Demystifying China's Mega Trends

The Driving Forces That Will Shake Up China and the World

To Margaret, Edwyn and Arthur

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Contents

List of Abbreviations

AIIB	Asian Infrastructure and Investment Bank
AREAER	Annual Report on Exchange Arrangements and Exchange Restrictions
BAR	Belt and Road Strategy
BoP	Balance of Payments
BIS	Bank for International Settlements
CDB	China Development Bank
CFIUS	Committee on Foreign Investment in the United States
CIC	China Investment Corporation
CNH	Offshore Renminbi (Chinese yuan) in Hong Kong
CNPC	China National Petroleum Corporation
CNY	Onshore Renminbi (Chinese yuan)
CPI	Consumer Price Index
EPMI	Emerging PMI for seven new industries with strategic importance
EU	European Union
EXIM Bank	Export Import Bank of China
FDI	Foreign Direct Investment
FTZ	Free Trade Zone
G3	Group of Three Countries – Japan, Europe and the United States
GDP	Gross Domestic Product
GFC	Global Financial Crisis
LGFV	Local Government Financing Vehicle
M&A	Mergers and Acquisitions
MNCs	Multinational Corporations

MoF	Ministry of Finance
MPC	Marginal Propensity to Consume
NDB	New Development Bank
NDFI	Non-depository Financial Institutions
NDRC	National Development and Reform Commission
NPL	Non-performing Loans
ODI	Overseas Direct Investment
PBoC	People's Bank of China
PMI	Purchasing Manager Index
PPI	Producer Price Index
PPP	Public-Private Partnership Scheme
QDII	Qualified Domestic Institutional Investor
QFII	Qualified Foreign Institutional Investor
R&D	Research and Development
RQFII	Renminbi Qualified Foreign Institutional Investor
SAFE	State Administration of Foreign Exchange
SASAC	State-owned Assets Supervision and Administration Commission
SDR	Special Drawing Rights
SOE	State-owned Enterprises
SEZ	Special Economic Zone
TSF	Total Social Financing
UNCTAD	United Nations Conference on Trade and Development
UNESCO	United Nations Educational, Scientific and Cultural Organization

Preface

Some mega trends have developed since 1990s that have propelled China to become the 'world's factory' and the second largest economy in the world after the United States. Initially, these trends are simple and have been widely discussed by businesses and China watchers in the forms of books and business research reports. They focus on the production and income sides of these China mega trends and draw straight-line projections for Chinese demand growth, painting a rosy long-term outlook for the Middle Kingdom and translating them into optimistic business opportunity forecasts in China. The prevailing work predominately focuses on the microeconomic and business aspects.

These books and reports share some common characteristics. They are descriptive of the trends and simplistic on the assumptions that government policies are static (and correct) so that these business trends will unfold as projected. They are microeconomic orientated, based on business data, interviews, surveys and even anecdotes from travel experience. They capture the prevailing market sentiment, and hype, on China's economic liberalisation. These analyses predominately assume that by opening up to the world, China would be changed by the global forces and move towards the global norms. This approach has been proven naive as China has become so assertive that it wants the world to play by its rules too.

Academic research on China's mega trends is lacking. There are some papers on individual topics on the changing dynamics of the Chinese economy, but the ivory tower economists have offered no integrated themes on the driving forces behind these changing dynamics. This is not a shortcoming but the nature of academic research. However, there is clearly a need for a general equilibrium approach to piece together the individual developments for understanding the secular forces behind China's structural changes and their impact on the world over the long term.

The biggest dissatisfaction of the analysis on China's mega trends by market practitioners is the lack of serious research effort. This has resulted in confusion and misunderstanding about the development and direction of the mega trends. Blind acceptance of these trends or reading them through distorted lenses only lead to erroneous business and policy decisions and reactions to the emergence of China.

China and the world are dynamic, not static. New mega trends have emerged in China over time, especially on the financial and policy sides, and they have not been covered by the earlier studies. There have also been changes to the prevailing trends due to changes in the structural forces in China and the world economy. Meanwhile, there are hidden issues, problems and trends that many observers have missed. Here are some of the examples.

- Who would imagine a new trend of reverse migration from cities back to rural areas has emerged in China recently when everyone is still expecting urbanisation to drive China's growth and when most global businesses are still forming their China business strategy based on urbanisation?
- Everyone talks about China's shrinking labour force. But there has been almost no discussion on China's early retirement problem (it has the world's earliest effective retirement age) and its profound implications on economic growth which is already threatened by an ageing population.
- Many observers still talk profusely about the brisk progress in renminbi internationalisation, capital account opening, Belt and Road (BAR) strategy, Chinese urbanisation, consumption etc., but without knowing (or just ignoring them intentionally for the sake of self-interest) that changes have crept in to alter the trajectory of the trends.
- Others project a gloomy future for China based on its structural woes as if they will only get worse and eventually drag China into secular doldrums like Japan. But they do not bother to understand the evolving secular forces that make their predictions of a Chinese Armageddon wrong for more than 30 years.
- Consensus has it that China suffers from a secular problem of excess capacity, but seldom noticed is the fact that it also suffers from under-investment at the same time. How can these conflicting trends coexist, and what are the implications on future growth, systemic risk and economic policy?

Another problem with most market analyses to-date is that they have focused too much on how the outside world will change China as the mega trends unfold, but not on how China will change the world. This is clearly a serious shortfall, as China's influence has become so big that even without an open capital account, a slight change in its policy move or development path has the power to send significant shock waves across the world. Witness the global market rout between late 2015 and early 2016, which was caused by a very small change in China's foreign exchange policy that move the renminbi by only 3% against the US dollar in six months and then stabilised (compared to the steady decline of more than 20% in the major currencies against the US dollar in 2015).

In general, studies on China's mega trends are thin on the ground, both inside and outside of the country. Westerners often do not truly understand China as they are preoccupied by their own values which are not appropriate for examining the structural dynamics in China. Meanwhile, Chinese/Asian analysts are often too stubbornly constrained by their oriental values that blind them from the global perspectives of reading China. Aggravating the problem is the proliferation of casual analysis on, and misrepresentation of, China by the western media, although the mainland Chinese media suffers from tight ideological control which also taints our ability to distil facts from narratives promoted by the Chinese Communist Party.

This book differs from all these aspects and aims at bridging the gaps between the East and West perspectives, and academic and market studies of China. It examines China's macroeconomic mega trends, backed by vigorous research and evidence. It is not descriptive and does not take the trends for granted. Rather it takes a critical approach to question and to assess the evolution of the mega trends through theoretical and empirical analyses.

It captures the new mega trends and reassesses the prevailing trends by examining the structural forces behind them, refuting conventional wisdom and demystifying media and market hypes. This is a significant departure from the existing work, which focuses on the business and microeconomic aspects and adds hype to conventional wisdom to generate exaggerated and erroneous analysis. Crucially, the discussions here cover both the impact of the world on China and China's impact on the world in its process of opening up.

Coverage of China's mega trends in this book is not meant to be exhaustive as new trends will emerge over time and the existing trends will keep on evolving. Thus, the discussions and views here may be controversial and even incomplete from a research perspective. But the purpose of this book is to dig deep into the hidden issues and uncover the changing dynamics of China in order to stimulate educated debates and further research to correct those distorted assessments that are clouding the understanding of the mega trends of the Middle Kingdom.

The plan of the book is as follows. As an introduction, Chapter 1 gives a bird's-eye view on some of the macroeconomic mega trends that are unfolding in China, while the rest of the book takes a deep dive into these and the new trends that have either been misunderstood or clouded by bad analyses.

Chapter 2 starts our in-depth analysis by exploring the trends of China's long-term growth and reform strategy from a risk perspective that most discussions have missed, namely the possibility of secular stagnation and the risk of an economic identity crisis in the reform process. While no one can pin down China's growth trajectory, there is evidence showing that it is moving towards a sustainable growth path without catching much attention, and that stagnant is a low-odds outcome but needs to be monitored.

