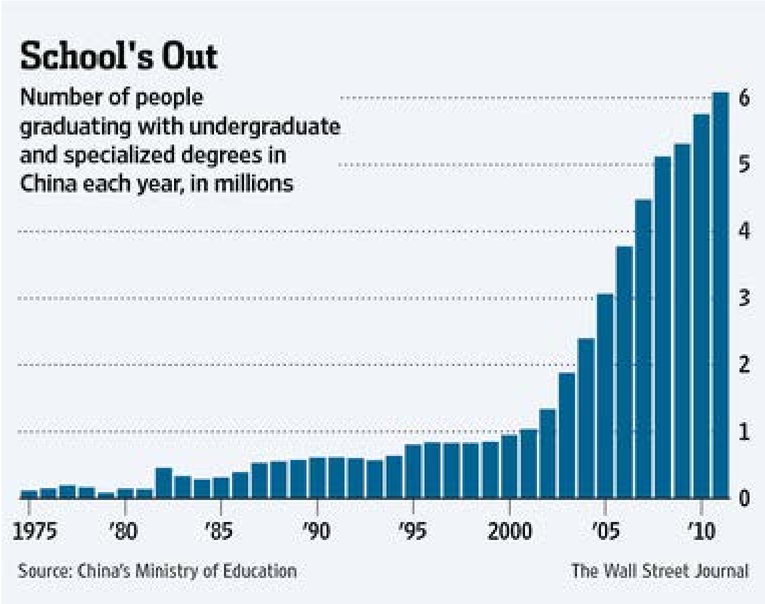

Figure 3.3: Number of graduates of higher education in China each year 1975-2011. The need for specialist job creation is ascending to match the number of both existing and newly graduated academics, (Lin, 2012)

This is a three-headed challenge. First, many young, talented workers with the capability to promote growth through R&D ply their skills abroad, supporting brain drain in China. Second, many highly educated graduates still choose the safe choice of SOEs[4]. Following the one-child policy, many graduates are laden with large family responsibilities. Ensuring that they can provide for themselves as well as their parents later in life, they strive for job security over other considerations. SOEs provide a safer choice than the private sector (Davis, 2013). Thirdly, with entrepreneurial and innovative minds immigrating or choosing to join SOEs, the development and growth within the private sector becomes marginalized.

[4] See Figure 3.4

Item	2008	2009	2010	2011	2012
Economically Active Population (10 000 persons)	**77046**	**77510**	**78388**	**78579**	**78894**
Total Number of Employed Persons (10 000 persons)	**75564**	**75828**	**76105**	**76420**	**76704**
Primary Industry	29923	28890	27931	26594	25773
Secondary Industry	20553	21080	21842	22544	23241
Tertiary Industry	25087	25857	26332	27282	27690
Composition of Employed Persons (total=100)					
Primary Industry	39.6	38.1	36.7	34.8	33.6
Secondary Industry	27.2	27.8	28.7	29.5	30.3
Tertiary Industry	33.2	34.1	34.6	35.7	36.1
Number of Employed Persons by Urban and Rural Areas (10 000 persons)					
Urban Employed Persons	32103	33322	34687	35914	37102
State-owned Units	6447	6420	6516	6704	6839
Urban Collective-owned Units	662	618	597	603	589
Cooperative Units	164	160	156	149	149
Joint Ownership Units	43	37	36	37	39
Limited Liability Corporations	2194	2433	2613	3269	3787
Share-holding Corporations Ltd.	840	956	1024	1183	1243
Private Enterprises	5124	5544	6071	6912	7557
Units with Funds from Hong Kong, Macao & Taiwan	679	721	770	932	969
Foreign Funded Units	943	978	1053	1217	1246
Self-employed Individuals	3609	4245	4467	5227	5643
Rural Employed Persons	43461	42506	41418	40506	39602
Private Enterprises	2780	3063	3347	3442	3739
Self-employed Individuals	2167	2341	2540	2718	2986
Number of Registered Unemployed Persons in Urban Areas (10 000 persons)	**886**	**921**	**908**	**922**	**917**
Registered Unemployment Rate in Urban Areas (%)	**4.2**	**4.3**	**4.1**	**4.1**	**4.1**

Figure 3.4: Employment in China. As the development shows, the primary sector holds a decreasing number as well as the total share of employed persons. State-Owned Units/Enterprises still create a large share of new employment, although private enterprises and units with funding from abroad, including Hong Kong, Macao and Taiwan, are seeing a steeper development of employment, (CSY, 2013)

Beyond these challenges, there are simply not enough jobs available for the many highly skille graduates. In 2003, 2.12 million Chinese academics graduated from domestic universities. In 2013 this number reached 6.99 million. According to a survey by MyCOS, a data firm in Beijing, in April 2013 shortly before graduation, 35% of these soon-to-be college graduates had found jobs. Among postgraduates, 26% had signed an employment contract (Gu, 2013). The postgraduate unemployment issue demonstrates the need for more opportunities in R&D or other specialized areas.

As the highly educated cannot find jobs matching their qualifications, they end up taking up lower skilled jobs that are also low-paid (Lin, 2012). Firstly, this development means that graduates are unable to earn as much and thus consume at the rate lower than their qualifications would indicate. They fail to deliver the consumption boost that should create jobs for people with no or lower education in the tertiary sector. Secondly, it means that the graduates occupy jobs for the less educated, who are supposed to boost the quantity of the middleclass and private household consumption, a trend that should have been appeared as the highly educated in high paying jobs consumed more, requiring more tertiary sector job growth.[5]

The challenges in producing employment opportunities are evident. The educational level is rising. The market forces will increasingly streamline and mechanize primary and secondary sectors to make them more cost-efficient and less labor-intensive. If the middle class is to grow and boost consumption, job creation is key. The focus must be on facilitating jobs for the highly educated as this will have a trickle-down effect for the rest of society.

3.1.5: A new understanding of xiaokang society

To truly boost middle class consumption, it is also important to look into developing the existing middle class. One method is to increase the quantitative size of the middle class as described. There is also a need to lift the economic latitude of the people in the middle class, vis-à-vis a qualitative improvement. The following section will analyze the emerging, lower middle class in universal terms.

In China, this social group is defined as "xiaokang", meaning "well-off and moderate prosperity". The term is deeply rooted in Chinese and Confucian culture as the understanding of working hard to acquire what is needed for the family to succeed (Xu, 2009: 1). The reforms, which started under Deng Xiaoping in 1979, borrowed the xiaokang term to describe China's ambition to end shortages of food and clothing, quadrupling the GDP of 1980 by 2000, and raising the Chinese living standard to a well off level.

[5]It is a small comfort that the graduates provide a labor force that excides the required qualifications for these jobs. Often, the graduates' prevailing theoretical qualifications are even leading to employers turning them down (Lin, 2012).

In 2000, the goals for the following 20 years were also defined as creating a xiaokang society. This time, the goal was “building a moderately prosperous society, or xiaokang society, in all aspects for the entire Chinese population that features accelerated economic development, enhanced democracy, advanced science and education, prosperous culture, harmonious society, higher living standard, more efficient use of resources and friendly environment,” according to Dr. Xu Xianchun, Deputy Commissioner of the National Bureau of Statistics of China (Ibid.).

In the area of economic development in China, Dr. Xu Xianchun mentions five indicators to review the development towards the new xiaokang ideal (Xu, 2012: 1):

- GDP per capita
- Share of R&D expenses in GDP
- Share of value-added of the tertiary industry in GDP
- Proportion of urban population
- Urban unemployment rate.

Dr. Xu Xianchun stresses the need for the GDP per capita to be quadrupled between 2000 and 2020 in order to facilitate a development towards the desired xiaokang society (Ibid.). According to data from the World Bank, this development is still on track with a GDP per capita in constant Yuan of 7,858 in 2000 and 23,441 in 2012. Still, China’s status as the second largest national economy in the world is not reflected in the GDP per capita. In 2012, China was ranked 83rd according to the World Bank (World Bank, 2014g). As for income distribution, the Gini coefficient publicized by China for 2013 showed that it is close to stagnation, and the wealth gap even increased according to most recent data from the World Bank in 2009 (Qi, 2014). The lopsided income distribution is an official concern for China, and the wealth gap might be even higher than the Gini coefficient released by China displays (Wang & Yao, 2013), which Dr. Xu Xianchun also indirectly mentions (Xu, 2012: 3). In a famously referenced quote, Deng Xiaopeng stated that some should be allowed to get rich first during economic development (Gittings, 2002). Now it seems that in order to raise living standards in overall society, China should not only turn to economic growth but also promote a higher level of egalitarian wealth distribution to achieve the xiaokang strategy.

The spending on R&D, measured as share of GDP, is, though promoted as pivotal, rather vaguely explained by Dr. Xu Xianchun (Xu, 2012: 2). He points out that it is hard to define the effect of R&D expenditure. This merely seems to cover up that it is also hard to make R&D expenditure result in growth and job creation in this phase of China’s economic development. According to data from the World Bank, China is increasing its R&D expenditure as share of GDP (World Bank, 2014c). When adjusted for the high-percentage GDP growth in China in recent years, it makes the increase even higher than the strict percentage increase would indicate. Still, as demonstrated earlier in this section

China is not able to offer a job market for the highly educated section of the labor force, which has a sizeable socioeconomic payoff. Instead, the socioeconomically advantaged graduates are a major liability to social stability, while causing imbalance in the remaining labor market (Bradsher & Wong, 2013). Putting R&D expenditure into more efficient job creation projects ought to be a focal point in the present xiaokang strategy.

The influence of a higher share of GDP growth stemming from the tertiary sector is consistent with findings described previously in this section. As the development towards a market economy occurs, automation of primary and secondary sectors will increase cost efficiency and decrease labor intensity. Thus, jobs need to be created in the tertiary sector, especially to accommodate citizens with lower education, professionally trained, or no education at all, the latter largely composed of migrant workers (Roberts, 2014).

