Making the new normal meaningful

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The strategies that raise a country from poor to middle-income status will not work to raise it from middle-income to rich. Economically, there is no reason to expect the strategies to work. Poor countries have very different capital stock, labor productivity, land utilization, and capacity for innovation than middle-income countries. Unfortunately, old policies seem politically easy or are even perceived as a source of social stability. Many middle-income countries try to become rich by sticking to a development model that no longer works.

This is the middle-income trap.[1] The middle-income trap makes the concept of "the new economic normal" in China a very valuable one. Chinese policymakers, business owners, workers, and farmers must understand that the old development model is changing because it must change. However, introducing the idea of a new economic normal is only the first, small step. It must be implemented with new and appropriate economic policies.

The last part—that new policies are appropriate—is where China has struggled until now. In particular, the idea of reforming the state sector through more cooperation with the private sector is dangerously wrong. Elsewhere, land and labor reform are proceeding too slowly, increasing the chance of being caught in the middle-income trap. And while financial reform is making progress, financial challenges are immense and require even stronger action.

If it is more than a slogan, the new economic normal can help China escape the middle-income trap. It must feature policies that:

1. Increase competition, not cooperation, in the corporate sector.
2. Give farmers sharper rights to their land, as the original reforms did in 1978.
3. Rapidly integrate labor markets, so a shrinking workforce is more productive.
4. Dramatically slow or halt the accumulation of debt to avoid stagnation.

The Middle-Income Trap

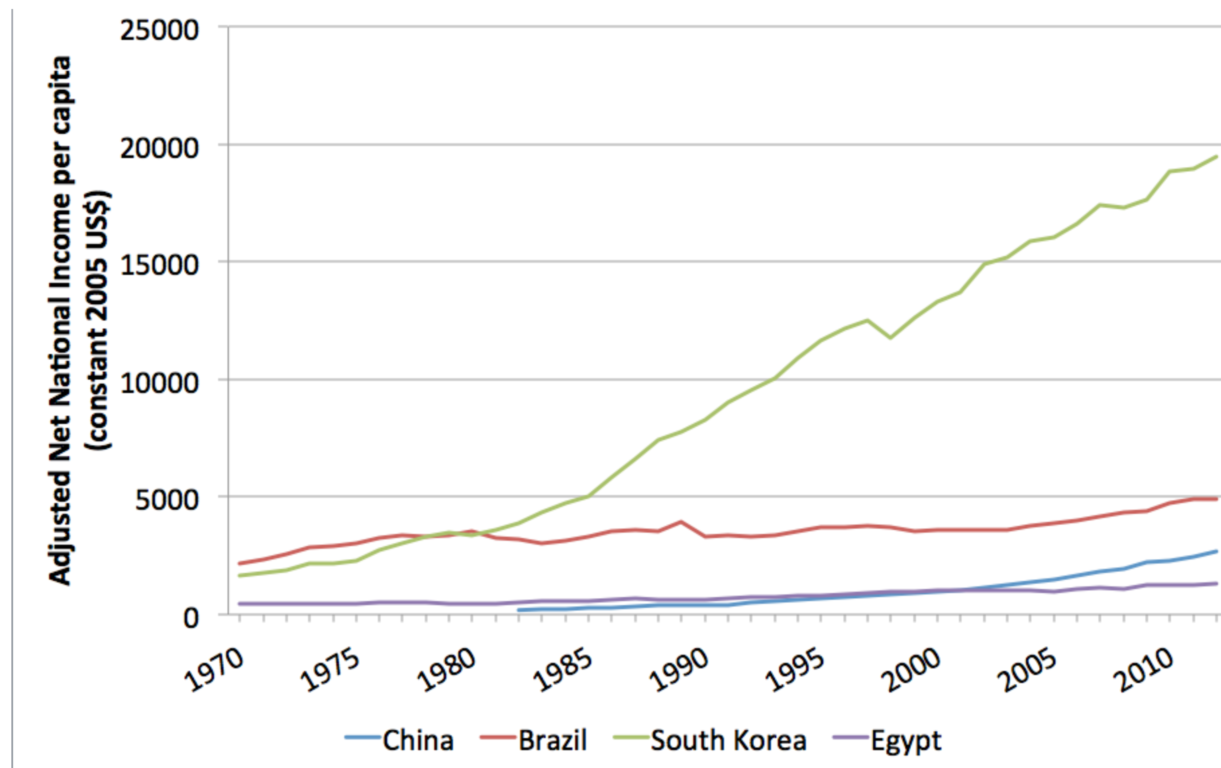
The middle-income trap is usually described as countries' failing to raise the average income of their citizens beyond a certain level. These countries never catch up to traditional rich countries, such as Canada and Germany. But what matters in escaping the middle-income trap is *why* there are many middle-income countries yet few truly rich countries. Why do even the countries that do extremely well in climbing out of poverty then become stuck?