Chapter 3 looks at China's demographic challenges through the emerging and hidden trends and problems, including the little-known reverse-migration from cities back to the farmlands, 'early retirement' and its related policy and incentive problems, the structural implications on Chinese consumption (especially the demand for financial assets) of an ageing population and the obstacles for transiting towards a consumption-led growth model.

While China's excess capacity problem is well known, it is seldom noticed that it also has an under-investment problem simultaneously. This bifurcated insight is quite non-consensus and is the focus of Chapter 4, which also reassesses critically the views that Beijing has the power to cut excess capacity at will and that its supply-side reform could yield significant efficiency enhancement. The discussion also highlights the inherent problem of incentive incompatibility in China's structural reform process that Beijing will have to resolve to make reforms successful.

Deleveraging is a key part of China's structural reform and a policy mega trend that unfolds gradually. Behind deleveraging lies the worry about China's 'debt bomb', which has led to pessimistic prediction of an imminent debt crisis sending shock waves across the global economy. Chapter 5 demystifies the debt-currency crisis by examining the structural factors behind China's debt and assesses the measures that Beijing may take to diffuse the debt bomb. Privatisation is a crucial solution, but there is also a conundrum that this book highlights but many China analysts have ignored.

Opening up the capital account is another mega trend unfolding in China. Although still at its early stage, this trend is already creating significant impact on the global policy and investment landscape and causing confusion, fears and hype among the international community. Chapter 6 discusses the 'controlled way' which China is using to open its capital account and seeks to debunk many of the myths behind Beijing's policy moves, notably the setting up of the two-way channels for capital flows between China and Hong Kong and the free trade zones since 2014. Many observers have mistaken the capital flow channels as a big step towards opening the capital account, while no one seems to be aware of an incentive incompatibility problem behind the free trade zones.

As China opens its capital account gradually, capital outflows have emerged as a related secular trend since 2013. Chapter 7 explores the dynamics of these outflows by examining the worries about capital flight from China, the evolving forces behind China's overseas direct investments, their global impact on the political and financial environment, and the effect of the emerging financial prowess of China on the world's development financing. All these shifts argue that there is a need for a change in the way that the world looks at China's investment and capital flows.

Chapter 8 zooms in to examine one particular aspect of China's capital outflows, the BAR strategy that underpins China's long-term strategic expansion on the global stage. The BAR initiative has been under-appreciated by the international community, which has either little knowledge about its strategic importance or distorted views on its impact on the Chinese and global economic development. This chapter assesses whether the BAR strategy has actually gained traction (as the optimists believe), identifies its development path and examines its impact on China's economic rebalancing (which has been misunderstood) and the concerns about whether China is using its BAR plan to 'conquer the world'.

Closely related to China's capital outflows and the BAR initiative is the internationalisation of the renminbi, which is one of the major emerging mega trends that is catching international attention and causing jitters. Chapter 9 focuses on the development, risks and challenges of renminbi internationalisation that China and the world are facing and seek to debunk some of the myths and hypes about this process. It is particularly discomforting to see casual analysis on pushing the view that the renminbi has been developed into an investment currency while its internationalisation process is still stuck in the first gear of being trade driven. Worst of all, no one seems to acknowledge that even the momentum of this first-gear development is hitting a limit.

Renminbi internationalisation will potentially re-write the global monetary order in the coming decades. But it is not a smooth-sailing process, and Beijing is already having second thoughts about its policy priority for promoting the global role of the yuan even at this early stage of its efforts. Chapter 9 also highlights Beijing's change of mind regarding renminbi internationalisation policy that most market analysts have ignored.

Our discussion on China's macroeconomic mega trends argues that it is not a matter of whether but when these forces will eventually elevate China's influence to the top of the world economic league. The eventual realisation of President Xi Jinping's 'Chinese Dream' will mean a global currency status for the renminbi challenging or even displacing the dominance of the current global reserve currencies. Chapter 10 wraps up our discussion by examining the future of the renminbi by identifying the necessary and sufficient conditions of a global currency and understanding China's incentives to acquire those conditions.

A reassessment of the global status of the world's three major currencies (the US dollar, the euro and the Japanese yen) is indeed timely at this point because structural changes behind them are starting to erode their basic currency functions. This argues that their global influence should fade over the long term. The global impact of these structural shifts will certainly be substantial, and even confusing and worrying in the short- to medium-term, because the geopolitical reality behind the future monetary order is that China's global influence is rising at a time when that of the United States and Europe are fading.

Nevertheless, this does not mean that China will dominate the world anytime soon because it still lacks many of the economic, political and cultural attributes that are essential for making it a global power. Our discussion on the renminbi's global status in Chapter 10 highlights the challenges for China to instil global confidence in its currency when it does not have most of those characteristics that create the necessary and sufficient conditions for the renminbi to serve, on a global basis, as a store of value, a medium of exchange and a unit of account.

I hope that this book will help demystify and clarify some of the important issues stemming from China's mega trends and open up new angles for further debates and research on the driving forces that will affect the Middle Kingdom and the global economy in the coming decades. It is not my purpose to jump into conclusions for the issues that we discuss here, as they are moving targets with no defined paths yet. Rather, by challenging consensus and conventional wisdom, and by correcting the crooked views and distorted analyses, I hope we can have a better reading on China by keeping an open mind and basing our understanding on proper research and evidence instead of sentimental judgement, partial analysis and distorted concepts.

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CHAPTER

1 A Bird's-eye View on China's Mega Trends

China is going through an economic structural transformation from a manufacturing-based investment-driven economy to a service-based consumption-led economy. This tectonic shift from an 'old' China to a 'new' China will not only create long-term seismic shockwaves in the Middle Kingdom but also in the global economy, with Asia feeling most of the shock due to its proximity to and economic integration with China.

Let us start with the Chinese currency, renminbi (or yuan, as it is called locally), as it is probably the most controversial issue in the global system during China's structural transformation. The price in which Chinese goods and services and assets are valued not only influences the attractiveness of the Chinese markets for the rest of the world but also global competition for export market share and capital allocation.

By unleashing its 440-million-strong cheap labour force and keeping the renminbi undervalued in the 1990s and the early 2000s, China became the world's factory and attracted foreign direct investment (FDI) from all over the world. However, as the supply of cheap labour falls and wages rise over time, the yuan has also become expensive. The forces behind China's structural transformation will manifest themselves in mega trends that will change China and its relationship with the global system for decades to come.

No More Cheap Yuan

China has been gaining export market share steadily for many years, thanks to rapid productivity growth, cheap wages and an undervalued renminbi exchange rate. In fact, China's export market share reached 12% of the world total in 2014 from less than 1% in 1980 when economic liberalisation in China started. During the same period, China also attracted huge amounts of FDI inflows from all over the world. Its real GDP growth rate averaged 10.4% a year between the mid-1980s and mid-2000s. This high-growth era was facilitated by financial repression (which artificially depressed the return on bank deposits for savers) and an undervalued renminbi that deprived households of consumption power and channelled national savings to state investment.

This development strategy produced a lopsided growth with excess savings feeding excess investment at the expense of private consumption. The resultant rapid build-up of output capacity made Chinese growth dependent on exports. In fact, the combination of rapid productivity growth in the 1990s and early 2000s and a cheap currency policy pursued by Beijing gave China's export sector a significant boost and made it a crucial driver for domestic investment and economic growth. But the Global Financial Crisis (GFC) of 2009 forced China to abandon this lopsided growth strategy as the crisis had decreased the world demand for exports, including China's (see Lo, 2009, chapter 4).