The challenges related to the proportion of urban population, such as inflated real estate prices, urbanization, and social security safety net, are thoroughly dealt with in other sections of this report. To summarize the findings of these sections, there are many obstacles to be removed in order to cope with the continuous urbanization of the Chinese population, which a partisan Dr. Xu Xianchun deems as a progressive development (Xu, 2012: 2). The increasing share of the population living in urban areas also highlights the challenge of job creation, where less labor-intensive primary and secondary sectors are to be counterweighed by tertiary sector jobs. This combination of tertiary sector jobs in urban areas in itself will both create a base for continuous higher wages, but also a long-term systemic risk if the rest of the macroeconomic development does not succeed to match tertiary sector development (Baumol, 1967: 421).

The urban unemployment rate in China was in 2012 estimated to 4.1%[6]. However, the official unemployment rates from China are widely considered to be fabricated as artificially low (Rogers, 2013). With the present, relative to both other countries and China's GDP, low level of social safety net in China, it is pivotal to have a job to obtain a xiaokang lifestyle. The unemployed share of the population of course has a hard time to take part of the rise or to enter this social group. Instead, they become an economic liability for the state living on social security and possible demands for social/political reforms (Gotchar, 2008: 22). Combining the relatively low financial rate of this social security, desperate measures might seem as a tempting way out of penury. Joining organized crime e.g. begging (Gotchar, 2008: 31, 42), is only one example of the crime increase that stems from unemployment, social inequality, and lack of education (Cheong &Wu, 2013: 31).

[6]See Figure 3.4

To summarize the current situation for these five economic development indicators towards the desired xiaokang society, much improvement needs to be made in order to succeed and create this "well-off and moderate prosperity" society. This definition, however, seems to help the CCP to set a discourse to measure the success of its ability to create prosperity for the Chinese people: It is not about getting wealthy and living in abundance, but rather having enough to avoid a struggle to cover basic needs. This serves as a valuable tool to tame any debate about social inequality and redistribution of wealth and risk of social instability. Still, parts of the population are and will continue to struggle for the foreseeable future. Observing that others do not struggle, it might lead to social disturbances.

A "well-off and moderate prosperity" approach for the household incomes seems ineffective in creating a middle class with the economic latitude to boost domestic consumption. Instead, the government should focus on higher income equality through redistribution of wealth and create a labor market accommodating the qualifications of various social groups as they are to find their labor force eligibility in a Chinese economy and society in transition.

3.1.6: The price of a prosperous middle class

The key concern is, of course, whether or not this increased household income in a growing middle class will have an effect. In 2009, this matter was thoroughly dealt with by McKinsey& Company, a global management consulting firm for businesses, governments, and institutions (McKinsey, 2014). McKinsey& Company found that a consumer-centric economy would allocate resources much more broadly in the Chinese society and boost further economic growth (Devan et al, 2009). To facilitate this, China needs to improve its international relatively low consumption-to-GDP ratio. This can be facilitated by reforms in three key areas (Devan, Dobbs et al, 2009: 8):

- Enable consumer spending
- Improve the social safety net
- Rebalance investment and income.

Although the areas of social safety nets and investment and income are somewhat processed in this section, other sections in this report handle these areas more comprehensively. The focus in this section is consumption, and McKinsey& Company define two major policy focal points that ma trigger higher consumer spending (Devan, Dobbs et al, 2009: 12):

- Expanding the availability and improving the quality of products
- Increasing the availability and uptake of consumer credit.

While the latter is analyzed in the interest rate liberalization section of this report, the relevance o supply and quality of domestic products is a very relevant factor in China. For instance, several food related scandals have hit the media, with tainted milk powder being the most prominent and persistent including severe influence on the global market (*The New York Times*, 2014). Also the Chinese auto industry has been taking blows for disregarding safety issues (Shirouzu, 2012). McKinsey & Company points out the value of a rising tertiary sector to boost a consumption growth and employment, as earlier concluded in this section (Devan, Dobbs et al, 2009: 13). McKinsey& Company finds that shaping a middle class spending increases will fuel future growth in China.

3.1.7: A government shift towards promoting consumption

Recently, Chinese leaders have put their words of concern into action in this area of economic development. After the second annual session of China's 12th National People's Congress in March 2014, Chinese Premier Li Keqiang gave a progress report on the government's policy concerning boosting household income and the middle class. Here, he announced it was the government's goal to create 10 million more jobs this year (Yi, 2014). Premier Li Keqiang mentioned three major tasks in social policy (Hui, 2014b), all very much in line with the xiaokang society idea:

- Meet people's basic living needs
- Provide the last resort for people to fall back on in case of special difficulty
- Promote social fairness.

Fluffy as this might be, the statements show an acknowledgement of the problems at hand. The progress report stated that the key to stable growth was to shift the growth away from the export- and investment-led model and let domestic demand be the "main engine" that drives growth and investment (Hui, 2014a). The need for reforms seems to be evident to the government. Various steps have been taken to regain consumer trust in domestic products, among them a focus on food and drugs (Chen, 2014)

However, there are signs that the government has not yet understood the problems of facilitating middle class job creation and thus fighting unemployment. Li Keqiang mentioned his ambition of increasing the number of rural students from poor areas that enroll in top-tier higher education institutions by 10% (Hui, 2014b). With the existing problems of employing higher education graduates in mind, this policy is not launched with due care and a sense of the actual needs for the middle class. More targeted policies are therefore needed, especially with the diversity of China's middle class in mind (Barton et al, 2013).

3.1.8: Looking forward on issues of domestic consumption

In short, China needs to promote both quantitative and qualitative growth of the middle class in order to boost domestic consumption; however, despite tremendous economic growth, this area has been somewhat neglected. The best way to achieve higher consumption is to secure employment in the tertiary sector, as this will facilitate domestic consumption and take over job creation from the market-reformed primary and secondary sectors. This will support the development of the tertiary sector, as higher rates of consumption must be initiated by a socioeconomically advantaged upper middle class, which should consist of the ever-increasing number of highly educated Chinese citizens. Unfortunately, the Chinese government has so far struggled to create the sufficient amount of high-skill jobs. This has stifled the trickle-down effect in the general labor market and is a liability to social stability.

The xiaokang society has a rather long tradition in Chinese culture. Though plans have been put forth that would promote the promotion of the "well-off and moderate prosperity" ideals, the current 20-year plan for this strategy faces major challenges. These plans are unambitious in terms of making domestic consumption large enough to be a driver for future economic growth. Instead, the Chinese should do everything to promote domestic consumption through policy-making and increasing consumer trust in consumption. The Chinese government has clearly understood the magnitude of this policy area. But it is still doubtful whether the right strategy will be implemented in time.

Section 3.2: Space and migration

China's economic success may well rest on its middle class and how successful the Chinese government's policies are in supporting and strengthening this burgeoning section of their society. There are a number of related issues that need to be explored in order to understand how the Chinese government is addressing this area of growth. Some of these issues include the real estate market, with the ever looming possibility of property bubble, as well as China's push toward urbanization, which will likely require a reform of the hukou household registration system. These issues are discussed in detail below.

3.2.1: Real estate

There has been much speculation regarding the possibility of a Chinese property bubble. Krugman (2011) compared China's property bubble, largely fuelled by rapid credit growth in shadow banks, to the Japan bubble of the 1980s and the US bubble of 2007. The IMF's consultation report (2011a) lists the property bubble as one of the, "near-term domestic risks" to China's financial sector alongside, "a decline in credit quality linked to the post-crisis expansion in lending" (p. 1). This same report state that, "a property bubble would pose serious macroeconomic and financial stability risks" (p. 9) Though there is not necessarily a consensus on the weakness of the real estate market, Xinhua New Agency (2014a) notes that the, "China Bank Regulatory Commission will keep a close eye on majo housing developers, and reduce the risk of default through weak links in the construction industry' money chain." Clearly problems with the real estate market in China have much to do with shadov banking, discussed in chapter two of this report, but China's property market still deserves closer inspection.

The IMF (2011a) states that the government has recently done quite a bit to decrease the growing property prices, with much of the curbing coming from the, "restrictions on purchases of properties for investment purchases" (p. 9). This same report has also found that Chinese citizens have been moving from purchasing to renting property, and while commercial property prices have continued to skyrocket particularly in China's coastal regions, the Chinese government has continued to tacitly adjust the housing prices by building housing for people with lower incomes (p. 9). This is seen simultaneously as a social good for China's citizens, a means to reduce housing demands that increases property costs, and likely serves as an important driver for China's GDP growth through construction.

Setting aside the issue of construction and demand, the IMF (2011a) has remained concerned about the cost of housing to total household income, a situation that may lead to loan defaults and the dreaded property bubble (p. 9). This may be disastrous as the, "property sector occupies a central position in the Chinese economy, directly making up 12% of GDP and is highly connected to upstream industries (like steel and cement) and downstream producers of appliances and other consumer durables," while also representing just under 20% of the credit portfolio for Chinese banks (p. 9). Property is clearly big business in China.

Despite the rather grim news, the IMF did not forecast an immediate implosion of the Chinese housing market in their 2011 consultation report. Though the amount of funding flowing into property, largely from a lack of alternative investment opportunities, and the property developers overinvesting in land, government authorities have begun to address the risks, emphasizing the need for fair housing prices as a means to redress, "inequality and social stability" (IMF, 2011a: 9). Furthermore, Chinese authorities will continue to build homes for lower income families for the foreseeable future, aiding the growth of property while keeping prices low thanks to government-controlled growth of the supply of homes.

Another important area of change is tied into social trends. Chinese citizens switching from homeownership to renting may impact social stability as citizens find the Chinese Dream harder and harder to attain, but it will at least reduce the possible number of failed loans that might impact China's banking system.

Again, it is important to stress the interconnectedness with shadow banking and the real estate market. Provided more people can get access to safe, fair loans, and are not reliant on unregulated and unsafe shadow banking systems, the property sector will hopefully remain stable for the foreseeable future. A liberalized economy that allows for additional sources of investment outside of property and other immature investment instruments will hopefully prevent the much bemoaned property bubble. The real estate bubble is therefore heavily dependent on the success of other reforms outlined in the previous chapter. It substantiates the argument that a failure to implement in-depth reforms could derail both China's financial and social sectors.