The answer is that they are tricked by their own initial success. When a country is poor, it has more workers and land than it has capital. Policies that heavily use land and labor to save capital are reasonable, though they are often criticized by rich countries. In addition, for poor countries, the key is absorbing plentiful foreign technology, not innovating at home.

What happens next even in a successful developing country is familiar. Land and resources are depleted for the sake of immediate gain, with environmental considerations put aside.[2] Education and training for the future are secondary to mass employment of labor in the present. The country benefits greatly from foreign technology, but its availability discourages domestic technology development.

By the time middle-income status is achieved, the rising generation faces a very different circumstance. (See figure 1.) Capital is more plentiful, greatly benefiting the country as a whole. But once-bountiful land has become expensive or polluted. The availability of capital has increased the need for skilled labor, which is much more costly to employ. A few middle-income countries, with China the most prominent example, also suffer from an aging labor force. The gains from absorbing foreign technology have decreased as the nation has advanced, bringing calls for domestic innovation.

Figure 1. The Middle-Income Trap



Source: United Nations Population Division, World Population Prospects: 2012 Revision, "Median Age by Major Area, Region, and Country, 1950–2100 (years)," http://esa.un.org/unpd/wpp/Excel-Data/population.htm (accessed February 4, 2015).

The clear implication is that the old policies must change, not mildly but dramatically. In theory, "the new economic normal" is the perfect framework within which to execute this dramatic change. But practice must match theory.

Priority 1: Letting Go of More SOEs

In the case of state-owned enterprises (SOEs), practice does not match theory. The current approach to the state sector continues the preservation and gradual reform of those SOEs deemed strategic by the central or local governments. This approach was utilized during China's breathtaking rise from poor to middle-income, but it is no longer appropriate. It discourages the innovation that is needed to climb from middle-income to rich. Instead, SOEs must withdraw from some industries.

While China is far richer than it was 20 years ago, the labor force is now aging, natural resources are being depleted, and debt has soared. For example, among those in the Fortune 500, Chinese firms have much higher debt burdens than American ones.[3] Chinese productivity must rise continuously for debt burdens to ease and economic growth to continue. Yet productivity may actually be weakening.[4] Productivity is a broad and difficult topic, but innovation is no doubt a crucial part. On balance, the present path for SOE reform discourages innovation.

In the past, innovation has come to China not because of SOE reform but in spite of it. Foreign investment and technology has been drawn to the huge market despite the continued limitations on access caused by the government's protection of SOEs from competition. This is no longer a viable model. Not only does innovation need to play a greater role, but China also is more advanced technologically than in past decades, making genuine advances from this point more challenging. Only the best foreign technology will have value, and multinationals will not offer this technology unless they get full market access, with special benefits for SOEs reduced.

Even more important is indigenous innovation. Indigenous innovation is sharply limited in a poor country, but opportunities expand with development. However, indigenous innovation cannot be commanded by the government. Governments can organize specific projects, such as national space programs. But they cannot anticipate the broad innovation necessary for countries to become and remain rich.[5] Successful indigenous innovation requires free entry and exit into industries, allowing new companies to rise and letting go of those that cannot innovate.[6] In China, this must include letting go of some strategic SOE's. The new normal must truly be different in the area of SOE reform.

It is certainly true that Chinese SOEs in 2015 are already far superior to those of 1980. The improvement is due to two factors: changes in the SOEs themselves and changes in their operating environment. Of the two, changes in the operating environment are more important. As an illustration, consider Sinopec and Exxon.

