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## Making sense of China's Economic Slowdown

By Yasushi SUZUKI <sup>†</sup>

**Abstract.** This paper aims to review the factors inducing China's successful economic transformation, so as to find the causes of the subsequent economic slowdown, from the New Institutional Economics (NIE) viewpoint and the Marxian viewpoint, respectively. The former school is primarily concerned about the "supply-side" driver (changing rules of game for producers) of increasing economic output and efficiency, while the latter is basically sharing with the Marxian concern of the "demand-side" driver (an egalitarian pattern of income distribution which underpins mass-consumption) of increasing economic output and sustainability. NIE emphasize that unless a free and open market for ideas is created, China cannot sustain its economic growth or advance itself into a global centre of technological innovation or scientific discovery. However, this paper points out that the creation of an active market for ideas would not always guarantee the sustainability of economic growth, drawing the lessons from Japan's experiences. This paper suggests that it takes more or less several years to create an active market for ideas to transform to a new phase of post-industrialization. In addition, in the phase of post-industrialization, rapid product obsolescence is brought by severe competition in which rival firms are accelerating the introduction of competitive products to the market, which may expose innovative firms to fundamental uncertainty.

**Keywords.** China, Economic transformation, Market socialism, Post-industrialization

**JEL.** B51, P30, P20

### 1. Introduction

The World Bank statistics report that China's annual percentage growth rate of GDP (at market prices based on constant local currency) recorded at 10.4 per cent in 2010, 9.3 per cent in 2011, then slowed down to 7.7 per cent in 2012, and 7.7 per cent in 2013, respectively. More researchers and scholars start shedding doubt on the sustainability of China's economic development. "The country's whole way of doing business, the economic system that has driven three decades of incredible growth, has reached its limits. You could say that the Chinese model is about to hit its Great Wall, and the only question now is just how bad the crash will be" (Krugman, 2013, July 18). What causes China's economic slowdown after its miraculous economic transformation? To understand the cause of its economic slowdown, we should review the cause of China's successful economic transformation and rapid economic growth. In a dialectical sense, each stage of development contains the seeds of its own transformation into a higher stage. On the other hand, each stage is an advance on those that have preceded it, however it absorbs and transforms elements from them. The process of change, in which new ideas do not so much defeat the old as resolve conflicts or contradictions within them, Hegel called the *dialectic* (Fine and Saad-Filho, 2004:2). Positive factors can

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turn into conflicts or contradictions for the next transformation. This paper aims to review the factors inducing China's successful economic transformation, so as to find the causes of the subsequent economic slowdown. Section 2 reviews two different views - the New Institutional Economic (NIE) view and the Marxian and heterodox view-on the inducement to China's successful economic transformation. Section 3 aims to draw the lessons from Japan's experiences to assess the NIE's view. Section 4 puts concluding comments.

### 2. NIE vs Marxian views on China's economic transformation

It is worth reviewing two different views on the inducement to China's successful economic transformation; one is the New Institutional Economics (NIE) view, while the other is the Marxian and heterodox view. This is because examining a sharp contrast between these views is suggestive for understanding China's economic slowdown. This paper attempts to review a NIE view by Ronald Coase & Ning Wang (Coase & Wang, 2012) and a Marxian view by Dic Lo (Lo, 2012), respectively (see table 1).

**TABLE 1.** Comparison between NIE and Marxist views on China's economic transformation

	NIE View	Marxian / Heterodox View
<b>Inducement to China's successful economic transformation</b>	1) Experiments for modernizing socialist economy: particularly, <i>four</i> marginal forces - private farming, township and village enterprises (TVE), individual entrepreneurship, and the Special Economic Zones pioneered in transforming the Chinese economy during the 1980s. 2) Decentralized political structure and intense regional competition (competition among local governments) in the 1990s. 3) Chinese people with full of optimism, energy, creativity, and determination.	1) Industrialization led by state-owned and collectively-owned enterprises. 2) An egalitarian pattern of income distribution which underpinned mass-consumption, thereby inducing investment and overall demand expansion particularly in the first half of the reform era between 1978 and 1992. 3) A switch in the early 1990s from labour-intensive growth to capital-deepening growth (in the second half between 1993 and 2007). The growth path also switched from consumption-led to investment-led between the two halves of the reform era. 4) Keynesian type fiscal stimuli in 1998-2002.
<b>Bottlenecks for further development</b>	1) Lack of a market for ideas. 2) Regulations less encouraging people's creativity.	1) Sluggish consumption expansion. 2) Enlarging the inequality of income redistribution

In general, New Institutional Economists insist that "institutions" in terms of rules that give economic players *incentives* and *sanctions* would matter to determine the economic efficiency and productivity. Ronald Coase (Nobel laureate) and Ning Wang point out that intense regional "competition" under the decentralized political structure in the *marginal* areas is the key to understanding the extraordinary speed of market transformation in China during the 1990s and beyond. They shed an analytical light on their account of "marginal revolutions" showing that China's market transformation in the 1980s was primarily carried out by the non-state (and hybrid) sectors while the state-led reform failed to revitalize the state sector. They raise *four* marginal forces - private farming, township and village enterprises (TVE), individual entrepreneurship, and the Special Economic Zones - which pioneered in transforming the Chinese economy during the 1980s.

