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China at the Crossroads

By Jingjing Vicki Zhang

The story of the rise of China reads like a tale of two nations. As late as the mid-1970s, Mao, the charismatic yet increasingly insecure leader, ruled his near-billion subjects with help from an army of under-educated peasant cadres. All instruments of production were owned by the state. Strict residence registration prevented any rural-to-urban migration and denied peasants access to jobs or benefits in the urban economy. In the urban area, a planned economy mobilized massive manpower to work in the heavy industry, while there were less and less consumer products to buy in the stores. Workers ended up putting the money into the state banks, which in turn financed the heavy-industry-centric planned economy. Urban employees were locked into all-encompassing work units. To further reduce inequalities, wage increases and bonus payments for workers were extremely limited. This was a nation of stagnation, doomed to a miserly decline.

Fast forward to today. Technocrats dominate key roles of leadership. A vibrant private sector, including both indigenous and foreign companies, is building the backbone of a consumer-oriented economy. A booming but overheated commercial housing market helps many realize their dream of becoming billionaires while keeping the rest in rented apartments, praying for windfalls to pay for that first down payment. Graduates from school enter an exciting and yet tempestuous labour market. The new social contract rewards those with good connections, a spirit of entrepreneurship, a foreign education and working experience. Peasants move into cities in overwhelming waves. Some succeed in becoming urbanites with a package of social benefits the previous generation could never have dreamed of, while many others leave a long trail of heart-wrenching tales about broken families and societal discrimination. This is a nation of great vibrancy and individual drives, coupled with equally great anxiety and uncertainty.

In the wake of a global financial crisis that seemed to have facilitated a paradigm shift of economic power from the established Western economies to emerging economies like China, this essay examines several key factors that have contributed to China's success in the economic reform spanning the past three decades and the double-edged nature of these factors going forward.

One common question people often wondered about the Chinese economic reform was this: How did the country achieve the miraculous combination of rapid growth and relatively low inflation rate throughout the reform years? We have all read about the hyperinflation rate that to an extent brought down the communist regimes in Eastern Europe and the

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former Soviet Union in the late 1980s and early 1990s. In China, however, there had always been an almost rhythmic cycle of fast growth and retrenchment. Many political economists now believe that the competitions between the generalists and the technocrats within the Communist party had surprisingly contributed to a generally stable reform era by creating checks and balances within the one party ruling. Generalists within the leadership build their careers in multiple provinces and party apparatuses and have a much larger base of supporters from local governments. Technocrats, on the other hand, usually ascend vertically through a certain bureaucratic group and have a much smaller base of support, but a greater and more direct control over monetary and investment policies. We see this factional competition most pronounced through the banking sector. When generalists dominated, in order to cultivate support from the local governments, they decentralized financial discretion and offered local cadres incentives to invest in their local economy. More loans and credits became accessible from banks that had to take cues from the prevailing economic policies and directives, which eventually led to inflation expectations. Generalists had to rely on the technocrats to overhaul economic activities through monetary and fiscal policies to prevent the inflation expectation from being materialized. Once technocrats gained control of the economy, they would centralize the financial authority through policy control, therefore steering the system away from a near-collapse. This would result in less lending from the banks and more stable market prices. However, as the technocrats had a much smaller support base, their agenda-setting power would soon be taken away by the generalists as soon as the inflation crisis was gone, and the cycle would start all over again.

The downside of this mechanism, however, is that it distracted leaders from genuinely putting forward an agenda of thorough and fundamental reform. After more than 30 years of reform, real changes in the banking system remain modest, and efficiency of capital allocation stays low. The People's Bank of China, China's central bank, is headed by a government minister and still values directives from the political leadership above market cues. In a way, a real reform of the banking industry would be threatening to both the generalists and the technocrats in the leadership. The generalists would lose the resource of rewarding their local supporters while the technocrats would lose the very reason they were ever allowed to seize power. No wonder, after rounds of structural changes in the banking system, the Big Four banks still often act like policy banks, and the bad loans to state-owned enterprises (SOEs) are still pervasive. A vicious cycle of channeling capital to the worst-performing sector while starving more dynamic ones creates mounting bad debts for the system and decreases overall credit availability crucial for economic growth. Moreover, in order to compensate for the low-interest non-performing loans that banks are essentially forced to issue, household deposit interest rates are kept low so that banks can take a much-needed breather in the gap between the low lending rate and the low deposit rate. Households, hit hard by the low interest rate, risk their money in China's fledgling stock and real estate market, leading to speculative behaviors and alarming bubble in these markets.

Another important factor of the Chinese economic reform is globalization. There was one thing the top leadership of China had been clear about from the very beginning of the reform: China has the largest population in the world, and it makes sense to initiate the reform through labour-intensive manufacturing business. Before diving headlong into a manufacturing- and export-centric economic strategy, China did not even bother to first clean up

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the house as Japan and South Korea had done during their period of modernization. This was made possible by the modulization trend in the global production chain. Thanks to modulization, knowledge and experiences that were previously tacit and transmitted face to face could now be codified and transmitted with low cost to anywhere on the planet. The result is that the formerly regimented production steps done in a single firm are now spread across multiple firms and nations. By allowing the multinational companies to outsource certain production tasks to China, China has outsourced the restructuring of its domestic industry to foreign companies. Gradually, international standards and rules have to be researched and adopted as foreign firms continue to push the compliance of their global standards. This leads to a trend, in which more westernized labour relationships and protection are followed, more technocrats rise to power, and a long list of international standards regarding enterprise ownership, foreign exchange, and legal codes are gradually adopted in China. In this sense, China has caught the globalization bandwagon on its way to modernization.