Sinopec and Exxon are two of the world's largest oil companies, one state owned and one privately owned. One way to reform Sinopec is to imitate Exxon. But Exxon's success does not come from its corporate structure or long-term strategy. Indeed, Exxon has failed to take advantage of the shale revolution in the US, being badly outperformed by much smaller companies.[7] The shale revolution occurred because the American energy market is open to competition, not because Exxon or Chevron is an efficient company. A Sinopec that looks just like Exxon would still have failed to innovate.

SOE reform where private capital is invited to take minority stakes is therefore exactly the wrong thing to do. Even if private minority stakes in Sinopec subsidiaries do improve the company's management, this is a minor gain. What would really boost the energy sector is for private capital to be able to operate independently and to compete freely with Sinopec. This would either force Sinopec to innovate or, as is the case with Exxon in shale, introduce innovation from new entries to the industry.

Worse than the Sinopec example is the merger of China South Locomotive and China North Locomotive. Chinese competitiveness in railcar technology is due to utilization of technology generated overseas, the scale of the domestic market, and overseas competition between China South and China North. One giant enterprise with almost exclusive market share at home has no reason to innovate. The new company will be a global champion for less than a decade before falling behind in the technology race. There are many other, less prominent examples of similar harmful restructuring, such as in flat-panel displays.[8]

The more industries that remain dominated by SOEs, the less commercial competition can occur, the less innovation will be encouraged, and the less economic growth will result. In late 2006, the State Council identified sectors where SOEs must lead.[9] This list has not been confirmed by the current government nor has it been contradicted by statement or policy. In addition to those on the 2006 list, SOEs also control media, banking, tobacco, and other sectors.

The new normal plainly cannot mean the dissolution of all SOEs. To be successful, however, it equally cannot mean the effective enlargement of SOEs with private capital. This would be more like a return to the past. Rather, a smaller list of truly strategic industries must be created. In less important industries, SOEs must be pulled back so that competition and innovation can increase. (See table 1 for an illustration.)

Table 1. Boosting Innovation and Growth

SOE-Led in 2014	SOE-Led under the New Normal?
Armaments	Armaments
Power generation	Power generation
Power distribution	Power distribution
Oil	Oil
Petrochemicals	Telecommunications
Telecommunications	Coal
Coal	Aerospace (not aviation)
Aviation	Shipping
Shipping	(Some) Non-ferrous metals
Machinery	Media
Autos	Banking
Information Technology	Railways
Construction	
Steel	
Non-ferrous metals	
Media	

Banking	
Insurance	
Railways	
Tobacco	
Environmental Technology	
Natural Gas	

The set of strategic industries where SOEs must lead will change over time, perhaps requiring SOEs to grow or be created in the future. But, under the new normal, the set must always be as small as possible. Otherwise, innovation, productivity, and China's growth are at risk.

Priority 2: Household Responsibility and Registration

Other threats to productivity and growth come from getting old before getting rich, as well as pollution. These challenges are well understood in China, but the necessary responses are yet to materialize. The new normal offers an indispensable opportunity to act more decisively to offset an aging labor force and damaged ecologic base for industrial activity. For example, there is insufficient water to support production in many parts of the country. The solution is greater economic rights for both farmers and workers.

Before anything else, countries that successfully move out of poverty into middle-income first increase agricultural productivity. This addresses food security worries and then frees up workers to be used in the secondary sector. This process began in Anhui in 1977 when farmers were given rights to crops grown beyond the requirements of government planning. Though foreign observers were previously worried about China's ability to feed itself, in 2015 such worries seem quite unjustified.[10]