3.2.2: Urbanization

Urbanization is a fact of life in China. It has been happening for decades and will continue to into the foreseeable future. The issue at hand is whether or not urbanization helps or hampers China’s economic development. Though some reports show that urbanization is not a direct driver of an economy, urban areas are important to any modern economy because they allow for the efficient dissemination of public goods and services while also being the base for most economic development. Chinese leaders recognize the importance of urban areas, and have been promoting them through national government policies, but there have been setbacks. Poorly implemented urbanization plans, often coupled with corruption among business and political leaders, has led to a rather haphazard effectiveness of urban areas and has only highlighted issues of income disparity as well as regional favoritism. Moving forward, China needs to ensure that their cities become efficient, ideal places to live rather than simply throwing money at city leaders and hoping they can keep the economy afloat.

Definitions: urban, urbanization, the hukou system

The first step in understanding China’s urbanization process is to understand exactly what is meant by the terms “urban” and “urbanization.” To put it simply, “urban” in an area related to a city, while “urbanization” often implies the spread of a city and its components (i.e. buildings, services, and population) into lower density rural environments. There are a number of factors in China that make determining what is “urban” and what is “rural” rather difficult to separate. Accounting for the process of urbanization, representing the outward urban spread pushing into rural areas, also complicates the definition.

The story of China’s modern urbanization trend begins in the post-Mao era. Chan (1994), analyzing urban data from the early 1980s, notes that at that time there were, “two types of officially designate urban places,” namely, “cities (shi) and towns (zhen),” (p. 248). The difference between cities, towns and other rural areas is important since, according to Chan (1994), these designations exist within government hierarchy whereby urban areas receive greater, “access to larger state financial resource for urban infrastructure, food subsidies for its resident, industrial investment, and [allows] the loca government a greater autonomy to raise certain taxes” (p. 248). Larger urban areas have greater acces to funds than smaller towns and rural settlements.

The city/town system is further complicated by additional subcategories beneath the city and town headings. According to Chan (1994), there are a number of provincial-level cities (e.g. Beijing, Shanghai) that are directly controlled by the Chinese central government, prefectural-level cities that are controlled by provincial government, and county-level cities that are likewise administered by sub-provincial authorities (p. 248). These extreme subdivisions complicate matters since, as Chan (1994) notes, cities at the provincial and prefectural levels may cover such a wide area-- usually divided into districts and suburbs-- that they actually include areas "predominantly agricultural in nature" (p. 251). In short, referring to a "city" as designated by the Chinese government may not present an accurate picture of a strictly urban environment.

Government officials and scholars alike seem equally frustrated by these difficult, contradictory divisions. Chan (1994) states that separating the rural from the urban became, "harder in the post-Mao era as the previous policy of rigidly segmenting the rural and urban sectors gave way to more flexible policy" (p. 257). Since then, though, the Chinese government has continued to refine its census statistic data and has introduced a number of additional "settlement subdivisions" (Chan, 1994: 257). Not wanting to go into too much detail, it is important to remember that the term "urban" in China, particularly as it applies to large areas with sizeable populations, must be viewed skeptically.

Though perhaps less statistically problematic than the term "urban," the word "urbanization" can also be rather difficult to pin down. Chen (2006) defines urbanization as the dual processes of "urban population growth," and, "the expansion of urban areas themselves" (p. 101). It is important to note that these two activities are neither identical nor mutually exclusive. Urban population growth normally means the migration of rural residents to urban areas. The expansion of an urban area might also include elevating a town to a city using the government nomenclature, or expanding the city limits that divide an urban area from a rural area. In this second definition, the spatial expansion of a city's area of control, the city would also capture anyone residing within the newly defined city territory, thereby simultaneously increasing both the city's land area and total population. People tend to think of China's urbanization growth as vertical, and with the number of skyscrapers growing day by day, that perception can perhaps be forgiven, but urbanization is also horizontal as rural land is devoured by urban sprawl.

Still, the urban population explosion is an important factor to track, something the Chines government knows well. Chen (2006) states that China uses a "hukou, or household registration, system (p. 101). It was designed by the Maoist era government as a tool to, "regulate and restric population mobility and was one of the . . . instruments used by the Chinese government to push cras industrialization" (Chan & Buckingham, 2008: 587). Chan and Buckingham (2008) go on to note tha even 50 years after the hukou's inception, "students in China consider the hukou, along with gender, age, and income, as one of the main variables defining exogenous constraints on individual behavior" (p. 582).

Chan and Buckingham (2008) state that the hukou system differentiates between urban and rural residents, largely in a discriminatory fashion, and determines access not just to right to settle but also, "basic welfare and government-provided services enjoyed by urban residents, ranging from small things like being able to buy a city bus pass," to larger issues like, "enrolling their children in public schools in cities where their parents work" (p. 583). The hukou system effectively keeps rural residents, "out of many urban jobs, except for those considered 'dirty,' dangerous or very low paying" (Chan and Buckingham, 2008: 583). The hukou system has not, however, prevented millions of rural migrants from flooding into cities in search of employment and opportunities that are simply unavailable to them in the poorly funded rural areas.

Much like with issues of defining urban and urbanization, the hukou system presents a number of problems when addressing the wider issue of urbanization in China. If a rural resident moves into a city illegally, without altering their hukou status, would they be counted among the rural population, the urban population, or both? Population statistics, even official government figures, should be considered critically, but for the sake of this report, the larger trends remain evident and important.

Modern urbanization trends

Looking back into China's recent history, the 1990 urban population in China was around 301 million. According to Chan and Hu (2003), pulling data from a number of sources including China's national census, there were just under 302 million urban residents in China (26.41% of the total population at that time) by year's end; but by the year 2000, that number rose dramatically to just over 459 million urban residents or about 36% of China's total population (p. 58). Yearly urban population increases during the 1990s ranged anywhere from .59% to 1.42%, not quite the brisk rush into cities that occurred during the post-Mao era in the late 1970s and 1980s, but still quite significant.

In 2010, with November 1 as the final deadline, China's National Bureau of Statistics completed the sixth population census. According to the census figures, from 2000 to 2010, the urban population of China rose from around 459 million people (36% of the total population) to just over 665.5 million urban residents (49.68% of the total population). This is an increase of around 207 million people representing an increase in the urban population of 13.46%.

Though the Chinese government will not perform another official census until 2020, the World Bank (2014g) predicted that at some point during 2010, China finally crossed the urban/rural divide with more than 50% of its citizens living in urban areas. The World Bank's most recent figures from 2012 suggest that around 52%, or approximately 702.5 million people, now live in China's urban areas. Lall and Wang (2012) note that as of 2012, one out of ten people on the planet now lives in a Chinese city (p. 1).

Urbanization costs and benefits

By this point, it should be clear that despite a number of issues, China will continue to urbanize for the foreseeable future, though not at the brisk pace that occurred during the post-Mao era. What impact might this seemingly inevitable trend have on China's economy moving forward into the 21st century?

Lall and Wang (2012) note that cities are often economic drivers, stating that in China, "Economic prosperity is concentrated in large cities," with 76% of urban exports coming from major cities while another 62% of total foreign capital investment occurs in these same larger cities (p. 2). Lall and Wang (2012) also state that, "A city's manufacturing employment share, urban clustering, and access to international market are highly correlated with urban productivity" (p. 4). Bloom et al (2008) outline a number of reasons why urban areas are advantageous for economic growth: they allow for, "concentrated economic activities," "offer large and diversified labor pools," allowing for specialized industrial operations, efficiently disseminate public goods like transportation, education, and housing, as well as capitalize on the innovative ideas that might arise in an area of highly concentrated talent (p. 772). The World Bank (2014f) largely agrees, referring to cities as the most efficient ways, "to provide water and sanitation to people living closer together, while access to health, education, and other social and cultural services is also much more readily available."

Despite these possible benefits, Bloom et al (2008) found that even though, "a country's population living in urban areas is highly correlated with its level of income," there is in fact, "no evidence that the level of urbanization affects the rate of economic growth" (p. 772). Though a contestable claim, there is evidence to suggest that urbanization is a byproduct of economic success rather than a core driver perhaps particularly in the case of China. Though urbanization is incredibly important for an economy, particularly as it relates to creating a domestic consumer market, urbanization might better be conceived as an organic offshoot of traditional economic success. That being said, Bloom et al (2006) insist that though, "urban development is important," and the needs of the world's urban population will require skillful governmental regulation, the outcome of their research states, "that policies specifically aimed at accelerating, or retarding urbanization are unlikely to speed up economic development" (p. 775).

Bloom and his team's findings are supported by China-specific examples presented by other scholars Chen (2006) states that, "the urbanization rate in China has lagged behind the rate of industrialization that is measured as the proportion of GDP contributed by the second sector (i.e. manufacturing, construction . . . roughly, service)" (p. 101). People moving into the cities are not able to contribute as much toward economic growth as their numbers would suggest. Despite a more liberal economic market, foreign direct investment, and China's own domestic economic plan, urban industrialization has not been able to keep pace with the number of citizens migrating into the city. Here we can see the logic of the hukou system that was used at least in part to control these potentially contentious population flows. But government plans do little to stop the movement of people looking for a better life.

Furthermore, China's GDP continues to rise and will likely do so for the foreseeable future, but there is a growing disparity between provinces as well as within them. Chen (2006) notes that many provinces and larger cities along the eastern seaboard, "have the most highly urbanized populations and industrialized labor forces," while much of the rest of the country, "western provinces, autonomous regions," and mountainous regions have comparatively low numbers of urban areas and industrialized labor forces. These two trends, broadly speaking China's richer east versus China's poorer west, roughly correlate, "with both regional and within-region income disparities"; in effect, the rural/urban income disparity in richer provinces is much lower than the income disparity in poorer provinces (Chen, 2006:105).

