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2021: Tapping the Endogenous Growth Potential of China's Economy

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In 2021, China needs to make adjustments in many aspects of policy such as structural reform, aggregate demand management, and opening up to the outside world; it will need to tap its endogenous growth potential, maintain stable economic operations, and allow the general public to more fully share the dividends of economic growth.

1. Structural Reform Policy: Letting 300 Million Migrant Workers Truly Integrate into Urban Life

Economic growth is a positive feedback process. The economy can continuously gain growth momentum and maintain sustained economic growth only with positive interaction among various sectors. The essence of any structural reform policy is to fix important weak spots or weak links. Doing so not only promotes growth in a particular sector but can also form benign interactions among various sectors, which will promote the development of the entire economy.

How do we find those weak spots in economic development? Without a frame of reference, it is difficult to find the actual weak spots just based on one's own feelings. So we take regular phenomena observed in high-income economies at similar stages of development as our frame of reference, and use them to make comparisons with the trajectories of China's economic growth and economic structural changes within that frame of reference, and in this way we find clues for discovering the weak spots in China's economy.

The growth and development of China's manufacturing sector has been very successful, and in fact the degree of manufacturing development has greatly exceeded that of corresponding high-income countries at similar development stages. Exports function as a mirror that reflects a country's manufacturing capacity. The degree of complexity of China's export products corresponds to that which can only occur in economies with per capita incomes of more than US$20,000. Some scholars point out that China's manufacturing industries still lag far behind their high-end counterparts in developed countries such as the United States, Japan, and

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Germany. This is true, but it should also be noted that considering that China's current per capita income is US$10,000, the development level of China's manufacturing sector is already outstanding. More importantly, evidence from linking data in many areas such as manufacturing R&D investment, division of labor in production, and product sales shows that the upgrades in China's manufacturing sector continue to advance. At the current stage of development, the manufacturing sector is not a weak spot in China's economy.

The biggest weak spot in China's economic development at the current stage is the fact that nearly 300 million migrant workers cannot truly integrate into urban life. In the frame-of-reference comparisons with other economies, China lags most conspicuously in the low proportion of employment in industry and services, its low urbanization rate, and low consumption ratio. The main reason for these gaps is that China still has 300 million migrant workers who cannot truly integrate into urban life and cannot be fully included in employment statistics. This explains why employment in industry and services is low, and it partially explains China's low urbanization rate and low consumption ratio.

Real integration of these migrant workers into urban life should be the number one goal of the next structural reform policies. This relates not only to social justice and the welfare of nearly 300 million individuals and their families, but also to the growth potential of China's economy as a whole. If this large group of workers can live securely in cities, China's economic growth potential will once again be greatly released. This will bring huge market demand and a huge improvement in human capital accumulation and supply capacity.

Achieving this goal, and enabling these migrant workers to enjoy the same public services and social security as other citizens, will require breakthrough adjustments in policies on social security, urban public services, land, household registration, and other areas. The government attaches great importance to the development of metropolitan areas, which function as the largest magnetic fields for absorbing new labor, but there are still many shortcomings in the development process that we still have been unable to fix.

The relevant reforms will present huge challenges to urban public services and management capabilities, and they will increase the burden of public expenditures. All of these will be short-term and local difficulties. In the long-term, overall perspective, the huge market demand and improvement of human capital that will result from nearly 300 million people to reside securely in cities will leave ample room for solving these difficulties. If we regard accepting migrant workers as full urban residents as a hard but necessary task, then a policy design can be forced out, and the difficulties will be resolved one by one.

2. Demand Management Policy: Let Standard Policy Tools Really Work

We must not underestimate the function of policies for managing aggregate demand. There are bound to be bumps in the growth process of positive economic feedback. Severe bumps like the Great Depression, severe unemployment, and large-scale corporate bankruptcies represent the worst kinds of damage in the market. Successful aggregate demand management policies can prevent or reduce such damage and are an indispensable guarantee for endogenous economic growth.

China has always attached great importance to macroeconomic stability, and in this regard it has also been relatively successful. However, there are many lessons about the choice of policy tools for stabilizing the macro economy. Since 2012, the overall characteristic of changes in China's economic cycle has been "easy to chill, difficult to heat," and the main task of aggregate demand management has been to increase aggregate demand. As for the choice of policy tools for increasing demand, the standard monetary and fiscal policy tools, such as lowering interest rates and increasing debt spending by the government, are not fully effective. On the surface, the latter is not included in government budget expenditures, but local governments participate in and in fact take the lead in it—debt investment with varying degrees of government credit endorsement has been very popular, and commercial financial institutions are also widely involved.