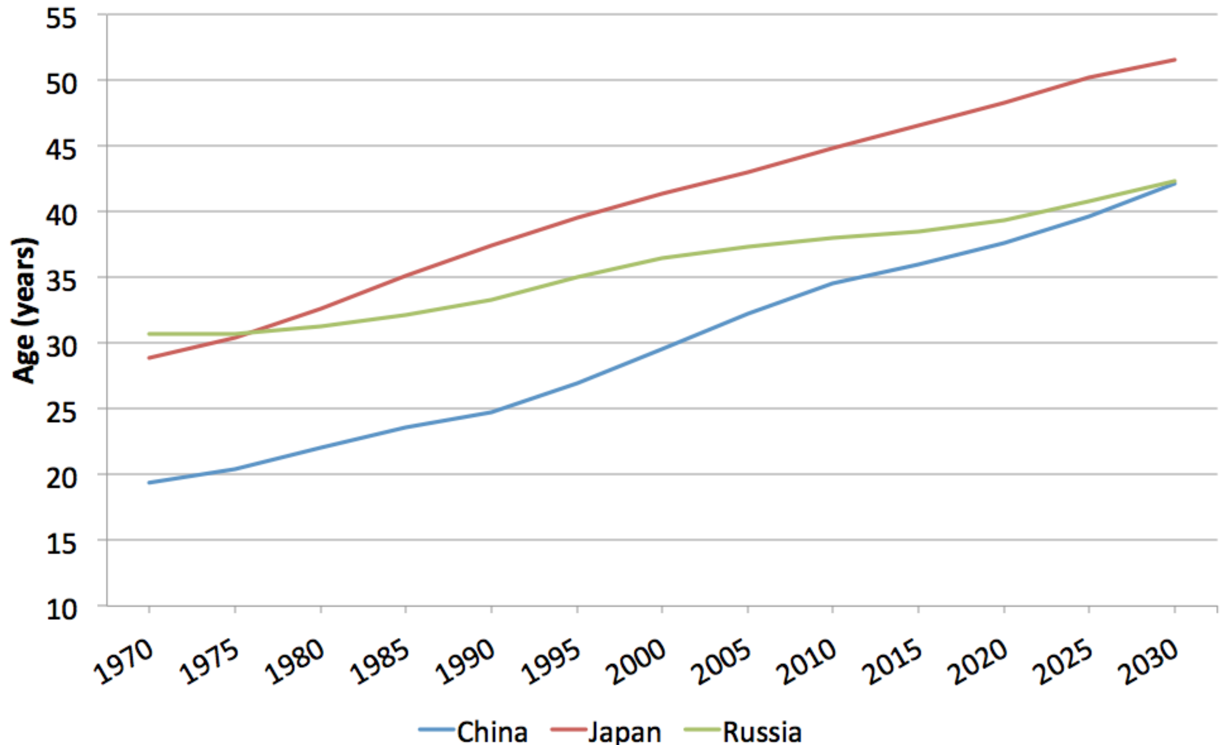
But increasing total output is not enough. Productivity per farmer must continuously rise so that food security is ensured with fewer and fewer farmers. If this occurs, the next step also requires additional rights. These are the rights of "unnecessary" farmers to seek better lives in other occupations. There was no famous Communist Party plenary meeting that formally and clearly granted such rights to Chinese migrant workers in the 1980s, but they were allowed to migrate nonetheless. Their participation in the secondary industry created the workshop of the world.

A surging number of urban workers is a phenomenon that has troubled many other countries trying to rise to middle-income status or beyond.[11] In contrast, China has marvelously utilized hundreds of millions of additional urban workers. Now, however, the opposite challenge is looming: not enough workers, especially young ones. While urban migration continues, it is becoming inadequate because of rapid population aging. China will become an old society as fast or faster than any other country.

This is a daunting prospect, because the economic record of older societies is poor. Rich countries in much of Europe have seen stagnation.[12] Russia, a middle-income country that previously faced an aging population and became completely dependent on commodities. (See figure 2.) China is neither rich nor well-endowed with energy and metals. In light of

demographics, China's middle-income trap will be more difficult to escape than that of almost any other country. If strong labor market policies are not adopted, economic growth will be strangled.

Figure 2. Aging in Different Countries



Source: World Bank, "Adjusted Net National Income per Capita (Constant 2005 US$)," http://data.worldbank.org/indicator/NY.ADJ.NNTY.PC.CD (accessed February 4, 2015).

In the past, China's acceptance of labor migration was balanced against concerns about overpopulation of major cities. Under the new normal, policy must switch to encouraging labor migration to wherever the economy is expanding. Otherwise, local labor shortages will repeatedly drive down production.