Yang (1999), analyzing the issue of income disparity, states that this, "rise in sectorial disparity has resulted from increased urban subsidies, investments, and credits, which have affected higher inflationary taxes on rural earnings" (p. 310). Yang (1999) goes on to note that the income disparities that exist between the eastern cities and provinces and the western regions have not only immediate effects on the, "economic incentives of the workers," but also impact, "the human-capital attainments of their children, which may further widen the rural-urban income gap" (p. 310). Again, the efforts of Chinese government to support both the economic and social wellbeing of their citizens by promoting urbanization in its many forms can be seen as having a somewhat detrimental effect on economic growth as it relates to disadvantaged rural residents and their children. This has the potential to spiral outward into future generations and affect China's national economy by decreasing the diversity of its labor pool in a time of slowing urban growth.

Chen (2006) largely concurs with Bloom and his team's assessment in that, "top-down governmen initiatives, such as upgrading towns into cities," thereby giving them access to more funds and ideall creating higher degrees of industrialization, is a tactic that needs to be reassessed (p. 125). In the cas of Fujian Province, Chen's (2006) area of study, more attention should be paid not to force industrialization but to urbanizing in such a way as to address, "the challenge of transforming a low value-added economy" (p. 125). It is not simply a matter of reorganization and funding. Urbanizatio campaigns must be conceived of and implemented in an intelligent and reasoned way; China cannot expect to throw money at cities and hope for them to become successful.

Again, China's national GDP continues to rise, and industrially-linked urbanization has played a major role in this rapid growth, but zooming down even to the provincial level of analysis creates a different picture of very disparate economies with sharp distinctions between the rich east and the poor western and autonomous regions. While GDP growth continues to trend upward, this disparity may go unnoticed, but income disparities may lead to future labor issues that may hamper continued, necessary growth. Social stability will also be affected if the CCP's urbanization policies—almost certainly harmful to the environment and likely to produce feelings of disenfranchisement—cannot meet the primary goal of pulling its population out of poverty.

Urbanization recommendations

Both as a matter of policy and as a matter of necessity, China will continue its process of urbanization, though at a slower pace than in the past. Still, Lall and Wang (2012) note that by 2030, around 1 billion of China's citizens will live in urban environments, an increase of almost 300 million over today's current urban population (p. 1). The Chinese government's push toward the city is understandable in light of the difficulties of doling out public goods to a rural populace. And as stated above, though urbanization appears to be more of an outgrowth of economic growth rather than a cause, it creates interesting opportunities for industrial specialization. Still, the process of urbanization in a country the size of China needs to be studied, analyzed, and regulated with caution and care.

Rural residents, deprived of the relative abundance of public goods and job opportunities available in urban centers, will continue to migrate into the city in defiance of their hukou status. Surely some of the migrants will do well and succeed in this endeavor, but many will end up in difficult and dangerous jobs while their families and the workers themselves will continue to have limited access to public goods. This lack of access in urban areas, coupled with de-urbanization in rural areas and continued income disparity, has the potential to damage both the current labor pool as well as future generations not to mention the impacts on society.

Clearly the hukou system needs to be reformed. This reform would not only create more socia stability by dealing with income disparity, but would allow for the freer flow of labor around th country, letting migrants go where they are needed rather than where they might be able to mor immediately find work and possible access to social support. There has been progress in this regard According to the World Bank report (2014e), cities may soon be abandoning the hukou system an moving toward a system, "based on residency, allowing [cities] to eventually provide 260 millio migrants with basic public services." More information on possible hukou developments will be lai out in the following section of this report. Regardless, the best laid plans of the central government may end up falling apart due to corruption, poor management, or profit-seeking predatory organizations; this is the danger of forcing urbanization in an inorganic fashion and expecting urbanized regions to succeed. The wave of urbanization shall continue, and provided China does not succumb to this wave, economic progress will not likely be hampered greatly in the near future.

Even as reforms in the cities move forward, China may continue to urbanize rural regions, a tactic that may backfire. Liu et al (2004), studying urbanization in the Three Gorges Reservoir Area, suggested that government leaders pursuing industrial development in their areas consider, “whether or not industry can provide enough jobs for rural laborers,” while also coupling this trend with additional educational opportunities in the area which would allow for new arrivals from rural areas a greater capacity to work in other non-agricultural jobs after the macro engineering projects are completed (p. 233). Education for the rural worker’s children might also be an ideal investment in the region’s future.

In March of 2014, Chinese Premier Li Keqiang released a government working report that outlines a wide range of domestic goals for the upcoming year. Xinhua News Agency (2014c) highlighted some of these goals: the addition of 10 million urban jobs, ensuring urban unemployment does not rise above 4.6%, and an investment of 457.6 billion Yuan into government projects in the less developed central and western regions of China. Xinhua News Agency (2014c), quoting the government report, noted that, “carrying out a new type of people-centered urbanization” would be a major task in 2014. China Daily (2014), quoting information released by Xinhua News Agency, stated that this new form of urbanization would, “grant rural people who live in the cities more social welfare,” currently denied them due to their hukou status; furthermore, Premier Li promised that the central government would, “grant urban residency to around 100 million rural people,” that have migrated into the cities as well as, “guide the urbanization of around 100 million rural residents of the central and western regions in cities.” These sentiments largely shadow China’s 11th Five-Year Plan, which initiated, “new spending programs [that] target the development of an inclusive countryside with the objective to reduce the existing sharp rural urban disparities in public service delivery” (Lall &Wang, 2012: 5).

China needs cities. Cities, though perhaps not the economic drivers that the government believes them to be, allow for the more efficient and productive use of labor and capital. Furthermore, cities allow for the efficient dissemination of public goods, an effort that will go a long way in supporting social stability. It is important to realize, however, that pushing people into cities, or reclassifying rural areas to provide them more funds for development, will not ensure economic prosperity. The rush toward urbanization must be carefully managed, with the needs of the urban residents—including public goods, employment opportunities, and the environment—must be taken into consideration. It is also important that inefficiency or corruption be curtailed as high degrees of government waste will likely only lead to massive cities with shoddy infrastructure and limited economic potential.

It is hard to generalize the future direction of urbanization efforts in China as different provinces and different city and prefectural leaders will react differently to future urbanization campaigns. It appears that leaders are trying to push people-centric urbanization rather than using cities as direct economic drivers. At the very least, this demonstrates that government leaders recognize the roles cities will play in the future of China’s economic growth: they will create markets and specialized labor pools, rather than being factory cities. Still, the continuing disconnect between central and local leaders will lead to inefficiency, corruption, and waste, almost certainly hampering economic growth. Continued urbanization is inevitable, and with people as the focus, China will likely move forward successfully, in that cities will not be too heavy a burden on the economy. Much of the success or failure of urbanization reforms will rely on the hukou issue discussed below.

3.2.3: Hukou system

Much has already been said about the increasing importance of the hukou system. Indeed, the household registration system in China has emerged as one of the key factors in China’s economic transition. In fact, after the renewed engagement of the government to allow the private sector to play a stronger role in the Chinese economy, the reform of the hukou, or the household registration system, came in a strong second place for the most important message to come out of the Third Plenum Meeting.

The household registration system is a government record of all families in China. In the early years of the Communist Party, this was a way to control the movements of the population to avoid overpopulation issues. However, as China began its rapid industrialization, the migration of workers became a foundation for the success of the Chinese economic growth model. According to government data, there are currently 260 million migrant workers who live in cities, but are not eligible to receive public services and benefits such as education and healthcare in that city because they are registered in their hometown. This has created a form of legalized discrimination, which is even more distressing given that the success of the China model rests largely on those migrant workers. Oddly enough, the outflow of migrant workers from cities is also a problem as many return to their hometown when they are ready to settle down and have a family largely to ensure they have access to government-sponsored services for their family members. According to the latest population census conducted by the government in 2010, almost 261.4 million Chinese had lived outside their locality or household registration for over six months. That is an increase of almost 117 million people or 81% from the previous census, which was conducted 10 years earlier.

Now that China is facing many demographic issues such as an ageing population and a shrinking overall labor force, migrant workers are needed more than ever to ensure the smooth transition from the old fixed asset investment and export-led growth method to the consumption-based one. The hukou system is likely the largest obstacle to urbanization. So far, the Third Plenum and subsequent government officials' statements leady many to believe that a reform of the household registration system will be completed in the next fifteen to twenty years. The debate is now open on the cost of such a significant reform.

Based on many estimates and surveys, the cost will range between 20,000 Yuan, per migrant worker in small cities and could be as high as 100,000 Yuan in larger cities. That is, an astronomical 23 trillion Yuan or 44% of China's 2012 GDP if all migrant workers were to transfer household registration in one year. Of course, the central government has announced that this reform will be gradually phased out and China Macro Strategist Andy Rothman suggests that a three-way split between the Party, employers and employees would further reduce the cost. With the government assuming one-third of the cost, and assuming that the first phase of the reform would "urbanize" 20 million migrant workers, it brings the cost to about 1.3% of China's 2012 GDP. Professor at the University of Washington, Kam Wing Chan goes even further in terms of affordability of the reform and insists that the amount estimated to urbanize migrant workers is not spent in one year of urbanization, but over their remaining lifetime. "The average migrant worker is between 27 or 30 years old; assuming he or she lives for a further 40 years, the annual cost would be 2,500 Yuan a year per person. In other words, offering urban hukou to 20 million people per year would cost 50 billion Yuan or 0.1% of China's GDP instead" (Chan, 2013). We can further estimate the cost of this reform based on the proportion it represents to the government's total revenues. According to Professor Chan, even considering that the cost of the reform would increase each year, it would still be affordable for China at 6% of the government revenues in 2012, because it represents only a fraction of the annual growth of such revenues in the past two years, i.e. 23% in 2011 and 13% in 2012 (Chan, 2013). But the benefits of such reform will also be great.

Firstly, it will contribute to reducing the risk of social instability. Second, and as already mentioned, it will increase the supply of migrant workers. Thirdly, it should also result in an improvement of domestic consumption, since as workers' social safety nets are increased in their city of residence workers will no longer need to maintain precautionary savings. These last two factors are critical to th successful transition of the Chinese economic model and the key question of this project. The Chines government is deeply aware of this and for this reason, reforms of the household registration will b carried out.