Since then, China has looked inward for growth sources through investment. Evidence shows that net exports have been a drag on, not a contributor to, China's GDP growth[1] since 2009 (Figure 1). This marks the beginning of a mega trend of China's growth transformation from being export-led to domestic-led. Those who still argue that China would need to devalue the renminbi sharply to stimulate exports to generate growth are

[1]China's national income accounting has only three components of GDP by expenditure, namely, consumption, investment, and net exports, as opposed to the proper international national income accounting which also includes government spending as a component. China's national income accounting combines private consumption and government expenditure in the consumption component. At the time of writing, the Chinese government is in the process of changing its national income accounting practice by following the conventional international calibration.

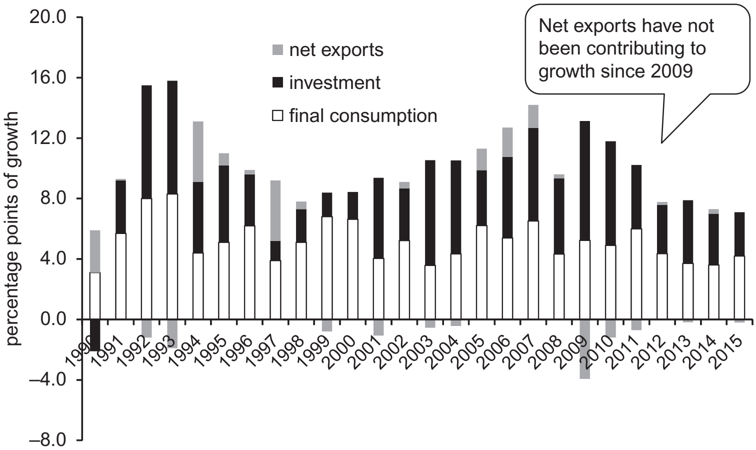

Figure 1: Growth Contribution of China's GDP Components. *Sources*: CEIC, Author.

ignorant about China's development and global development. The challenge for China is to manage the structural changes within the domestic sector from investment-led to consumption-driven growth in the coming decades.

A dear currency does not help a country's growth as it hurts exports. But contrary to conventional wisdom, in China's case a cheap currency will not help Chinese exports and, hence, growth. This can be seen from the fact that despite an appreciating renminbi exchange rate (both in real and nominal effective bases) for more than 20 years since the mid-1990s, Chinese exports have kept gaining on global market share (Figure 2). This proves that the renminbi exchange rate was not a significant factor affecting Chinese export performance. Adding this to the fact that net exports do not contribute much to China's GDP growth anymore, it is clear that renminbi devaluation will not help Chinese growth much.

Over the years, there have been political and market noises calling for Beijing to devalue the renminbi sharply (by 20–40%) in order to rejuvenate Chinese growth under the weight of its structural transition. After many years of balance of payments (BoP) surplus, China saw an unprecedented large BoP deficit (due to a shrinking current account surplus and a growing capital account deficit) between late 2014 and early 2016 for the first time in more than 10 years.

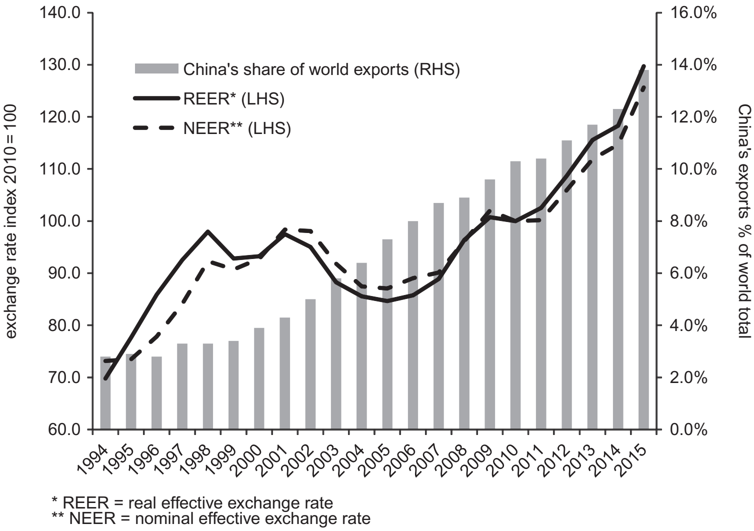

Figure 2: China's Global Export Market Share Continues to Rise Despite a Rising Renminbi. *Sources*: CEIC, WTO, Author.

This prompted the People's Bank of China (PBoC) to intervene heavily in the foreign exchange market to keep the renminbi from falling too sharply. This intervention created a passive liquidity tightening effect on the domestic economy and aggravated the weak growth momentum. Developing economies usually respond to such a situation by devaluing their currencies. Advocates of devaluation thus argue that China should do the same to regain export competitiveness and stem capital outflows.

Even if we accept for the moment the competitiveness argument of devaluing the renminbi, the comparison is fundamentally flawed. At the time of writing, China is the world's second largest economy that runs the largest trade surplus in the world. Developing economies that devalued successfully were much smaller in size, which made it easier for the global system to absorb the increase in their exports. Evidence also shows that they devalued after their overvalued currencies had caused persistent large current account deficits.

There is no evidence of an overvalued renminbi (Cline, 2016). The main economic reason for Beijing to resist devaluing the renminbi, despite that fact that it has been the dearest currency in Asia since the mid-2000s, is that rather than boosting growth, a weaker currency makes a surplus country (in terms of its current account balance) more precarious. This is because in deficit countries, where domestic savings fall short of investment, slowing growth destroys foreign confidence and, thus, scares off foreign capital inflows. This, in turn, causes domestic investment to fall.[2] Currency devaluation may help offset or cushion this negative impact on growth in deficit countries.

Devaluation reduces real household disposable income and, hence, consumption, so that the consumption share of GDP falls. By definition of national income accounting, the savings share must rise. This rise in savings can happen in several ways, but typically it happens because the devaluation increases the profitability of the tradable goods sector (i.e. exports), which increases the saving of this sector (in addition to the increase in household saving due to the fall in consumption). In other words, currency devaluation redirects income from consumption to savings. The rise in domestic savings reduces the country's dependence on foreign capital and, thus, keeps investment from falling even when foreign inflows decline.

However, devaluation does not work for surplus countries the same way because they do not suffer from saving deficiency; and China's national savings are excessive at 50% of GDP. Devaluing the renminbi would only depress the already-low domestic consumption and increase the country's already-excessive investment and reliance on exports to release the excess capacity. The point is that for surplus countries, devaluation replaces consumption demand with investment demand and trade surpluses.

From China's perspective, this certainly goes against the purpose of its economic rebalancing from investment-led to consumption-led which Beijing is striving to achieve. This gives it the incentive to resist renminbi devaluation. But keeping a stable, and dear, renminbi also means difficulties for China's export sector, especially when it is losing the advantage of cheap labour cost to its Asian neighbours (Figure 3). Well, this is typically the cost of structural rebalancing.

From a global perspective, in a world with growing trade tensions and persistent weak demand, if Beijing pursues a devaluation policy that would boost China's trade surplus, it may likely

[2]By definition, a deficit country funds its investment by foreign savings (i.e. capital inflows). When foreign inflows decline (or in the worst case scenario change into outflows), domestic investment is forced to decline due to the contraction in foreign funding.

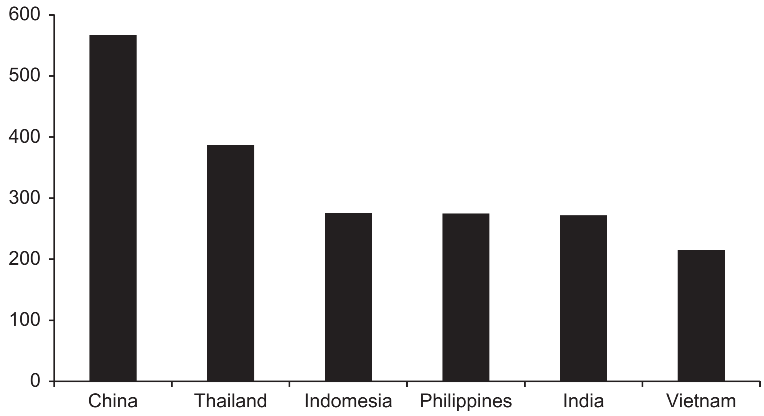

Figure 3: Manufacturing Workers Average Monthly Compensation (2014). *Sources*: JETRO, Author. *Note*: This includes wages and mandatory social contribution.

ignite more currency wars, encourage trade protectionism and risk turning back the process of globalisation. Assuming China does not opt for devaluation in its economic transformation process, Vietnam, India, Indonesia and the Philippines will likely be regional winners due to their cheaper cost of labour (see Figure 3).