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These economic experiments enjoyed some political freedom as long as their presence was no longer perceived as a threat to socialism. "Once peasants and unemployed city dwellers were allowed the freedom to pursue private entrepreneurship, it did not take long for their endeavours to outshine the state sector and convince the pragmatic Chinese leaders to recognize these experiments as beneficial rather than inimical to socialism" (Coase & Wang, 2012:165). They emphasize that China's decentralized political structure and intense regional competition in the 1990s and beyond arose as the most powerful driving force behind China's economic transformation. Since local government officials are ultimately appointed by Beijing based on the performance of the local economy, Chinese local governments run their jurisdiction - the province, city, county, town, and village - much like a business corporation (Coase & Wang, 2012:171). In particular, the *kaifaju* fever (*kaifaju* were mainly industrial estates) of the 1990s reflected a highly decentralized pattern of industrialization in China's countryside (see Hsing, 2010). In addition to the incentive structure to governmental officials, the Chinese government still controls many important economic resources particularly bank loans. "Repetitive and duplicative investment is inevitable, and indeed, an essential part of the process. This has resulted in an erosion of economies of scale to capital due to its under-utilization, but has greatly accelerated and diffused industrialization, turning China into a formidable workshop of the world in less than thirty years" (Coase & Wang, 2012:173-4).

Basically, Coase & Wang attribute China's successful economic growth to seemingly "unintended" modernization of socialism. "This is the most unexpected aspect of the Chinese economic transformation. ... The story of China is the quintessence of what Adam Ferguson called 'the products of human action but not human design'. A Chinese proverb puts it more poetically: 'flowers planted on purpose do not blossom; the willows no one cared for have grown into big trees offering ample shade'" (Coase & Wang, 2012:154). It is quite interesting that Coase and Wang point out the Chinese people with full of optimism, energy, creativity, and determination as the root cause of the miraculous rise of the Chinese economy. Private entrepreneurship was illegal before the economic reform, but now it has been recognized as a primary driver of the economy. It appears that they attribute China's success to an unintended modernization of socialism which has given the Chinese people with creativity an attractive reward incentive through the encouragement of "competition" - basically upon the direction to a market economy - particular in the above mentioned four marginal areas and the real-estate sector.

On the other hand, Dic Lo insists that while the orthodox notion envisages that the 'natural path of development' would occur in the context of a market economy, it is not clear whether this judgement could remain valid if the economy is in fact dominated by public firms, that is, state-owned and collectively-owned enterprises (Lo, 2012:107). In 1992, state-owned and collectively-owned enterprises combined to account for 86 per cent of the output of Chinese industry as a whole (Lo, 2012:112). The dynamics of Chinese economic growth in the 1978-92 period as characterized before presupposes the existence of two necessary conditions. First, the process of structural change involved both an expansion of the share of industry in the economy and the leading role of a wide range of mass-production industries. Second, there must exist an egalitarian pattern of income distribution which underpinned mass-consumption, thereby inducing investment and overall demand expansion (Lo, 2012:109). We should note that the state-led industrialization may have contributed in the first half of the reform era to enhancing social justice in terms of egalitarian pattern of income distribution within the state-owned and

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collectively-owned enterprises, consequently leading to the consumption-led economic growth.

Lo points out that China's economic transformation has been dominated by three discernible attributes. First, industrialization has been the immediate driving force of economic growth. Second, there was a switch in the early 1990s from labour-intensive growth (in the first half of the reform era between 1978 and 1992) to capital-deepening growth (in the second half between 1993 and 2007). Third, the growth path also switched from consumption-led to investment-led between the two halves of the reform era (Lo, 2012:103).

He is concerned about the sustainability on the demand side which hinges on the pace of product innovations. "It is through product innovations that the variety of investment goods could continuously expand, and that the law of diminishing demand for the output-mix would not set in" (Lo 2012:111). Turning to the economic growth path in the second half of the reform era, 1993-2007, its capital-deepening nature is most clearly indicated by the upward movement of the incremental capital-output ratio (ICOR) during this period (Lo, 2012:109).