The biggest challenge to come out of the hukou reform will come from local governments who will bear the burden of cost of such reform. These governments are reluctant to see their social spending dramatically increase by the attribution of urban hukou to all of these migrant workers, particularly in areas that host significant numbers of migrant workers. Guangdong province for example, which is a major factory hub, counts as many as three to four million migrant workers in a total population of 10 million. But again, as this is such a crucial reform for the economic development of the country, and the CCP, the central government will use the mechanisms already in place to transfer the needed funds to other echelons of governments. Another way to tackle this challenge may be explained by the prudent first phase of reforms announced by the authorities. As Rothman argues, “a limited reform program will be much easier to sell to local officials nervous about their budgets. If the initial stages go smoothly, it can then be expanded with less pushback.” (Rothman, 2013b). Officials may increase pace of reform to extent it much quicker as millions of migrant workers receive urban hukous and pressure grows on the government to speed up the process.

Thus, a successful reform of the household registration system is to be expected. The supply of migrant workers in China will therefore be increased and consumption levels should also continue to rise. However, the overall success of the reform will rest on the government’s ability to also pursue a successful overall urbanization plan, which we will explore in greater detail in a subsequent section of this paper. In the longer term, the government will also need to ensure that these migrant workers have enough confidence in the system to renounce their rural hukou rights in order to gain an urban hukou. That means forfeiting money associated with the renunciation of their rural land, but also the confidence that they will be ensured social services in the city. On the renouncing of their land rights, the government has recognized that this is too complex an issue to resolve in the near future and has pledged to make it clear to the migrant workers that they will not be required to forfeit their rural land rights to obtain urban hukou.

Chapter 4: Supporting Reforms

How broad and in-depth the reforms outlined in the previous chapters will be is heavily dependent on the amount of social support for these reforms. Two key factors in this support that need the attention of the government this report has analyzed, are social policy and the environment. Reforms in these areas are needed for both economic and social political reasons. Both reforms are a balancing act, however; the government needs to balance the social impact and the financial cost of supporting reforms. Doing nothing is not an option; not only does this have the potential to create severe social unrest, the quality of growth will also suffer.

Section 4.1: Social policy reform

A strong middle class and an economic growth model based on domestic consumption will require the government to implement major social policy reforms. Too many Chinese workers still feel their situation is overly precarious to be confident consumers. Successfully implemented social policies will also contribute to reducing income disparity and inequalities, which in turn will contribute to avoiding social tensions and instability. CCP officials continuously repeat that social stability is of foremost importance in the pursuit of continued economic growth and in ensuring the party's future. As this chapter will demonstrate, social policy reforms can also contribute to China's economic growth. For example, as China faces significant demographic issues, such as shortage of labor force and the world's largest ageing population, reforms on retirement age and education will be crucial. For the purpose of this research we will focus on significant social policy reforms that are needed for a successful transition to a developed economy in three areas: health-care, demographic policies, pension, and education.

4.1.1: Overview

China's government spending on social programs has increased significantly in recent years. According to the OECD Social Expenditure Database, "in 2012, it stood at 9% of GDP, exceeding the levels in some other emerging economies, (i.e. Mexico or India), but standing below the OECD average (21.8%), Russia (15.5%), and Brazil (16.3%)." In 2011, the government released its 12th Five-Year plan in which it projected public social expenditure to further increase and rise faster than GDP, which is expected to stabilize at around 7% in the coming years. The Five-Year Plan also stated that a social security system covering all residents, from urban and rural areas would be put into plac by 2020. While China has, in about a decade, created a basic welfare-system comparable to that o some developed countries in just the fraction of the time, the Chinese system remains inefficient an inaccessible to many. But it is still an improvement from the previous system, under which a little ove 10% of the rural population was covered by the country's medical insurance system.

Chinese authorities have maintained that: "the 'fundamental end' of economic transformation is to improve people's lives, which could only be achieved by improving social welfare system (…), unswervingly realize the shared prosperity and bring the benefits to the people." In line with this, the Third Plenum of the 18th Central Committee of the CCP proposed to direct 30% of the profits of state-owned enterprises, currently estimated at 400 billion US Dollars, into so called 'social safety nets.'

4.1.2: Health care system reforms

According to a McKinsey& Company report, "If China's health care spending simply keeps pace with projected GDP growth, it will to 480 billion US Dollars by 2018" (McKinsey& Company, 2010). Improvement of the health care system is a core component of the 'social-safety nets,' and as then China's Vice Premier, now Premier Li Keqiang said in 2011: reforms will aim "to establish a universal basic health-care system providing safe, effective, convenient, and low-cost health-care services by 2020" (as quoted in McKinsey& Company, 2010).

Changes have been underway since 2009 and noteworthy reforms have already been implemented. These reforms include: the generalization of the minimum subsistence allowance to the countryside, new medical insurance schemes for people with rural registration status, dependents of registered urban employees and students, and the introduction of a new pension system for people living in the countryside and another for migrant workers.

Overtime, the Chinese government should aim to implement a universal, and mostly financed by tax income, health care system worthy of a developed country. However, for now, the harmonization of the benefits across different health insurance schemes and insuring efficiency of the administration should be the primary focus of the government. For this, the use of electronic health records could be expanded and measures to regularly monitor the quality and cost of the system should be implemented. These should not necessitate major increase in costs, but rather require better allocation of resources.

Overall, thorough integration of the social policy with the economic policy will be needed to ensure the successful implementation of the reforms. A good example of this is the situation of the current household registration system, which was studied in greater details in a previous section of this report. As it stands, a person is only allowed social benefits in the area where they are registered. This affect in larger part migrant workers who leave their rural hometowns to go and work in the factories mostl located in cities. These workers who have been instrumental in China's amazing economic growth, ar not allowed basic health and education services for their children in the city where they work and live As China is facing a potential major shortage of labor force, the authorities will need to ensure that th mobility of millions of farmers is supported. Specifically, the authorities will need to ensure tha migrant workers are provided with education, health services and minimum social benefits in their residential area.

One of the many explanations for Latin America's failure at developing a sustainable growth model economy is the regions longstanding inequality and the failure of the governments' social policies to respond to this issue. Latin America's failure at overcoming its profound income distribution inequality rests in the lack of political consensus that it creates. China, with its unique political regime will not face this issue, but if China is to be successful, it will need to learn from other countries' mistakes and successes and ensure that these are adapted to its specific conditions.

On funding, the Central government should assume the majority of the burden and ensure adequate mechanisms are in place for an even redistribution to all areas of the country, rich and poor. A good example of this are federations around the world where the federal government collects taxes from provinces and redistributes funds to ensure equality on certain services for all citizens.

4.1.3: Demographic policies

There are several social policies that can be implemented to ease the cost of much-needed social reforms, but also to prepare for an ageing population. One of the major announcements to come out of the Third Plenum on social reforms was the relaxation of the long-standing one-child policy. While the news was received with optimism as a step in the right direction for the advancement of human rights, and it is also to contribute to maintaining a positive perception of the government, its effect on economic growth should be insignificant. According to Deputy Director of the National Health and Family Planning Committee, Wang Peian, the ending of the one-child policy is unlikely to change the longer-term trend towards a lower fertility rate as well. The pressures of modern life, i.e. urbanization, rising costs of food, housing, education, and Confucian traditions lead couples to have smaller families. Realizing this, the national health and family planning commission announced during the 2014 National People's Congress that it would study the impacts of a universal two-child policy. According to the commission, such a policy would increase the population by 10 million people each year. While such a baby boom could bring a lot of pressure on society, many sociology scholars in the country have called for further steps towards a complete abolishment of birth control policies to respond to increasing demographic issues, including labor force shortages and the world's largest ageing population. However, according to demographic experts, this is something that is unlikely to be introduced before the 2020 Five-Year Plan.

A better way to deal with an increasing aging population will be to make changes to the current retirement age, which is still very low compared with developed nations at 60 years old for men, 55 for white-collar women and 50 for blue-collar women. According to the World Bank, these retirement ages were set at a time when China’s life expectancy was about 50 years old. It has since then increased by more than 20 years, to 75 years old. Most OECD countries have an average effective age at which older workers withdraw from the labor force at closer to 70 years old. Realizing that this will present a major challenge in dealing with an ageing population and a shortage of labor force, a spokesperson for the Ministry of Human Resources and Social Security said that the government was looking at lifting the retirement age to keep in line with the rising life expectancy. According to the article by the South China Morning Post, the ministry will gauge opinion and will propose detailed ideas to top leaders “on condition that a consensus is gradually reached when the time is right.” (Zuo, SCMP, 2014) However, a survey conducted by the Canton Public Opinion Research Center in April 2013 reveals that 54% of respondents opposed the lifting of the retirement age and only 26% showed support.

As in most developed countries, raising the age of retirement – aligning the genders then linking to life expectancy – is both a crucial and inexpensive way to increase labor productivity. The increase of the retirement age in OECD countries has proven to deliver positive results for economic growth both in the short and long terms. According to a 2013 report by the organization, “Ensuring adequate labor force participation by older women and men is often essential for the adaptation of pension systems to demographic changes” (OECD, 2013).

A study by the Australian National University clearly outlines how higher aged participation, rather than higher fertility, is the best option to increasing the workforce.

According to a study by the Australian National University, “Male 60+ participation is set to raise from 24% in 1997 to 43 % in 2030, while female participation rises from 4% to 21%.” (Golley & Tyers, 2006) This has an economical effect of 8.7% to real GDP. Chinese authorities should implement a gradual lift of the retirement age in line with its different regions’ life expectancy.

4.1.4: Pension system

In conjunction to the lifting of the retirement age, the reform of the pension system must remain a social priority for the Chinese government. According to a research paper prepared for the World Bank, “A serious obstacle to China’s economic reform is the lack of an effective and sustainabl pension system.” (Yan et al, 2001). On this too, the results of initial reforms are evident. In 200 around 100 million Chinese citizens, less than 10% of the population, were covered by the pensio system, most of them city residents. Today, almost 700 million are covered. This is a good step, bu much more needs to be done in the coming years. It is crucial that Chinese have the confidence tha they do not need to save excessively to ensure decent living conditions during retirement.