Urbanisation and Demographics

China's working-age population (15–64-years old) ballooned between 1970 and 2010, fuelling double-digit GDP growth rates for four decades. But this is a thing of the past as its labour force as a share of the total population started to shrink in 2012; in terms of absolute numbers China's working population started shrinking in 2015 (Figure 4). The United Nations projected that China would be adding more retirees than employees in the next two decades (United Nations, 2015). While China will remain the world's most populous nation and will add another 40 million people by 2030, *ceteris paribus*, its demographic dynamics is certainly deteriorating. As the baby-boomers age and they haven't produced enough children to replace them, a circle of rising wages, declining demand and falling savings rate will reduce potential growth. This will also put more pressure on fiscal spending to support the ageing population.

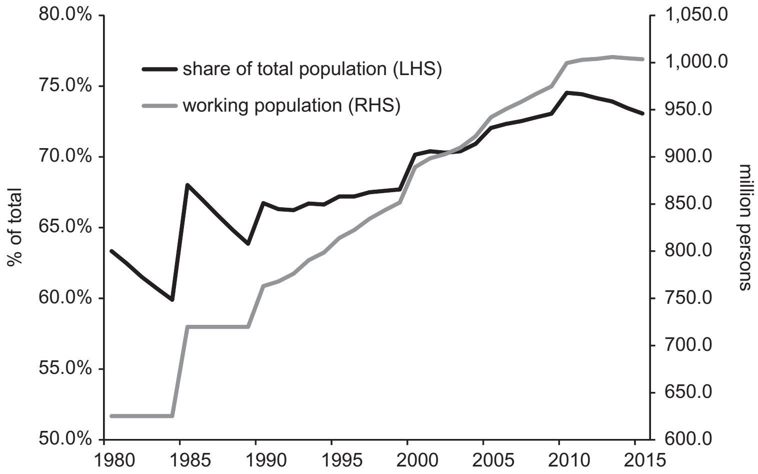

Figure 4: China's Shrinking Work Force (15–64-Years Old). *Sources*: CEIC, Author.

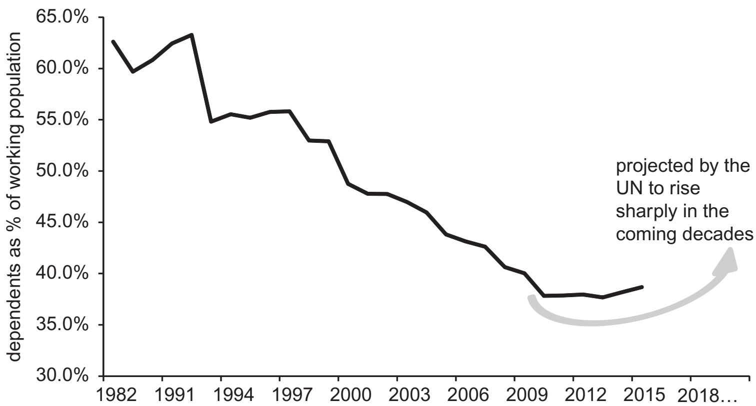

Figure 5: China's Dependency Ratio. *Sources*: CEIC, Author.

After declining for decades, China's dependency ratio (the numbers of young (0–15-year olds) and old (over 64-year olds) people as a share of the working-age population) is poised to rise sharply again (Figure 5). The median age will rise to 41 in 2025 from 37 in 2015, according to the United Nations projections. But Beijing is aware of this population 'time bomb' and has implemented two measures since 2014 to cushion its impact.

The first is relaxing the *hu kou*[3] (or household registration) restriction in 2014 and the second is changing the One-child policy[4] to a Two-child policy in 2015. Although the ultimate impact of these reform measures is expected to be limited, they show that the Chinese government was willing to make changes to address the impending economic problems.

Beijing issued reform guidelines in July 2014 relating to its decades-long *hu kou* system. The market saw this as a significant step towards increasing labour mobility and productivity gains and unlocking 'dead capital' (Lo, 2007, pp. 33–38) in the rural regions. In reality, the impact of this reform is likely to be very limited because to achieve the full benefits, China needs to scrap the system altogether. But Beijing knows that such a drastic move would face severe resistance and is thus implausible to implement in the short-term. So the reform guidelines were more a sign of incremental progress than a big step forward.

China has a dual *hu kou* system that has divided people into urban and agricultural households since 1958. Different *hu kou* holders enjoy different social benefits. Urban *hu kou* holders receive better education, medical care and pension than their rural counterparts, who are entitled to farmland use rights and

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[3]In China, a *hu kou* is a record of household registration in the government system as required by law. This household registration record officially identifies a person as a resident of an area and includes identification information such as name, parents name, spouse name and date of birth. In 1958, the government officially promulgated the *hu kou* system to control the movement of people between urban and rural areas. Individuals were broadly categorised as a 'rural' or 'urban' worker. A worker seeking to move from the countryside to urban areas to take up non-agricultural work is called a migrant worker and would have to apply for permission through the relevant bureaucracies. The number of workers allowed to make such moves was tightly controlled. Migrant workers would require six passes to work in provinces other than their own. They would not qualify for social welfare including housing, education and health care in the geographical areas where they work.

[4]The One-child policy was a population planning policy of China. It was introduced in 1979 and was changed to a Two-child policy in 2015. The One-child policy allowed many exceptions and ethnic minorities were exempt. In 2007, 36% of China's population was subject to a strict one-child restriction, with an additional 53% being allowed to have a second child if the first child was a girl. Provincial governments imposed fines on violations, and the local and national governments created commissions to carry out registration and inspection work.

are allocated rural land to build houses. A chapter in Beijing's reform guidelines document says that China would set up a unified *hu kou* system by removing the rural–urban distinction. Some analysts have jumped to the conclusion that this would mean giving rural residents the same rights as urban residents in terms of employment, education, medical care and housing.

This is not true. The reform does not totally remove the rural–urban distinction and, thus, does not remove all the barriers to migration and labour mobility from rural to urban areas. The document states that a system of 'residence permits' would be set up to allow qualified migrants to enjoy urban services and social benefits. Whether a rural emigrant is eligible and to what extent he/she can enjoy these benefits depends on how long the person has lived in the city and how long he/she has contributed to social insurance programmes. Anyone who does not have a residence permit is still not entitled to equal urban benefits, whatever type of *hu kou* the person holds.

This dual *hu kou* system makes rural migrants feel discriminated against and hinders migration and, hence, geographical labour mobility within the country. The reform is trying to narrow the difference between the two types of *hu kou* and, hence, raise labour mobility and facilitate urbanisation. It is intended to be implemented initially in towns and small cities, where a resident who has lived long enough to get a residence permit can apply for an urban *hu kou* and enjoy urban social welfare benefits.

China plans to urbanise a total of 100 million rural residents and migrants[5] by 2020. Official data show an urbanisation rate of 51% in 2015. This still lags behind the rate in many other countries which boast an average rate of more than 70%. Crucially, China's genuine urbanisation rate is only about 32% when adjusted for the 260 million migrant workers, who work and drift between cities and never contribute effectively to urban spending (as they tend to save and send the money back to their hometowns). Granting residence permits to these migrant workers could effectively help boost GDP growth via investment and consumption spending.