Japan provides a clear lesson. Japanese workers legally can move anywhere, yet they still do not respond to new hiring because they cannot easily move their pensions. Facing an aging population and low labor mobility, Japanese manufacturing has progressively moved out of the country, and national income has stagnated for more than 20 years.[13]

China must move much more aggressively than Japan has to eliminate barriers to labor movement. Workers must have the maximum possible rights to legally live and receive benefits throughout the country. All cities must be open. This is the only way to maximize worker productivity and offset a shrinking labor force.[14]

The policies adopted to date to make labor migration easier are, therefore, not enough. Nationally, their implementation is too gradual—the labor force is already shrinking, and growth is already being lost because of lack of labor movement. The limitations on registration in major

cities could block regional economic booms based on those cities. In the rise from poor to middle-income, policymakers frequently had to worry about very fast growth triggering inflation and instability. Because those days are over, the new normal must fully capitalize on growth opportunities wherever they occur.

Rights for farmers can also make a contribution to fighting off stagnation caused by aging. Chinese agricultural productivity has room to increase further.[15] Allowing better farmers to acquire land from less-efficient farmers would maintain agricultural production and make more workers available for manufacturing and services. This is the right way to achieve increased urbanization and, as with additional labor rights, the sooner the better. Waiting until 2020 means increasing the risk of local labor shortage and contributing to economic stagnation.

Giving farmers more rights to land will also strike a blow against pollution. The more ownership a farmer has over land, the better he or she will take care of it, preserving water and defending against the burying of toxins. Private ownership of agricultural land is a politically controversial topic, but all steps short of full land ownership should be granted. In the late 1970s, China started to escape the poverty trap with dramatic, not cautious, endorsement of greater rights for farmers. A similar action could help it to escape the middle-income trap.