We can see that while Coase & Wang are primarily concerned about the "supply-side" driver (changing rules of game for producers) of increasing economic output and efficiency, Lo is basically sharing with the Marxian concern of the "demand-side" driver (an egalitarian pattern of income distribution which underpins mass-consumption) of increasing economic output and sustainability.

From a NIE perspective, private entrepreneurs are considered to still face many prejudices and adversities. Therefore, to keep the people's optimism, energy and creativity would be a very important strategy for China. In particular, Coase & Wang point out that China has not yet created an active market for ideas. The whole process of creating, spreading, and consuming ideas, from the education system to the media, has remained under tight ideological control and state surveillance (Coase & Wang, 2012:190). "The lack of a market for ideas is directly responsible for the lack of innovation in science and technology, the Achilles' heel in China's growing manufacturing sector" (Coase & Wang, 2012:193). They emphasize that unless a free and open market for ideas is created, China cannot sustain its economic growth or advance itself into a global centre of technological innovation or scientific discovery. This is a great and important challenge for China to transform its economy to a new phase of post-industrialization.

From a Marxian perspective, it is pointed out that the Keynesian type fiscal stimuli in 1998 -2002 did not result in the resumption of the previous egalitarian pattern of economic transformation. "Consumption expansion has continued to be sluggish, and its leading role has been taken over by investment - hence the characteristic of 'producing investment goods for producing investment goods'. At another level, consistent with capital deepening and economic growth based on increasing returns is the rapid expansion of large-scale enterprises: their value-added share in Chinese industry as a whole increased from 27 per cent in 1998 to 36 per cent in 2002" (Lo, 2012:116). One of the implications from this Marxian view is that the recent trend of enlarging the inequality of income redistribution may have undermined the sustainability on the demand side which hinges on the pace of product innovations, consequently resulting in the overall economic slowdown.

As Lo points out, since the millennium, there are signs that the state leadership has even attempted to reinstate the importance of socialist concerns in the actual process of economic transformation - as is evident in the slogan of "constructing a harmonious society" and the policies associated with this slogan. "The character of the new pattern of economic transformation that has emerged since the late 1990s

implies that the Chinese state, while lessening its socialist commitments, has turned to strengthening developmental concerns (to retain control over the commanding heights of the economy and thereby to direct the path of overall development) rather than to embracing the free market doctrines *in toto*". He suggests that China is likely to stick to the logic of production (industrialization) rather than that of exchange (the natural path of economic development) in the foreseeable future (Lo, 2012:167). As Lo points out, since the second half of 2009, waves of labour unrest in foreign capital-invested enterprises in coastal China have resumed the impetus for enhancing labour protection and compensation (Lo, 2012:167). However, we should consider the two effects by the safety net for protecting the minimum wage rate to the sustainability of the demand side and to the ill-incentives of the supply side.

### 3. Japanese parallels

As was mentioned, NIE emphasize that unless a free and open market for ideas is created, China cannot sustain its economic growth or advance itself into a global centre of technological innovation or scientific discovery. However, the creation of an active market for ideas would not always guarantee the sustainability of economic growth.

Japan had experienced a switch from the "high economic growth" to the "moderate economic growth" period. Suzuki (2011) divides the structural change in Japan's economy into the following phases; (1) The "catching-up" period, that is, the period up to the mid-1970s when Japan's economy enjoyed high economic growth. (2) The "moderate economic growth" period from the mid-1970s until the hard landing of the bubble economy. During this period, many Japanese industries had already reached the international technology frontier. By the end of this period, Japan had become what he can describe as a "frontier economy" in terms of technology. (3) The period of prolonged economic stagnation since the onset of financial crisis when the bubble finally burst.

A number of empirical studies have observed a trend of technological change in Japanese firms since the mid-1970s. The trend of technological change intensified in the mid-1980s. Incubating innovative firms would be a key requirement in its transformation to a new phase of post-industrialization. At the same time, we should note that innovative firms are exposed to severe competition and their future would become more uncertain. Suzuki (2011) refers to a report by the Small and Medium Enterprise Agency (SMEA) which finds that the life cycle of hit products (best-selling products / products of marketable goods) has been shortened in Japan. This report shows that although the life cycle of about 60 per cent of hit products was more than five years in the 1970s, the percentage of hit products that were marketable for more than five years has since dropped radically - to only about 5.6 per cent in the 2000s. Recently, the life cycle of more than 50 per cent of hit products has been shortened to "1 to 2 years" or "less than 1 year". As a result, Japanese firms have been exposed to higher business risks associated with product obsolescence (Suzuki, 2011:160-1).