Expanding the *hu kou* reform to its true form (i.e. eliminating the rural–urban difference and, eventually, the *hu kou* system altogether) is easier said than done. Urbanisation will require all

[5] 81 million out of the 100-million total will be rural residents and the rest 19 million will be migrant workers.

levels of governments to spend more on social welfare and construction. However, under the current asymmetrical budget structure, local governments have to remit 100% of their fiscal revenues to the central government but only get 40% of that back in the form of fiscal transfer. Meanwhile, they have to pay for 80% of their fiscal spending. Thus, many local governments are financially strapped and are putting up strong resistance to the *hu kou* reform that would facilitate urbanisation.

Ultimately, the *hu kou* reform cannot succeed without parallel land reforms that allow farmers to trade their farmland and transfer land titles in the open market to unlock their 'dead capital'. Medicare and pension programmes will also have to be unified nationwide so that people can enjoy equal services wherever they live in China. All these involve fiscal, land and social welfare reforms, which will take longer than many observer have expected. At this point, the urbanisation drive by Beijing calls for the creation of multiple city clusters, such as the Beijing–Tianjin–Hebei economic zone, the Yangtze River Economic Belt and the New Silk Road Economic Belt (or the Belt and Road (BAR) plan).

Regarding the change in the One-child policy to a Two-child policy, the effects on cushioning the adverse demographic dynamics are more uncertain than the *hu kou* reform. The good news is that such a policy shift will, in principle, help reverse the worsening demographic trends in China in the long-term. The bad news is that it will not have any material impact in the short- to medium-term. Even the presumed long-term benefit of boosting China's population growth depends on whether this Two-child policy will work to increase the fertility rate.[6]

With China's 'population dividend' turning to a 'population tax', Beijing is trying to reverse the negative economic impact by relaxing the One-child policy. In principle, the Two-child policy should boost the fertility rate in the long-term. But in the short- to medium-term, it will only aggravate the increase in the dependency ratio by adding more babies to the old population.

[6]Fertility rate of a population refers to the average number of children that would be born to a woman over her child-bearing age, that is between 15 and 44 years. On a net basis (births minus deaths), a country needs a fertility rate of 2.1 (i.e. 2.1 children born to each woman) to prevent its population from shrinking.

As Japan's experience shows, it is difficult to make the general population youthful again once it has aged.

This Two-child policy shift has come too late to change China's deteriorating population dynamics. As the baby-boomers age and their children are not numerous enough to replace them, this will put upward pressure on wage growth and fiscal spending and downward pressure on savings and GDP growth. What's more, it is uncertain whether the Two-child policy will boost the fertility rate. While the One-child policy has been blamed for China's rapid ageing population, the demographic transition would have happened anyway due to rising levels of education and income, as cross-country evidence shows.

China's fertility rate started falling even before the introduction of the One-child policy in 1979. Even today, its fertility rate does not differ much from other countries that do not have population control policies. Surveys in China show that about 50% of Chinese couples that already have a child would want another one. This implies that if there were no policy restrictions, China's fertility ratio (the number of children per woman) would be about 1.5 (but according to the government and local research estimates, China's actual average fertility ratio is only about 1.2 to 1.3).

However, the reality is quite different from the survey results, as policy is not the only, or main, factor depressing fertility. Schooling, working, social freedom and rising cost of raising children are all important factors prompting women/couples to delay having children or have none at all. Indeed, earlier relaxation of the One-child policy did not yield the desired result of boosting fertility.

Rural families whose first child is female have been allowed to have a second child since the 1980s. Couples who are both single children are also allowed to have two children. The policy was relaxed further in 2013 for couples to have a second child when only one parent is a single child. This move allowed an additional 11 million families to have a second child. But as of mid-2015 (the latest data available at the time of writing), only 1.45 million families had taken advantage of it. While relaxing the One-child policy does not hurt, it is far from certain that it would reverse China's deteriorating population dynamics. China will still need more diapers in the future, but likely for adults.

Notwithstanding the uncertainty about the *hu kou* reform and the relaxation of the One-child policy, these efforts (if implemented properly) may still create economic growth momentum amid the mega trend of economic rebalancing. Economic sectors such as transportation, telecommunications, information systems, environmental protection and sectors catering for the baby and young population, such as baby/child products and education, should benefit from the economic transformation process. There will also be more demand for investment in education and health services.

Changing Growth Structure

An expensive renminbi and an ageing population are combining with prolonged weakness in global demand after the GFC in forcing China to change its growth structure. Indeed, structural upgrading of China's economy to high value-added production and service-based consumption-driven growth is what Beijing set out to do in its 13th Five-Year Plan in 2015.[7] As wages rise on the back of a shrinking work-age population and an expensive renminbi exchange rate, and as economic maturity pushes the Chinese economy closer towards its production possibility frontier, China's factors of production have become more expensive and scarce, prompting Beijing to turn to a new industrialisation strategy through innovation.

There is indeed ample room for upgradation. Currently, China's manufacturing and export sectors are still quite labour-intensive, despite progress in climbing the value chain (Figure 6), as high-skill and technology-intensive exports account for only a little more than one-third of exports, according to the United nations Conference on Trade and Development (UNCTAD). The government is determined to change this economic structure by increasing funding in research and development (R&D) and investment in targeted sectors that are consistent with industrial

[7]China's Five-Year Plans are a series of social and economic development initiatives. The economy is shaped by the Communist Party through the plenary sessions of the Central Committee and national congresses each year in accordance with the broad directions set by the corresponding Five-Year Plan. The Party plays a leading role in establishing the foundations and principles of Chinese socialism, mapping strategies for economic development, setting growth targets and launching reforms. The first Five-Year Plan was established in 1952 for the five-year period of development between 1953 and 1957. The most recent Five-Year Plan is the 13th, established in 2015 for the period between 2016 and 2020.

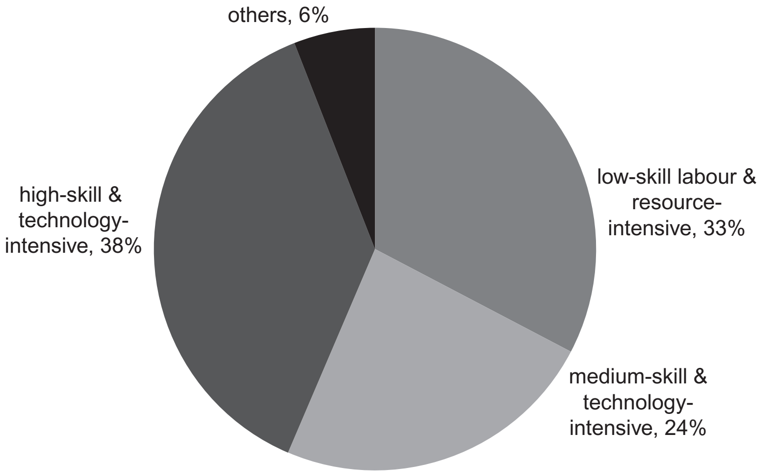

Figure 6: China's Export Breakdown by Value (2014). *Sources*: UNCTAD, Author.

upgrading. These include information technology, robotics, marine equipment manufacturing and medical and optical equipment.

Regarding R&D, Beijing is aiming at creating a number of national laboratories that will focus on research on telecommunications, semiconductors, nuclear power stations, advanced urban railway systems and high value-added electronic equipment. China is already spending an amount equivalent to 2% of GDP on R&D in recent years, according to the United Nations Educational, Scientific and Cultural Organization (UNESCO). This amount is higher than that for some of the developed countries, such as Canada and Norway, although it is still lower than the global technology powerhouses, such as South Korea, Japan, Germany and The United States (Figure 7).

The question is whether China is able to broaden these changes when its system is still plagued by moral hazards, rent-seeking, inertia and resistance to change? Only time will tell. But there are signs from the reform blueprint, the 'Decision' document (China Daily, 2013), which the Chinese leadership announced in late 2013 showing that it wanted to make these changes by improving the underlying institutional framework.