The above methods of increasing aggregate demand are costly. First, systemic financial risks have risen sharply. A large number of commercial financial institutions and bond markets have been relying on beliefs instead of business logic. They are deeply involved in the various investment and financing activities led by local governments, and have derived significant benefits from them. If we really spread open the account books, we find that the income prospects for these local government-led investment projects are not optimistic, and many of the local financing platforms can sustain themselves only by incurring new debt to pay off the old. The scale of the relevant assets held by financial institutions is huge, but the quality is worrisome. Second, local governments have to rely excessively on land financing, and the high land prices and high housing prices are closely related to this. Third, due to lack of a standardized supervision mechanism and risk assessment, it is difficult to avoid the waste of resources.

The way to get rid of this dilemma is to open the front door of aggregate demand management policy and let the standard monetary and fiscal policy tools really work. When there is insufficient demand, the first tool to be used should be lowering interest rates—making full use of interest rate policy tools. If this is not enough to reverse the situation, then budgetary expenditures can be expanded. By doing these things, the debt expansion of local financing platforms can be reduced, prudential supervision measures can be truly implemented, and high-standard credit risk assessment standards and high-standard credit principles can be adopted. This is not only about reducing credit risk, but also about optimizing resource allocation.

Prioritizing the use of a lower interest rate policy increases aggregate demand. On the one hand, lowering interest rates reduces the cost of debt for enterprises and individuals, and on the other hand, it increases the value of the assets they hold. It is a two-pronged approach that strengthens the balance sheets of enterprises and individuals, which in turn promotes increased expenditures. It gives priority to the market's own power to respond to insufficient demand. China's current debt scale has reached 260 trillion yuan, so a decrease of one percentage point in interest rates means a reduction of more than 2 trillion yuan in debtors' debt costs. If we also take into account the way that lower interest rates increase asset valuations, we cannot underestimate its role in improving the quality of the balance sheet and in expanding expenditures.

The natural worry is that lowered interest rates will bring money growth and inflation in house prices, but this might not be the case.

If lower interest rates have stimulated private sector credit demand, which in turn has driven growth in aggregate demand, then the local governments' expansion of credit for the purpose of maintaining growth can be contracted. To achieve the same kind of growth in aggregate demand, less private sector credit is required than public sector credit. Lower interest rates might not bring higher credit and money growth, but rather lower credit and money growth. In a lower credit and currency growth environment—and considering that under this model, the local governments' dependence on land financing has fallen sharply—housing prices might not necessarily rise.

3. Foreign Economic Policy: The Security Threats Come from Monopolies, Not Openness

Without opening up, China would not have had its miraculous economic growth. Opening up has brought a bigger market, and it has brought advanced concepts, technologies, and management experience. Opening up has also become an important driving force for reforms. The importance of openness cannot be overstated.

After decades of opening up to the outside world, China has become deeply tied to that world. China has become accustomed to allocating resources around the world and sharing the huge dividends brought about by the division of labor and economies of scale in the international market. To raise just one example: the various kinds of meat that we eat every day cannot be separated from imported plant protein. If we were to grow all of this soybean in China, that alone would take up more than 600 million acres of land. We cannot even imagine what would happen if China were to leave the international market.

The higher the degree of openness, the stronger the dependence on the international market, and worries about security issues will naturally follow. What needs to be recognized is that security threats do not come from opening up, but from monopolies, including various monopolies in the international market. It is monopolies that threaten supply chains, and it is monopolies that have inserted wedges into the industrial chains. In recent years, China's market competition with developed countries in the high-tech field has increased. Some developed countries, among whom the United States is representative, have become more confrontational with China; some of them have used administrative means to suppress China's high-tech enterprises. These repressive methods can be effective only because they rely on the developed economies' monopolies in certain products and services.

The way to break monopolies is not to close doors and try doing it on your own. Historical experience has fully demonstrated that this is neither efficient nor safe. What we need to do is to participate actively in international economic and trade agreements like the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), find more consensus with the international community, and work with the international community to resist monopolistic behavior. We need to open the door even wider to the outside world in science and high-tech fields, better protect intellectual property rights, and fully mobilize the spontaneous power of the market to break monopolies. We also need to introduce more effective incentive mechanisms in basic scientific research fields in order to promote benign interaction between basic scientific research and industrial development.

（Translated by Thomas E. Smith）