Drawing the lessons from Japan's experiences, first, we should note that it takes more or less several years to create an active market for ideas to transform to a new phase of post-industrialization. Second, in the phase of post-industrialization, rapid product obsolescence is brought by severe competition in which rival firms are accelerating the introduction of competitive products to the market, which may expose innovative firms to fundamental uncertainty. Third, we should note that Japan has actually suffered a financial bubble in the phase of post-industrialization and a lingering economic slump since the bubble burst.



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Japan's financial crisis in 1997-98 (also the subsequent prolonged - lost two decades - financial slump) can be explained in terms of an intensification of "uncertainty" which magnified previously manageable structural and institutional problems in the Japanese financial system. That is, an important driver behind Japan's prolonged slump was the inability of Japanese banks to respond to the "uncertainty" created in the economic environment as a result of the structural changes introduced through the 1970s and 1980s as Japanese banks tried to integrate into a global financial market in a context where Japan was itself transforming from a catching-up economy into a frontier economy.

Similar to Japan, China is also currently experiencing high economic growth, which brings gradual shift in its industrial structure. The economy in China, especially in big cities, is apparently moving towards frontier economy and the share of tertiary industry is in an increasing trend in provinces. The economic reform changes the financial system by ensuring market based lending instead of long cherished budgetary allocation. But, the financing pattern of big four state-owned commercial banks (SOCB) remains unchanged with a focus of patronizing the state-owned enterprises (SOE) involved predominantly in manufacturing. Even, the increasing market share of tertiary industry is financed mostly by private and informal sector, which works so well to achieve huge economic growth. But there is no guarantee that private and informal base can sustain the economic growth forever.

The official data about the size of the overall informal or so-called "shadow banking" system in China have not been published. RIETI (2013) introduces the estimation of the size of China's shadow banking system by the Chinese Academy of Social Sciences to be 16.9 trillion yuan (equivalent to 36 percent of GDP) as of the end of March 2013, and by the Standard & Poor's (S&P) at 22.9 trillion yuan as of the end of 2012 based on a wider definition of shadow banking (Suzuki 2014). The existing debate seems to understate how the non-state and hybrid sectors have been raising the necessary fund for their investment. Many researchers point out that *informal* finance sources in China, including "internal financing and trade credits, and coalitions of various forms among firms, investors, and local governments" (Allen *et al.*, 2008) are far more important than formal sources; especially for financing private enterprises, which have been the life-blood of rapid GDP growth.

At this point in time, the emergence of systemic risk in accordance with the expansion of shadow banking in China does not seem to be a strong possibility, partly because even if the turmoil in the shadow banking occurs, commercial banks typically are not responsible for compensating customer losses so far as an effective firewall between commercial banking and shadow banking is constructed. Meanwhile, it can be concluded that it is high time for Chinese banks to respond to economic transformation. More specifically, SOCB requires adopting some kind of transformation in financing pattern and as well in monitoring and assessing credit risks. Otherwise it is most likely that the banking system in China will face similar failure observed by Japan.

### 4. Concluding comments

In its frontier economy, many Japanese industries were getting closer to or even reaching the international technology and marketing frontier. It appears that the Chinese economy is becoming a frontier economy, too. How does the transition to a frontier economy affect the Chinese economic system? On what path should the Chinese economy go? On what conditions can China sustain its economic growth preventing its banking sector from undertaking excess credit risk?

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From a NIE's "supply-side" perspective, the keys to the successful further transition to a frontier economy are: (1) to develop a free and open market for ideas and (2) to implement further deregulation encouraging people's creativity, aiming to increase economic output and efficiency. These directions are necessary to responding to the intensified fundamental uncertainty, but will not necessarily guarantee the survival in a competitive global market. On the other hand, from a Marxian "demand-side" perspective, the keys to the successful further transition to the sustainable development are: (1) to expand the consumption level and (2) to fulfil the social justice in terms of seeking to redistribute income, aiming to seek greater equality of income distribution which underpins mass-consumption, the "demand" force of which would consequently contribute to the technological change in the production. However, we should recall Jeremy Bentham who said that the goals of civil law are to promote subsistence and security as primary goals followed by equality and abundance (Bentham, 1931). While the effect of greater equality is clear, Bentham pointed out that too great concern with equality can affect the security of property rights and if output collapsed as a result, everyone would suffer.

Presumably, China is taking a trial and error process of changing rules of game for producers, while not enlarging the inequality of income for households which would ill-affect mass-consumption, aiming to the successful transformation to a frontier economy. How long China is allowed to still take the trial and error process under the severer competitive global market is an ultimate key to its successful transformation. The allowed time, however, must be not so long.

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