Among the 60 reform objectives spelled out in the Decision, those on economic reforms were nothing new. Most of them, such as private sector development, protecting intellectual

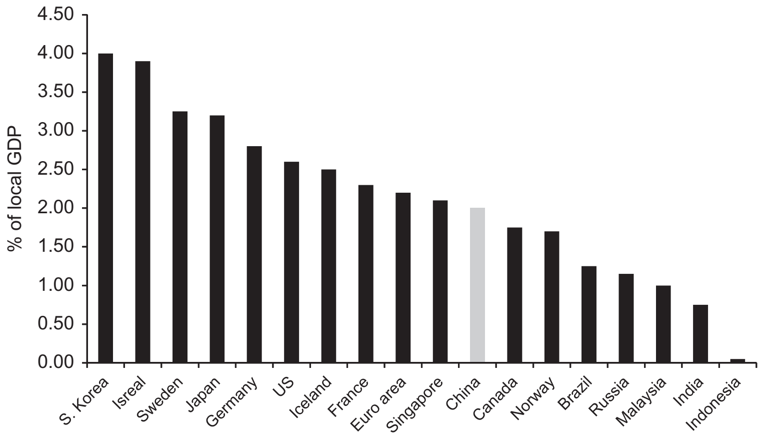

Figure 7: Comparison of Spending on R&D. *Sources*: UNESCO, Author.

property rights, cutting red tape and promoting market forces, could be found in the resolution of the previous Five-Year plans back in 1993; and they have not been effectively implemented.

The potential game-changer this time lies in the two intended legal reforms which, IF implemented properly, could go a long way to address the root problems of the lack of governance and rule of law that have plagued the Chinese system. They may also act as the prelude to political reform later, which will go a long way to deepen China's structural transformation.

First, the Decision seeks to strengthen judicial independence, separating law from administrative jurisdictions at the local government levels. The purpose is to free the local courts from local government control and, thereby, to destroy a large part of the rent-seeking mechanism. Second, the Decision wants governments' commitment to respect and protect human rights, prohibit interrogation and the extraction of confessions by torture and to scrap re-education labour camps.

These are wholly new resolutions. But as past reform efforts have been ineffective, how will these tougher changes be implemented? China's future reforms indeed depend on whether President Xi Jinping's move to centralise and strengthen his control in the Party to fight against vested interests and maximise his ability to impose structural changes will pay off.

A leaner, centralised leadership may make a difference this time. The 'harmonious society' model under the former

Hu-Jintao-Wen-Jiabao decentralised bureaucratic regime has proven insufficient. Exports struggled as labour cost rose. Investment returns fell steadily as the focus changed from income-generating projects, such as infrastructure, to less-productive projects, such as shopping malls and luxury property development. Productivity of the state-owned-enterprises (SOE) plummeted (Figure 8), revealing the problem of a bloated state sector – whose employment expanded from 40 million to 70 million under the previous Hu-Wen administration – crowding out the private sector. Last but not the least, local government funding through land-grabs was reaching its limits.

As a start to address these excess problems, President Xi has cut the number of top leaders in the Standing Committee of the Politburo from nine to seven. He has ousted some powerful left-wing and reactionary voices (notably Bo Xilai and Zhou Yongkang), relegated some extreme right-wingers (Li Yuanchao and Wang Yang) to the second tier and waged an anti-corruption campaign. He has also set up both a senior group to enforce structural reforms and bureaucratic compliance and a national security commission to coordinate foreign policy.

All this boils down to a bet on President Xi's ability to rein in the extreme forces and improve policy coordination to facilitate his power consolidation so as to push for deeper changes. This is a tall order. Meritocracy is the foundation of China's political system, but it has been eroded by a political culture of cynicism, cronyism and sycophancy. Building a mechanism to pick the

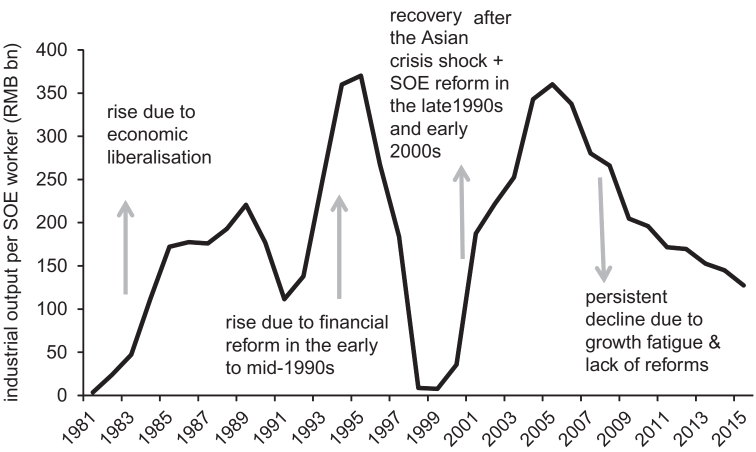

Figure 8: China's SOE Productivity. *Sources*: CEIC, Author.

right bureaucrats is the most challenging yet basic task for implementing the action plan for future reforms amid the inherent conflict of interests and moral hazard. President Xi will have to lead a 'long march' in the coming years.

From Basic Consumption to Luxury

The flip side of rising labour cost is higher income for workers and, hence, higher purchasing power. Per capita income in China rose by 24 times to USD7,600 a year in 2014 from USD320 in 1990. Going forward, a declining labour force and slowing investment will give labour a bigger share of income, facilitating the structural transition towards a consumption-led economy. Still, at this stage more than 60% of China's consumption expenditure is on basic necessities, such as clothing, food and shelter.

Alongside the changing economic structure is the changing structure of Chinese consumption. One way to understand this mega trend is by analysing the evolution of the income groups. Let us divide Chinese consumers into five income groups: the poor, the urban poor, the low-income middle-class, the middle-class and the affluent (Table 1). It is clear from this distribution that almost half of China's population is still in the poor category, while the middle-class (the major consumption class) accounts for less than 13% of the population.

According to the 13th Five-Year Plan, the government is planning to urbanise 81 million people from the rural areas by 2020. This means that 81 million people will move from the poor income category to the urban poor category, boosting the

Table 1: Chinese Consumers by Income Groups (2015).

Group	Annual Income (USD)	Number of People (mn)	% of Total Population
Poor	<3,000	627	47.1
Urban poor	3,000–5,000	140	10.5
Low-income middle-class	5,001–10,000	271	20.4
Middle-class	10,001–15,000	168	12.6
Affluent	>15,001	125	9.4

Source: CEIC, author.

share of urban poor population by more than 6 percentage points, *ceteris paribus*.

As a result, we can expect that a large part of the consumption growth in the future will likely come from the urban poor category and the low-income middle-class (the number of which will grow along with income growth) because the marginal propensity to consume for the poor is much higher than that for the rich. Currently these two categories together have a total of 411 million people, compared to 293 million in the middle-class and affluent categories. The gap will likely remain large as the growth of the urban poor and low-income middle-class cohorts is faster than the middle-class and affluent groups.

Even with the highest annual compound rate of growth from 2008 to 2013 among its Asian peers, average household consumption in China is still lower than Thailand and Malaysia and significantly lower than South Korea (Figure 9). This was mainly a result of financial repression that deprives Chinese households of a decent return on their savings, high import tariffs for many consumer goods and a cheap renminbi. But these constraints have changed. The deposit interest-rate cap was scrapped in 2015, some import tariffs are coming down and there is not going to be one-way renminbi appreciation anymore.