However, although a labour-intensive manufacture-oriented economic strategy has driven the rapid growth in China, created numerous jobs, and made China the largest export country, in recent years China has recognized that such strategy would only put itself squarely at the bottom of a global production value chain while the rest of the world reaps benefits from the higher-value activities such as product design, R&D, marketing and branding. An obvious solution is to move up the value chain. So far such attempts have been earnest but with mixed results. One pitfall of such efforts has been the emphasis on vertical integration—to move up one value chain. We often see Chinese companies reverse-engineer components of existing products, which on its own is a type of R&D activity. However, in this process, the designing of the products is modulized and standardized due to the need of producing lower-priced products to compete with the original products, and that leads to lower entry barrier and thus lower profits. The policymakers may want to look into the Taiwanese model that emphasizes component specialization and horizontal movement among different potential end products that use similar components. Moreover, China should further strive to move up the R&D value chain as well, by focusing more on "R"—the research for new technology, rather than only on "D"—the localization of existing products and finding new product platforms based on existing technology. Indigenous firms interested in doing R&D need to have better access to bank credits and loans. Moreover, they need to attract talents, who have been trained using government subsidy but currently contribute more to the foreign multinationals in China. Intellectual property laws also need to be strengthened to provide more sufficient protection and incentive for indigenous R&D companies. Those policies would be crucial in determining whether China can successfully move out of the pitfall of dwelling at the bottom of the global production value chain.

Moreover, in recent years, especially during the financial crisis and collapses of overseas consumer markets, the trend has been to drive domestic spending and to build a consumer-oriented society within China. A few Chinese holidays are stretched from one or two days into week-long vacations in order to drive domestic consumption. During the 2012 Chinese New Year, I was astonished to see Central Television reporters frequent shopping malls to interview consumers who had just spent a fortune on gold jewelry. The previously quiet residential districts in my

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old neighbourhood in Shanghai have been transformed into a parade of endless shopping malls and restaurants. However, such trend has not prompted the paradigm shift that the economy needs, in order to move away from its unbalanced and unsustainable nature. The concept of working-hard-and-consuming-hard still builds on the dangerous assumption of perpetual growth, while clear signs of an economic slowdown have already been observed in China. The first-quarter GDP growth rate in 2012 is at a three-year low and lower than the average growth rate in the past 30 years. World economists within and outside China unanimously predicted that compared to the past three decades, China's growth rate would be permanently lower going forward. In the meanwhile, China now has a geographically mobile population and millions of people seek to enter the urban workforce. Even with the one-child policy, the population is still growing, with more working-age people needing jobs as well as more seniors seeking support from the young. Without new jobs being created quickly in a fast-growing economy, social instability may soon loom on the horizon. The energy and resource intensive nature of the past growth pattern also raises grave concerns on the destructive impact on the environment.

Therefore, China will need a new strategy for the economic reform going forward in order to face the many challenges that have become more and more evident recently. A balanced and sustainable growth should have less emphasis on capital-intensive and industry-led structure and allow more room for the public and private service sectors to grow. The government, as well as the masses, needs to see green development as an opportunity in both technological innovation and building a sustainable economic pathway. China must also continue its integration with the global markets and trade networks, and keep demonstrating itself as a global team player.

One of the key areas of future reform that is particularly of actuarial interest is the government's stated desire of building a better and stronger welfare system including pension and health care programs, in order to close the financial gaps and mitigate tensions among various social groups caused by the unbalanced growth in the past three decades. As recently as in 2009, less than 30 percent of Chinese adults were covered by public pension plans, and that number quickly grew to over 55 percent by the second quarter of 2012. However, such aggregated statistics are far from telling the whole story. China's individual pension funds are not segregated from local governments' general funds and are therefore at the mercy of local officials. Some regions essentially implement a pay-as-you-go scheme by giving the current pensioners money from individual pension accounts that the younger generation paid into. Some local governments are reported to appropriate the pension funds for real estate market speculations or to pacify the disenfranchised laid-off workers from the earlier reform era. In the end, it is a matter of political will. But actuarial expertise and monitoring function will be crucial in the process of reform to ensure the future retirees receive their entitled share of the provisions the country in aggregate is consciously making for its future. This is especially important in light of the projected demographic changes and increased burden on the pension system in the next 20 years when nearly 30 percent of Chinese will be 60 or over. On the asset side, financial and investment actuarial skills will be essential to help transform the current Chinese stock market to a more mature and open one that offers a better investment environment for retirement savings. In the sphere of health care reform, China in the past three years has made major headway in decreasing patients' share of spending, building or revamping community-based care centers, and increasing health insurance coverage for the population. However, the overall health care cost has not been overhauled in any significant way due to the fact that both utilization and unit price of medical services have long been driven by incentives to overprescribe treatments and sell medicines on the part of hospitals and doctors. China is still in its early stage of designing medical service pricing schedules and medical provider compensation schemes to curb the "grey income" and wastes in the health care system that had resulted in the crippling costs for both the patients and tax payers. Health actuaries' expertise will most likely be in demand.

Future opportunities and challenges abound as China stands at the current crossroads. It is high time the nation and its leadership switch gears from a mentality of "crossing the river by groping for stones." The actuarial profession has a lot to offer in helping to chart out a new blueprint of China's economic reform with a more long-term, sustainable vision. □