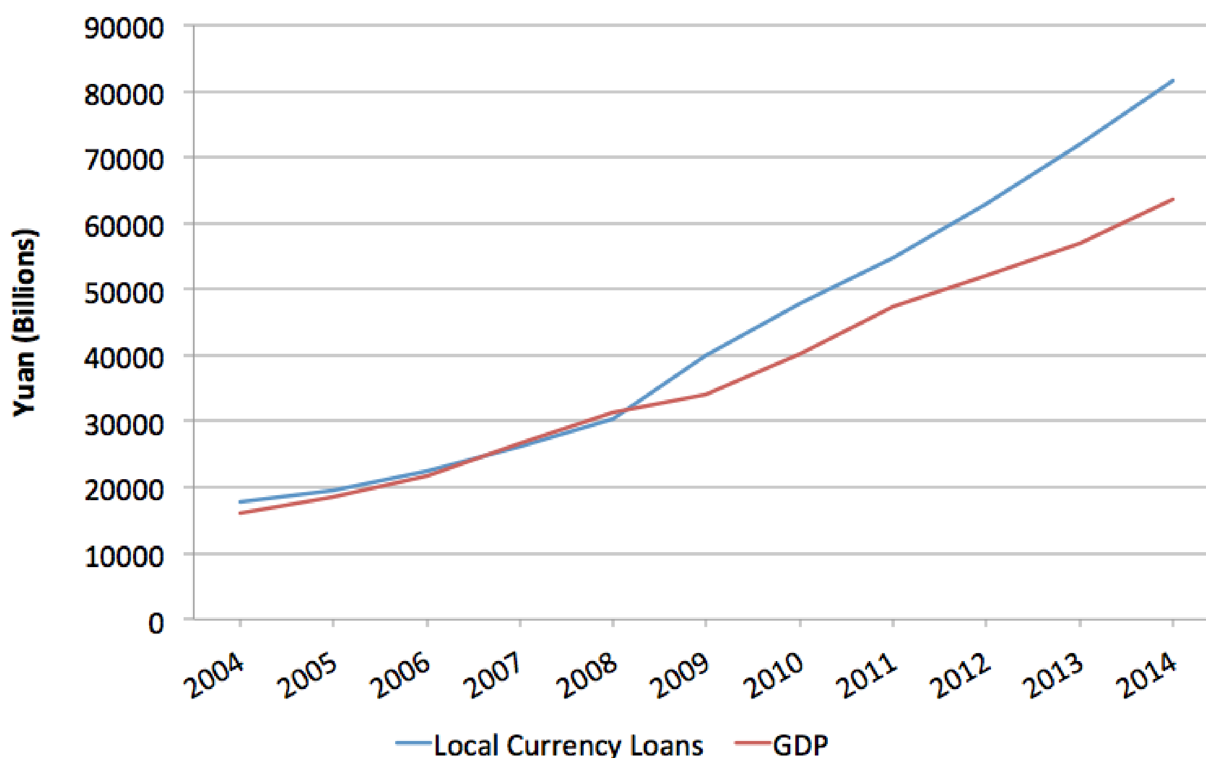
Priority 3: Defeating Debt

There are no rich countries with collectively owned farmland, sharp requirements for labor registration, and dozens of giant SOEs. On these matters, China will either become more like current rich countries or chart a new, very difficult path. In finance, though, most of the world looks very similar—too much credit with too little benefit. Many countries face the choice of extending yet more credit or finding an alternative path. The new normal makes clear that China's financial policies should change. In particular, "targeted easing" should become "targeted tightening," where promising sectors of the economy receive as much or more credit than before but weaker sectors see less.[16] This should be accomplished by switching from primarily political credit allocation to primarily commercial.

Poor countries do not have to worry about extending too much credit because they have no capital base. As countries rise to middle-income status, social wealth is generated, which can be mobilized by governments. This is a positive development, but many governments then become too aggressive. Unwise projects become common, leading to so-called debt crises.[17] While these are often less serious than creditors say, the waste of money certainly contributes to the middle-income trap.

The last seven years have seen a "debt crisis with Chinese characteristics." (See figure 3.) A strong financial position at the end of 2007 became a weak one by the end of 2014.
There is no true crisis. However, researchers at the National Development and Reform Commission found that there has been an enormous amount of wasted investment.[18] This obviously cannot continue if China is to become wealthy.

Figure 3. Borrowing and GDP



Source: China National Bureau of Statistics, "China Local Currency Loans in Millions RMB," and "Gross Domestic Product" (accessed February 4, 2015).

The People's Bank and other financial institutions have taken sound steps to improve the financial system. For example, interest rate liberalization is steadily proceeding**.** But these steps are inadequate to avoid new debt, much less reduce the existing debt burden. By itself, interest rate liberalization merely changes the cost charged for excessive borrowing. In the current environment of very high liquidity, borrowing costs will remain very low.[19] In addition, if SOEs and other firms receive subsidies, they can easily afford any higher rates that may result from liberalization.

If the debt problem is to be solved, there must be a genuine option for banks not to lend when they deem it unwise. For a country to become wealthy, financial institutions have to be able to say no. They must be able to say no even if they are heavily pressed by local governments. This can occur only with independent, private banks. Private banking licenses are now being issued but, unless the process is dramatically accelerated, state-controlled banks will remain dominant for many years to come. These banks are highly vulnerable to political pressure to overlend, a feature of many countries caught in the middle-income trap.[20]

The much-greater role for China's nonbank finance offers another means of reducing the debt burden. There are certainly problems with nonbank finance: the quantity is excessive, and it is underregulated at present. These problems, however, can be addressed by tightening the money supply and giving nonbank finance a higher priority in terms of oversight. The corporate bond

market, especially, has enormous room for growth if better regulated. The gain is that nonbank finance, such as through bonds, appears to be driven more by the market than bank finance is.

In a large economy, it is always better to improve internal policies before external ones. First, progress must be made toward an independent financial system. Then it is time to open the capital account and let money freely move in and out of the country. It is true that capital controls protect countries from instability, but they also reduce growth opportunities, which are precious in the middle-income trap. China also has the advantage of an enormous amount of foreign exchange, so there is no chance of a payments crisis when the capital account opens.

There is no doubt that greater independence for financial institutions, and an open capital account will curb credit flow to some parts of the economy. Sectors with sustained overcapacity, such as shipping, will contract because of lack of credit, causing job loss. Balancing that, however, is the eagerness of private banks, nonbank financials, and external capital (whether foreign or returning Chinese money) to lend to firms and industries that are seeing strong profits. The financial system can become much more efficient. Rather than politicians insisting that old industries be sustained, credit flow will ensure that new industries quickly replace them. For the new normal to be successful, finance must support a continually evolving industrial structure.

More Than a Slogan

If the new normal is just a slogan with few sound policies, it will soon be known as the new no-growth normal. Promises that the hard reforms will occur in the future should be changed to announcements that the hard reforms will occur now. The state sector should shrink, labor and land rights should be sharpened, and credit should be largely depoliticized. If these things occur, the new normal will be known as the key to escaping the middle-income trap.

Notes

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