In terms of consumption pattern, Chinese consumption is still concentrated on basic goods. This will change as China's household income catches up with the level of its rich neighbours, such as South Korea. Currently, Chinese household spending on daily

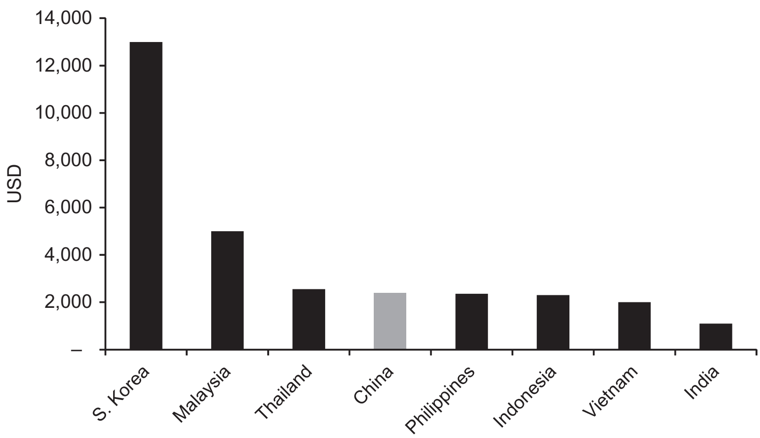

Figure 9: Annual per Capita Household Consumption (2014). *Sources*: CEIC, Author.

essentials, such as food, clothing, tobacco and liquor, accounts for more than a third of the typical consumption basket, compared to only 15% of the Koreans.

So the trend is for Chinese consumption to move away from the basics towards luxury and non-essentials. Generally, as Chinese household income rises, they will want to eat better, live better and enjoy more luxury. Middle-class and affluent households will continue to increase their demand for protein foods and other better quality foods, such rice, dairy products and even wine and cheese. So high-quality food imports will rise. There will also be increasing demand for health products, such as air purifiers, health foods, fitness and sports equipment and clothing. The government will also likely spend more on pollution and environmental control.

Urban household spending on recreation and culture is bound to increase swiftly. From entertainment, travel, dining, sports, gaming to using technology for these purposes (think smartphones and computers) and for connectivity with the rest of the country/world, Chinese consumption is definitely moving towards more leisure and luxury. For example, the Chinese film market is already expected to grow bigger than The United States by 2017, according to Motion Picture of America.

The evolution of China's demand for tourism is especially noteworthy because the trend is changing rapidly so that history is not a good guide for the future. The number of Chinese travellers has ballooned in recent years, with overseas tourism growing even faster than domestic tourism. For example, Chinese outbound tourists amounted to almost 100 million in the first three quarters of 2015 (the latest data available at the time of writing), up by 14% year-on-year. Despite the huge number, Chinese outbound tourism is still very limited mainly due to the passport constraint. On average, only 5% of the Chinese population has passports, compared to more than 10% in America.

While the positive impact of Chinese tourists on the global economy is rising, the distribution effect is changing rapidly. Hong Kong and Macau used to be prime destinations for Chinese tourists, accounting for three quarters of all Chinese outbound tourists. But they have fallen out of favour since 2010 (Figure 10) as the Mainlanders head for other Asian destinations, notably Thailand and South Korea, and other foreign countries, such as The United States and Europe.

According to China Internet Watch, a Mainland database service provider, Hong Kong is expected to fall from being the

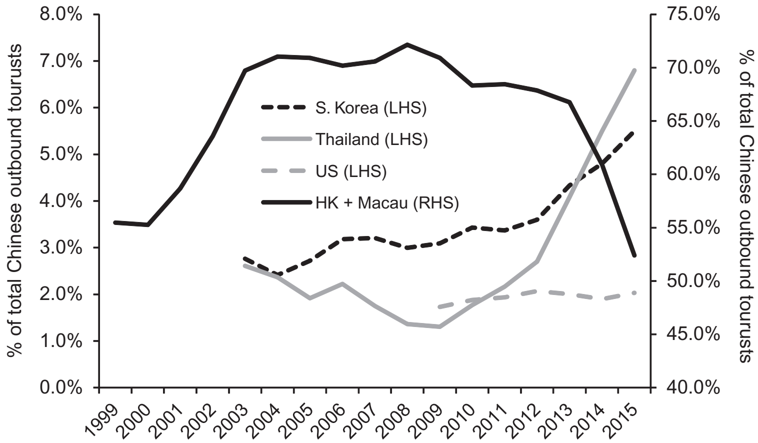

Figure 10: Chinese Tourist Destinations. *Sources*: CEIC, Author.

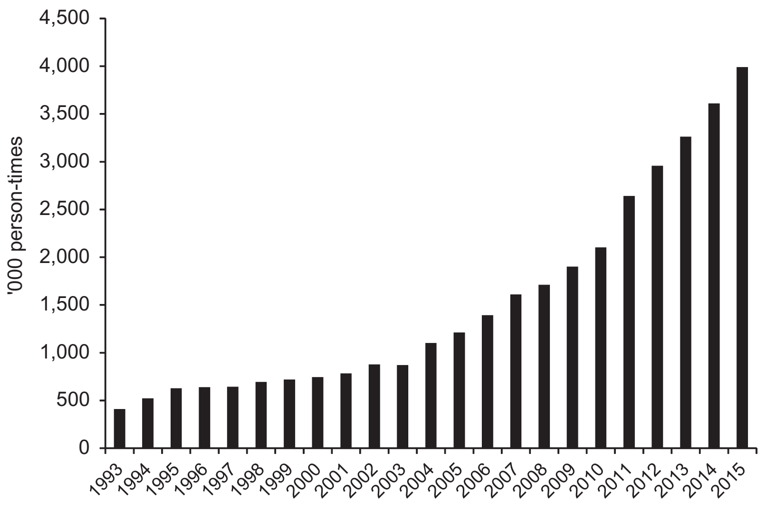

Figure 11: China Domestic Tourists. *Sources*: CEIC, Author.

largest recipient of Chinese tourists to the ninth place in 2016, while Thailand, South Korea and Japan will become increasingly popular destinations for Chinese tourists in the coming years. Meanwhile, domestic travel is also rising rapidly (Figure 11), helped by the government's drive to boost the service sector as part of the economic rebalancing effort.

Last but not least, Chinese consumption will also see a revolutionary change towards demand for financial assets (stocks, bonds, insurance products and asset management service) driven by steady, albeit slower, income growth in China. We shall examine this trend in more details in Chapter 3.

Shaking up the World's Political Economy

Arguably, the most visible impact of China's mega trends on the global system will be its increasingly assertive foreign policy, which is backed by its increasing economic affluence. Since President Xi Jinping came to power in late 2012, he has been pursuing a vision of China which is decisively different from his predecessors. He aims at bringing China to the top of the world through means that are akin to building an empire by controlling territories beyond its borders through soft or hard power (though the Chinese strongly disagree with this interpretation) and by using its currency in international payments. Arguably, this assertive Chinese vision is what prompted The United States to install its 'pivot Asia' policy in 2012 (right before Xi Jinping took office) in an attempt to strike a balance between the influence of The United States and China in Asia.

President Xi's 'Chinese Dream'[8] to rejuvenate China is a signal of his assertive vision to establish a future place for China in the world. The new China under Xi Jinping is, thus, no longer content with accepting the status quo but rather wants to rebuild China's glory by exporting the Chinese model. To do that, he has embarked on internationalising the renminbi so as to reduce China's dependence on using the US dollar, exporting China's

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[8]In this nationalistic framework, President Xi Jinping seeks to combine national and personal aspirations in order to 'reclaim national pride enhance personal well-being'. In economic terms, this amounts to creating incentive compatibility between the state and the people to maximise national and individual interests, subject to political and resources constraints. President Xi is in fact driving home the point of structural rebalancing from export-led growth to consumption-led growth: In his vision, China has been manufacturing and exporting products to meet the consumption appetite of the West for more than three decades. Now China is ready to consume what it produces and to realise the materialistic aspect of the Chinese Dream.

excess capacity to countries with infrastructure needs, expanding trade routes to increase the number of 'captive' markets and diversifying China's savings away from US dollar assets.