In February 2014, the State Council announced that it would merge the pension systems for urban and rural residents at the national level and adjust how it subsidized payments for provinces. As of February 2014, 15 provinces have already combined the two systems. However, despite many reform initiatives, the system remains fragmented and raises issues of efficiency as we are observing the emergence of a complementary private system. The current pension system operates under a multi-pillar system, which combines different components, such "pay-as-you-go," a mandatory individual account and a voluntary supplementary scheme. The government should extend the current coverage from a basic pension to a universal state pension system that does not differentiate between rural, urban, and migrant individuals. Improvements to the administration of the system are also needed. For that, the Central government will need to ensure that local governments are provided with sufficient resources to cope with the financial pressure resulting from the current arrangements.

China should emulate Sweden's successful "notional" defined-contribution pension system. Under this system, benefits are adjusted according to average life expectancy and economic growth, which has the benefit of ensuring system sustainability and the contribution rate is fixed so financial commitments for future plan funding are known in advance.

It is possible for the Chinese government to implement significant reform to its pension system at a minimal cost to GDP. The transition cost to move to a reformed system could be financed by various taxes, such as a corporate tax, a value-added tax, a personal income tax, and a final demand tax. The study prepared for the World Bank estimated that, "The annual transition cost is estimated at around 0.6% of GDP between 2000 and 2010 and decline to 0.3% by 2050." (Yan et al, 2001).

4.1.5: Education

While these are all steps in the right direction, much remains to be done for China to successfully face the challenges ahead. Forecasts vary, but China analysts agree that the country's labor market could be approaching a turning point. According to a 2013 study by PricewaterhouseCoopers' on Global wage projections to 2030, China will become more significant as a consumer market and other South East Asian countries such as the Philippines, Malaysia, Thailand, Indonesia, and Vietnam could take over from China as a key low cost production hub. One crucial factor to successfully prepare for such transition and keep a strong human capital factor lies in education. "Sustaining growth to high incom level will require improvements in the skills of many workers and young people who lack th education required to prosper in an increasingly sophisticated economy." (Lim et al, 2011) Majo reforms will be needed in China's education system at both the higher and lower levels.

South Korea provides the best example of a country that successfully absorbed the significantly hig number of university graduates. The key to this success seems to lie with a large decline in relativ earnings of graduates. As will happen in China, the rising level of education will mean that skilled workers will be available at a relatively cheaper price and this will shift the country’s comparative advantage into more skilled-intensive manufactures and services. For this, China’s economy’s sectorial structure will also need to be adapted.

Learning from the experiences of the US and the UK, China should also improve its lower education levels, particularly in the rural areas, as to reduce the burden of a poorly educated underclass in a modern economy. It will serve to avoid both the major waste of human resources and source of income inequality in which it can result. This has to be a priority of the government as the children who are educated in the next decade will be part of the labor force for the next generation.

4.1.6: Social policy projection

In order for the Chinese economy to successfully transition to that of a developed country, reforms to the social sector will be crucial, particularly in health care, pension, and education. For the time being, unemployment benefits remain a luxury in China. The proportion of the unemployed receiving benefits is comparable to South Africa at about 10%. There are many other priorities that need to be addressed and that are sufficient to ensure the successful transition of the economic model. It is imperative that the Chinese government be mindful not to rush into adopting too many reforms, but rather take a gradual approach. While some of China’s cities have the GDP of some of Europe’s developed countries, it still very much remains a developing country and should not embark on too many high costs social reforms.

The government should focus on implementing essential social reforms to secure its growth, i.e. to support a stronger middle-class and domestic consumption and measures proposed above will be sufficient to achieve that. Most China experts have stated that the recent CCP Third Plenum could be a turning point in the country’s development. On social policies, as in many other sectors, only time and implementation will tell of the results to be expected. China’s announcement in early 2014, that its GDP growth hit a lowest point in recent years and particularly, further comments by Chinese government officials that they are willing to see GDP growth drop further to ensure reforms is certainly a good sign for social policy reform hopefuls. While it is difficult to predict future policy implementation and their potential success in China, strong government commitment leads us to b optimistic. Moreover, as this chapter demonstrates, these reforms are instrumental in fulfilling th government’s economic agenda.

4.2: Environment

Where in the past the Chinese government focused mainly on the output of its economy, sustainabilit and the protection of China's environment are becoming more important, if not vital, challenges th government has in transforming its economic model. The current economic growth model is having a severely negative influence on the environment and increasing the economic cost of environmental degradation. The large 'dirty' industry in China is characterized by high levels of emissions. At first glance, this increased environmental degradation cost is a logical consequence of the process of industrialization. One only has to look at the history of Western powers and their process of industrialization and the accompanied pollution problems to see the same phenomenon. In 1952, for example, the smog and pollution in London (and other major industrial centers) reached such a drastic level that the mortality rates in these centers drastically increased (Bell et al, 2003).

Looking at history would therefore suggest that China’s current negative impact on the environment is nothing new and will follow the same ‘cleaner’ Western model for economic growth in the future. The drive for sustainability in China, however, is unique when compared to industrialized (mostly Western) countries. Whereas issues in sustainability are usually historically linked to private consumption, in China it is the industrial processes which are supporting China's economic development model that provide the sustainability issues (Brubaker, n.d.). China’s environment and sustainability issues are severe and there is no clear cut policy solution to these problems. It is often hypothesized that environmental protection and economic policy are in competition and negatively affect the opposing factor’s outcome (European Commission, n.d.). This means that China has to make a clear decision as to how committed it is to finding a sustainable solution in the trade off against the economy. This trade off will affect the future of China and can even affect its ability to transform the economy. To analyze the impact of China’s environmental policy first an outline will be given of the cost of environmental degradation to the GDP. Second, a projection will be provided on what is achievable for China looking forward to 2030. This projection will be held up against China’s actual policy and its possibility of success. Finally a conclusion can be derived and a realistic image of China’s economic future with regards to the environment can be presented.

4.2.1: Cost of environmental degradation

Air pollution

Air pollution is one of the clearest consequences of China's industry-heavy economic growth model. China has some of the most polluted cities in the world with Beijing competing with New Delhi, India, for the top spot (Busch, 2014). Not only does the air pollution have a clear financial consequence, i[t] also creates social instability since it is one of the most obvious effects of environmental degradatio[n] that is directly visible to the general population. According to the World Bank, the cost of air pollutio[n] and its negative effect on health accounts for157.3 billion Yuan, roughly 1.16% of the total GD[P] (2003 statistics). This number can even be increased to 3.8% of the GDP when analyzing the extr[a] money the general population is willing to spend to avoid mortality risks (World Bank, 2007).

The severity of air pollution in China is not a new phenomenon but has been a common characteristic in Western or other Asian countries during their periods of industrialization. This pattern does not mean that China should underestimate the cost of air pollution to the GDP; it took a concentrated effort from Japan, whose air quality in the 1960s is comparable to modern Beijing, to bring its pollution under control and it will require the same of China (Midori, n.d.).

Water pollution

China accounts for around20% of the world's population while at the same time only has 7% of the global fresh water supply (Adams& Ma, 2013).This scarcity is exacerbated by the polluting effect of China's industry on the country's water supplies. In 2013, China's government calculated that 90% of the groundwater was polluted while at the same time 25% of the country's rivers were polluted to such an extent that they could be used for neither agriculture nor industry. Furthermore, 70% of the rivers in China are polluted from frequent use by chemical or textile plants. This has caused severe health issues as well; so called 'cancer villages' are sprouting up alongside these polluted waterways (Garland, 2013).The water scarcity due to pollution is calculated to cost 147 billion Yuan year or roughly 1% of the China's GDP (calculated in 2003) (World Bank, 2007).

Desertification/Deforestation

Desertification due to overgrazing or misuse of water resources in both industry and agriculture is a very big problem in China's economic model. More than one quarter of China's landmass is either desert or in the process of desertification (Patience, 2011).Desertification has three different subfields—agriculture, siltation, and transportation—and each carries a hefty price tag. Agriculture is affected due to the loss in soil nutrition and animal husbandry. Siltation due to desertification can be found in rivers, reservoirs, and irrigation canals. Transportation is affected due to railway and highway facility loss as a result of sand-blown disasters. Another factor influenced by these disasters is the increased cost in the airline industry due to delays and cancellations of flights. It was calculated by a Chinese high ranking official that with China's current desertification policy it will take around 300 years to restore areas hit by desertification (Patience, 2011). Several respected researchers have tried to make an estimation of the costs with varying results. The average cost in 1999 according to the United Nations Convention to Combat Desertification was roughly 1% of China's GDP (UNCCD, 2013).

Crop and material damage

The cost to natural resources also attributes to the cost of environmental degradation, although to lesser extent than the effects previously mentioned. Acid rain costs about37 billion Yuan annually; 30 billion Yuan due to crop damage and 7 billion Yuan in material damage. Agricultural output is also affected due to polluted irrigation sources. Since 90% of the groundwater and 25% of the river way are severely polluted, the risk of using polluted water in agriculture is present. It is estimated that polluted water irrigation costs 7 billion Yuan, subtracted from the agricultural output. Water pollution also affects fisheries which see their aggregate income diminish to an extent of 4 billion Yuan (World Bank, 2007).

Total cost

The problem with making an estimate of the total cost of environmental degradation in China is the wide variety in research methods and criteria used by different agencies. The World Bank, for example, estimates the total cost of environmental degradation to be 5.78% (World Bank, 2007) while the Chinese government calculated the cost to be at 3.5% (Wong, 2013). The World Bank actually corrected its own 5.8% cost using additional factors in natural resource degradation to a whopping 9% (of total Gross National Income) environmental degradation cost (World Bank, 2012).Important to note is that these numbers are already deducted from the total GDP in calculating the GDP growth of that year. So the 7.7% GDP growth in 2013 has already taken the environmental degradation cost, whether 9%, 5.78%, or 3.5%, into account (Wang& Yao, 2014). The Chinese industry and manufacturing sector keeps growing however which will increase the total cost environmental degradation unless China finds a way to put a halt to, or even diminish, environmental degradation. Even though the current situation looks very bleak, there are opportunities for the Chinese government to cope with environmental degradation and develop a more sustainable economic model.