The renminbi internationalisation, and the corresponding capital account liberalisation, process had a strong start for six years. But it has slowed down significantly since 2015 due to Beijing's concern about the opening up process creating too much volatility that will risk crushing China's growth and the banking system. Overall, the internationalisation process has made some progress on international payments, with the renminbi rising to the rank of being the fifth most-used international payments currency in the S.W.I.F.T. system[9] in early 2016 from having no ranking before 2009. The yuan has also been included in the International Monetary Fund's Special Drawing Rights currency basket since October 2016, which has made it a reserve currency by stealth.

A lot of blind faith has been put in the mega trend of the renminbi becoming a global currency with erroneous forecasts being made over the years for its financial impact on the world markets. In reality, further steps are needed to widen the demand for renminbi from trade settlement purpose to non-trade purposes (see Lo, 2013, Chapter 5). China is trying to do so by building a renminbi offshore market with offshore centres spanning from Asia to Europe and North America, and by setting up financial institutions, including the New Development Bank (NDB), the Asian Infrastructure and Investment Bank (AIIB) and strategic plans (the BAR) that will, presumably, enhance the global demand for renminbi.

The NDB, with a capital base of USD50 billion and based in Shanghai, was created under Chinese leadership with an aim of financing infrastructure investment needs in the BRICS countries.[10] The nature of the NDB is equivalent to that of the World Bank which has a four times bigger capital base than the NDB. But the NDB differs from the World Bank and other multilateral

[9]S.W.I.F.T., or the Society for Worldwide Interbank Financial Telecommunication, provides a network that enables financial institutions worldwide to send and receive information about financial transactions in a secure, standardised and reliable environment. It also supplies software and services, on a fee basis, to financial institutions for using the SWIFTNet Network.

[10]BRICS countries include Brazil, Russia, India, China and South Africa.

development banks in two major ways: (1) it is controlled by emerging market countries rather than developed countries. (2) While emerging market countries usually borrow from the World Bank in US dollars, the NDB tries to break the US dollar dominance by lending in the currencies of each of the BRICS member countries.

The AIIB shares the same nature as the NDB, except that its lending mandate is not restricted to the BRICS countries. It is seen as a direct challenge to the Asian Development Bank (ADB), which is a Japanese initiative in Asia. It is headquartered in Beijing and has a working capital of USD100 billion, with China contributing the largest share of USD30 billion to the capital base and holding a 26% voting share. Beijing's intention is for the AIIB to lend mostly in renminbi, thus providing a platform for deepening the internationalisation of the Chinese yuan. More crucially, the AIIB is expected to serve as the financing arm of Beijing's BAR initiative (see Chapter 8, the Belt and Road Strategic Plan).

The BAR strategy is a flagship initiative of President Xi Jinping for realising his Chinese Dream by building regional and eventually global commercial and trade links by focusing on infrastructure investment. The key financing sources are the AIIB, the state-owned Silk Road Infrastructure Fund and co-investment by private funds. The BAR projects also serve as a release vault for recycling China's excess capacity by expanding its investment to other countries.

Clearly, sectors with excess capacity in China and relevant SOEs will benefit. But emerging Asian countries with heavy infrastructure needs will also benefit from additional funding by the AIIB and China's direct investment. The advent of the AIIB will also increase competition among the existing multilateral development banks and lead to efficiency gains in development finance (see Chapter 7, The Great Emigration of Chinese Capital).

In the grand scheme of things, it seems that in realising his Chinese Dream, Xi Jinping's strategy is to rebuild China's global power by exporting the Chinese model, notably to the BAR countries. This implies that China may be competing, on purpose or not, with the western world led by The United States in exporting their development strategies to other parts of the world. Since this contest is largely hidden from public view, the outcome will have far-reaching and unexpected impact on global geopolitical development in the coming decades.

China's BAR initiative represents a striking departure in its policy by seeking to export its development model to foreign countries instead of focusing on investing in Latin America and Africa in their commodities and mining industries and building infrastructure that needs to transport them to China. The BAR strategy aims at creating foreign demand by first developing industrial capacity and consumer demand in the foreign countries. In other words, rather than extracting raw materials, China is now seeking to shift its industrial capacity to less developed countries, making them richer so as to create demand for Chinese products.

Domestically, this is a new development model under Xi Jinping and is totally different from the old supply-expansion model in which economic agents invest/produce/build first to expand supply and create jobs so that demand catches up in due course. This old growth model worked for more than 30 years when the country was chasing high-growth rates creating swift demand catch-up. But when President Xi came to power in 2013, he changed the country's growth objective to one that focuses on growth quality via structural reform from the old one that chased growth quantity at all costs.

Nevertheless, this new growth model of China is still based on state-led investment in infrastructure (motorways, electricity, railways, roads, bridges, airports and ports) that lead industrial development. By contrast, the modern development model in Europe and The United States focuses on investment in 'soft' infrastructure, such as gender equality (notably women empowerment), public health, anti-graft measures, environmental protection and support for global civil society.

Granted, these are laudable goals, but the fact is that countries do not get rich by investing in them alone. The developing world (and China) values these admirable goals quite differently from the western world for the simple reason that poor countries need growth to feed their essential needs before considering empowering females and enjoying clean air, for example. True, public health is crucial for sustainable growth, but if a country's hospitals and clinics lack reliable electricity and clean water to run, or if there are no good roads for access, they serve no purpose. That is why China's state-driven investment and infrastructure-based development model have gained strong support from the developing countries.

The question is which model will prevail in the future? If BAR works according to China's plan, the whole of Eurasia would be transformed in the decades to come. This could turn out to be a win-win outcome for China and the regions that adopt China's model which would raise incomes in these regions and, thus, their demand for Chinese products. The global status of Central Asia would be elevated from peripheral to core (or at least part of the core), and China's system of central/authoritarian leadership would gain momentum in the BAR regions, challenging the democratic system of the western world.

However, this does not mean it will be all smooth sailing for China's BAR strategy. Investment-led growth has worked well in China until recently because Beijing has absolute political control over the domestic system. It is not the same when Chinese investment goes abroad as foreign political and economic frameworks would be out of Beijing's control. Indeed, China has already found itself confronting angry stakeholders, nationalistic legislators and unstable commercial relationships in some African and Latin American countries, such as Nigeria, Ecuador and Venezuela.

This also does not mean that the western world should sit on its hands to wait for China to fail. BAR may be facing a bumpy road ahead and it may not work for some countries. But it is still a mega trend of China that will create critical effects on regional growth with global impact in the long-term. The developed world used to build massive dams and transportation networks in the 1950s and 1960s, but these projects fell out of fashion as the western world economy matured. The western world has offered little to developing countries in terms of infrastructure investment. But it needs to ask why is it so difficult for it to build (or upgrade) infrastructure not just at home but also in developing countries. As China's mega trends unfold, the developed world is risking ceding the future of Eurasia and other parts of the world to China's development model.

Back to China

The above analysis provides only a bird's-eye view on the mega trends of China. It is not meant to be an exhaustive list as new trends will emerge and existing trends will change over time. How the trends will evolve depends on how China will manage its structural transformation. Any reform process produces winners and losers as well as short-term pains. The pain threshold and the ability/resolve of the authorities to manoeuvre the political fallout will determine the likelihood of the various reform outcomes which, in turn, will affect the development of the mega trends.

I do not think the Chinese authorities have found the conclusive answers to the important questions stemming from its quest for a new China. The old China is not working, but the road leading to the new China is full of uncertainties. The Chinese government under President Xi Jinping has a vision, a Chinese Dream, of what an ideal new China would be – one that could shed its excess capacity, raise people's living standard, emerge to global prominence, escape the middle-income trap and leap to the developed country status. But before it can get there, the transition process is a tall order for China and a tectonic shift that will generate seismic waves for the global system.

In the following chapters, we shall examine the mega trends of China in more details. The crucial thing to bear in mind is not how the world will change China as it opens up to the international system but also how China's mega trends will change the world as they unfold.