4.2.2: China's sustainable cost projections

McKinsey& Company outlined two different future projections for China's environmental policy called the 'baseline' and 'abatement' projection with 2030 as final projection (McKinsey& Company, 2009). The baseline projection is based on current technological investments and policy in China. In short, the baseline represents China's current policy towards environmental degradation and sustainability. It will still take a concentrated effort from the Chinese government to implement this policy and is in no way a guarantee of current Chinese policy. The abatement projection takes it a step further and requires no less than an actual 'green revolution' in China. This projection looks at current and expected technological developments and construes a Chinese policy that heavily invests in sustainable technologies. This investment is on top of the already existing baseline scenario. It gives the 'best case scenario' for China's economy with the maximum feasible sustainability incorporated.

The abatement scenario follows a model which would mean a 1.5-2.5% GDP investment projected in 2030. It is important to note, however, that this is an investment with limited returns since only one third of the investment will have a profitable return, one third will come at a medium cost, and one third will come at a high cost. The capital investment needed for the abatement projection is outlined in the Figure 4.1.

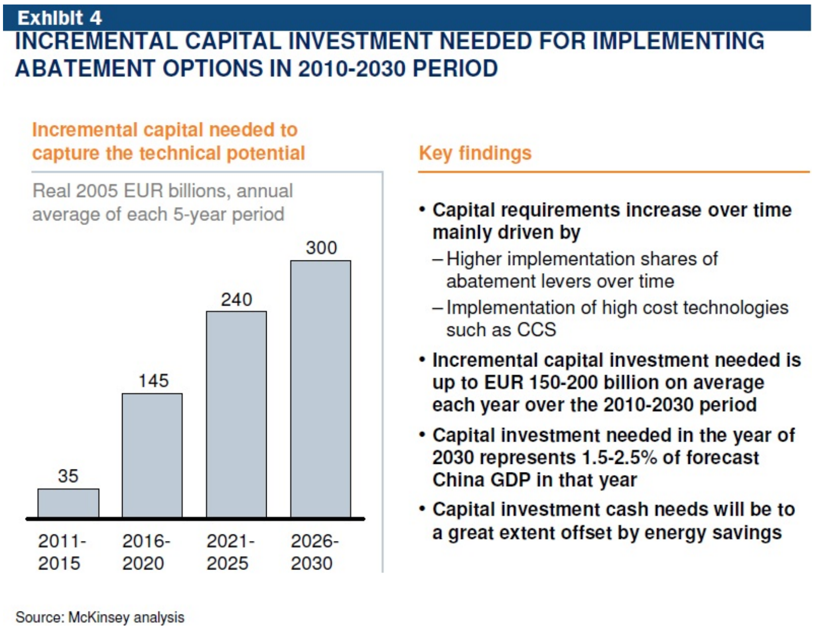

Figure 4.1: Capital needed for abatement options, (McKinsey& Company, 2009)

This would mean that China should spend 35 billion Euros annually, between 2011 and 2015, in order to reach the abatement goals. The Chinese government actually outlined its environmental investment plans in its 12th Five-Year Plan on environment in which it stated it would invest a total of 3.4 trillion Yuan total between 2011 and 2015 (China State Council, 2011). Compared to the total investment of the 11th Five-Year Plan, which amounts to 1.4 trillion Yuan between 2006 and 2010 (an average of 1.35% of the GDP), this means an increase of 41% or 2 trillion Yuan (Bloomberg News, 2009). This would amount to a total of investment of 37.5 billion Euros annually between 2011 and 2015.[7]

Financially it seems that China is actually on par with the abatement projection outlined by McKinsey & Company and is actually investing more than required to meet the end state of the projection (35 billion Euros annually). One problem with the monetary statistics outlined in China's 12thFive-Year Plan is that it does not give a clear and objective representation of China's actual investment into a sustainable economy. In 2007, the Chinese Academy of Engineering Physics (CAEP) noted that roughly half the money spent on environmental protection is either lost through corruption or spent on non-environmental projects (Economy, 2013). So even though statistics show that China is actually spending more than outlined in the abatement projection, the actual investment figure should be set a 18.75 billion Euros, which is 53% of the required investment needed for the abatement projection.

[7]1RMB is 0.093923 Euro (2005 number) 2 trillion x 0.093923 = 187,846 billion Euro. 187,846/5 = 37,569.2 billion Euros annually.

Since it can be reasoned that China will not reach the abatement projection outlined in the McKinsey& Company report, the baseline projection and its feasibility have to be analyzed. This baseline projection is based on current policy and technological developments on which the Chinese government already focuses. The problem, however, is that in its drive for a sustainable economy, the Chinese government is unable to obtain the emission goals it has set out for itself. The 11th Five-Year Plan outlined clear emission goals for China's sustainable policy but the government was not able to reach these goals. Energy intensity per unit of GDP was supposed to be reduced by 20% but only a total of 19.1% was achieved (Cohen, & Siu, 2012).In the 12th Five-Year Plan this trend has continued since China again seems unable to fulfill the goals set out in the plan. The energy intensity is supposed to fall an additional 16% in the 12th Five-Year Plan but it had only dropped 5.5% by the end of 2012 (Stanway, 20130.Regarding new technological investments, the Chinese government is also falling behind its own strategy. While China aims to increase its dependency on non-fossil fuels to a total of 11.4% between 2011 and 2015, only an increase of 0.8% to 9.4% was obtained in the first two years of the Five-Year Plan. One reason for China's failure to meet the environmental goals of the 11th Five-Year Plan is that environmental plans were based on a GDP growth of 8% while the actual GDP growth during these years was 10.7% (Zhang, n.d.).This is caused by a difference in strategy between the national and provincial authorities. While Beijing aims to set a countrywide aim of for example 8%, provincial leaders see economic growth as more important and strive for higher GDP growth in their specific province with numbers reaching up to 13% (Cohen, & Siu, 2012). The problem is, therefore, not easily solved by an increase in budget since the fault lies with implementation of policy.

4.2.3: Realistic projection

Economy and environment are negatively affecting each other; the greater the GDP growth, the greater the cost to the environment. With an expected doubling of the GDP per capita by 2020, the outlook for the environment looks grim (World Bank, 2012).And even though the non-industrial (service) sector is expected to grow in the process towards a high income economy; this does not mean an overall diminishment of the contributors to environmental degradation. Furthermore, since China is not able to obtain the 'best case scenario' outlined in McKinsey& Company's abatement projection, the cost of environmental degradation is likely to rise. This outlook grows even darker when analyzing the government's inability to reach its own emission goals in the last two Five-Year Plans. If the cost of environmental degradation is calculated to take a noticeable portion of the GDP, the graph predict that this cost will increase; however, since the cost of environmental degradation is already detracted from the GDP and the government is still able to reach high GDP growth numbers, it seems that environmental degradation will be more an issue that is secondary in China's priority list. Due to its secondary status, the cost of environmental degradation will increase in China's drive for a high income society. The drive for sustainability will likely increase when China has reached this high income status, though both the social and financial costs will be greater than they are at present.

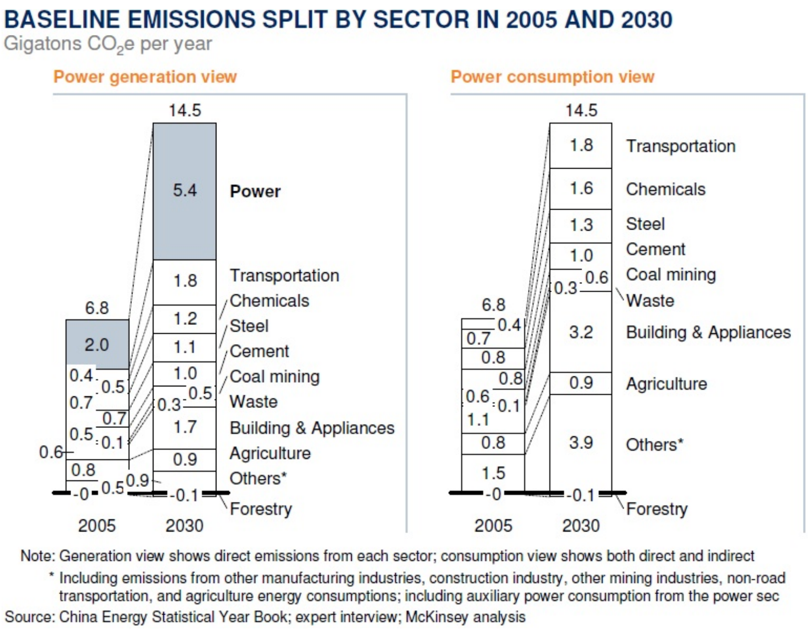

Figure 4.2: Baseline emissions by sector, (McKinsey& Company, 2009)

Chapter 5: Conclusion

This report asked a seemingly straightforward question: will China successfully transform its economy from a fixed asset investment and export-led model to a consumption-based model driven by its domestic economy? It is a seemingly simple question that would normally be answered with a yes or a no; however, analyzing China's economy has been a daunting and laborious undertaking. Below, we outline some of our research methods, explore China's advantages and disadvantages when it comes to its economic transition, provide a conclusion regarding our research question, and offer suggestions on future areas of study in this topic area.

Theoretical orientation

Our research has consisted of straightforward policy analysis. Each chapter utilized different criteria, different sets of data, and covered different areas. Each chapter was analyzed independently using the same overarching pattern: identify the problem, find a solution, and determine the Chinese government's current policy approach. This process has allowed us to identify the major hurdles and choking points in China's economic transition. We will use the balance of each chapter's conclusions to provide an answer to the overarching question regarding China's economic transition.

Research constraints

In order to tackle this question, we were forced to limit our research in several important ways. China's economy is huge, both in terms of geography and scale. In many ways, China is composed of several major economies with its gigantic cities and large prefectures. China is a continental economy more akin to Europe as a whole rather than any individual country, centralized government notwithstanding. This means there are drastic differences between separate geographic regions, particularly between the developed eastern seaboard and the mountainous western regions. China's economy is also huge in scale, representing the second largest economy on the planet, and potentially even the largest by some metrics based on a recent World Bank study. Even this seventy-page report does not do China's economy justice.

These issues of scope and scale required us to generalize across the country, a tricky proposition in a continental economy. To deal with this issue, we focused on macroeconomic policies, financial reform, and other major socioeconomic trends rather than drilling down to grassroots-level economic processes. That being said, the Shanghai Free Trade Zone pilot scheme was instrumental as it serves as a laboratory to observe possible initiatives the Chinese government may implement throughout the country in the coming years. The Shanghai pilot scheme is very much a cornerstone of China's economy and things that succeed there are likely to be implemented elsewhere.

Another major limitation is the fact that no economy exists in an economic or political vacuum. China has a number of economic and political relationships that affect the economy, and many of the issues there are completely out of the Chinese government's control. It is difficult to predict how the world will respond to China's rise, therefore this report focused on the things that were in China's control rather than include possible scenarios involving other countries. This does lead us to wonder if there may be major political or social shocks, either domestically or internationally. Protests, often involving some of the issues brought up in this report, are a daily occurrence in China. The government may be forced to change its policies rapidly in response to these situations. Likewise, an international incident, with Japan for example, would also impact China's economy in ways this report could not predict.

Also, there are limitations on the validity of data and clarity of statements made by the Chinese government. There were often major discrepancies between different organizational statics, like the ones reported by the World Bank versus official figures provided by the Chinese government. Also, the Chinese government's modus operandi is traditionally making vague promises that may signal policy shifts, but these shifts are only obvious after years of progress. The recent Third Plenum report was a prime example of these statements that are currently difficult to decode, but will become clearer as the year progresses. This report had no choice but to embrace this issue of unclear or vague information in the hopes that even though no specific forecasts could be made, general trends and patterns would emerge and allow for at least generalized predictions regarding future trends in China's economy.

Advantages and disadvantages

In total, this report identified a number of advantages and disadvantages in China's economic structure with regards to the research question. Though often decried by the western world, China's authoritarian governmental structure does allow for quick, concise changes in policy that are dictated from the top rather than reached by democratic consensus. Thankfully, based on government reports and their agreement with World Bank or IMF suggestions, Chinese leaders at the highest levels seem aware of many of the problems facing China's economy and will be able to decisively dictate changes as they see fit. The government's heavy hand in the economy will allow for a gradual, structural approach to solve economic issues and promote growth.

Unfortunately, this same government structure is also a problem lamented regularly in this report Many communist and former communist economies have found that planned economies are inefficien and effectively bad for business. Though the Chinese government is responding to this by slowly allowing for the liberalization and privatization of its economy, there are other areas, like SOEs, wher government control has actually increased in strength in recent years. As stated above, China i moving quite slowly when it comes to restructuring its economy, likely based on lessons learned from watching Russia transition away from a planned economy after the end of the Cold War. But slow and steady may not always win the race. If China is moving too slowly, they risk hampering their economic growth in the near term as well as make it more difficult to change course in the long-term.

There is also the very real issue of corruption plaguing China. The national government may be able to dictate policy from on high, but if provincial leaders or their subordinates misuse funds, China will not be able to meet its goals despite the best wishes of its leaders. The sum of these advantages and disadvantages point to a very serious obstacle on the road to reform: a serious disconnect between central and local level government leaders. This disconnect is crucial to our conclusion and shall be discussed in more detail below.

Research conclusion

Our research leads us to conclude that the financial market reforms, or at least the government's commitment to these reforms, are sufficient in dealing with the key obstacles in China's economic transition. Even though the financial reforms are a balancing act that has the possibility to derail China's economic drive, the gradual approach and strong grasp in this particular area leads to an optimistic outlook. The fear that shadow banking is spiraling out of control is real and present. The government, however, is aware of this and its gradual policy might actually be beneficial to the reform of the shadow banking system. A hasty policy would lead to a collapse of the private sector while sluggish implementation would mean a Chinese debt crisis. Because of the nature of the Chinese state (authoritarian) and its awareness of the issues, this report concludes that in the field of financial reforms, the government will be able to overcome these obstacles.

The process of making the Chinese economy more market oriented is less 'clear cut'. While the government has announced reforms in this area, past reforms of SOEs have actually made them more 'monopolized' contrary to the goals of the state. In this particular field, it is less a process of willingness but rather of 'ability'. Tentative steps, however, such as market pricing of resources, as well as letting a company in Shanghai default show a new form of commitment to market orientation reform. This clear sign of a 'new kind of policy' under Xi Jinping and Li Keqiang, demonstrates a break with China's historic lack of commitment to letting the market determine economic outcomes This leads the report to be optimistic about reform and progress in this area.

Even though both market orientation and financial reforms are key in China's economic transition, th important factor that helps China sustain the process is reform in the area of domestic consumptio The problem in this area is that China's support system (e.g., education, etc.) does not support socia mobility. This leads to a slowdown of the system: college graduates are unable to find jobs that matc their education level which leads them to take middle or low paying jobs. This process displaces poor and uneducated workers who are trying to make the transition from poverty into a higher income class. In the end, this leads to the stifling of middle class growth, which runs counter to China's ability to make the economic transition. Growth in the middle class is what is supposed to be the main driver for China's post-transition model; with people stuck in a lower class, the transition seems to be in dire straits. What makes matters worse is that the government is actually trying to increase the level of education in rural areas without linking this to the amount of jobs available for these future graduates. This leads the report to be negative on China's ability to increase domestic consumption and the middle class.

On the issue of space and movement of people, a lot is dependent on other fields of reform. The issue of real estate in China is, for example, very dependent on reforms in the area of shadow banking. Furthermore, this report concludes that urbanization is not a driver for China's economic transition, but rather increases social stability, or social support, for the government's reform policy. This combined with China's tentative steps in reforms of the hukou policy leads this report to be reasonably optimistic on this particular area of reforms.

A detractor to social support, however, is China's lack of commitment to environmental reforms. As opposed to commitments outlined in, for example, the most recent Third Plenum, the government is choosing economic progress over a 'green policy'. Even though this does not affect China's ability to make the transition in the short-term, it will affect China's socioeconomic state and social support for the government. Furthermore, it will determine what China's future economy will look like since the cost of environmental protection and 'green policy' in the future will increase exponentially. Social policies that have an impact on the population's public support seem to be improving after a long period of decline. This improvement is of relatively less importance than other reform areas but leads to a general positive outlook.

A key obstacle, however, is the issue of China's aging population and its impact on the economy in the short-term. Two options to solve this problem are either changing the 'one-child policy' or lifting the retirement age. Research has shown that only the lifting of the retirement age will be sufficient to overcome said obstacles. So far, the government has shown no real commitment to lifting th retirement age due to fear of losing social support. Instead, it is focusing on changing the 'one chil policy', clearly the wrong tool for this problem. What leads us to be optimistic is that the Chines government is an autocracy, which means it can implement policies on the short-term without havin to slog through the bureaucratic process of a democracy. Since the government still has a window o opportunity to implement far reaching social policy reforms, this area does not seem a huge obstacl for China's transition.

The overarching problem that stretches across all fields of reform is the gap between local governments and the state. As outlined above, the implementation of reform dictated by central government is very dependent on the local governments. These localities, however, show a varying degree of commitment or ability to implement said reforms due to issues such as corruption, inefficiency, and discrepancies between goals at the central and domestic levels. This leads to the conclusion that in some areas it is less a problem of willingness but rather of ability.

Combining the different chapters this report concludes that China will be able to make the transition into a more consumer based society. The problem, based on this report's research, might not actually be the transition itself, but rather the ability to sustain the end result and even the quality of the end result. While the middle class might grow in years to come, many poverty stricken areas will remain poor due to the lack of high-income jobs for the highly educated. This creates a very unstable model for China's long-term growth not only in the field of macroeconomics, but also in the field of public support. Furthermore, the exponential cost rise of the environment leads to a grim outlook on the quality of China's transition. With the general public already vehemently criticizing the state of China's environment, the government needs to address these issues to create social stability. Added to these is the cost of the implementation of social policies, which do not have a priority on the short-term, but can have severe consequences in the long-term. Combining these costs will create an increased strain on China's post-transition economic model, which leads us to question whether the current transition can be classified as 'success'.

Future research

During the research phase for this report, we identified many different areas of study that might be useful for future scholars. As mentioned above, the Chinese government is also quite vague about what promises or policies it plans to implement in the near future, as in the Third Plenum. If this report was written a year later, it might derive different conclusions based on newly implemented policies or future government statements. That being said, there are a number of other academic issues worth exploring with regards to China's economic transition.

In much the same way, this report has a very narrow window of prediction. We focus on short-term economic growth trends but there are larger and long-term economic trends that are important to analyze. These long-term trends would likely need to include possible political or social changes brought about by domestic or international stimuli. The success or implementation of the Regional Comprehensive Economic Partnership or the Trans-Pacific Partnership might alter China's economy quite drastically. A conflict with Japan or unrest in various parts of the country might also affect social stability and provoke long-term political or social changes that may impact China’s economy or politics in various ways.

This report has several times made it clear that large scale economic reforms require a great deal of social support. For example, changing China’s retirement age would require a great deal of social capital and would upset social stability, meaning the Chinese government is currently unwilling to alter this policy. It would be useful to analyze how much social support China’s government has for specific areas of economic or political change. Areas that produce a great deal of friction may become sizeable problems in the not too distant future.

Finally, since the discrepancy between the national government and the local government is such a vital factor in China’s economic success, it will be important to understand how successful local governments are in implementing the edicts of national level leaders. Analyzing the amount of inefficiency in implementation due to corruption, self-interest, or competing goals would be quite useful for many studying China’s economic development.

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