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CHINA ANALYSIS

CHINA: HITTING THE MIDDLE INCOME WALL

ABOUT

The Chinese have long been obsessed with strategic culture, power balances and geopolitical shifts. Academic institutions, think-tanks, journals and web-based debates are growing in number and quality, giving China's foreign policy breadth and depth.

China Analysis, which is published in both French and English, introduces European audiences to these debates inside China's expert and think-tank world and helps the European policy community understand how China's leadership thinks about domestic and foreign policy issues. While freedom of expression and information remain restricted in China's media, these published sources and debates provide an important way of understanding emerging trends within China.

Each issue of *China Analysis* focuses on a specific theme and draws mainly on Chinese mainland sources. However, it also monitors content in Chinese-language publications from Hong Kong and Taiwan, which occasionally include news and analysis that is not published in the mainland and reflects the diversity of Chinese thinking.

The French version of *China Analysis* can be accessed online at www.centreasia.eu.

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Introduction
by François Godement

China's per capita GDP, as measured by power purchasing parity (PPP), hit $13,000 in 2014 – a level Japan exceeded in 1986. It may seem ludicrous to compare today's China with 1986 Japan. After all, Japan then was far more closely knit and egalitarian, and did not have the large pockets of underdevelopment that still exist in China today. What's more, in classical terms, China's GDP overtook Japan's in 2011, the same year that its industrial sector's output overtook that of the United States.

Despite this, in some ways, the two are fascinatingly similar. The Chinese authors presented in this issue of China Analysis discuss a long list of issues currently affecting the growth of China's industrial sector, and they question the management of the stock market before this year's spectacular boom-and-bust cycle.

Within that litany of woes, they make some very realistic statements. In the new internet-driven innovation environment, "since innovation is a process full of uncertainties, the government cannot [...] choose any one industry or enterprise to support, as it has tried to do in the past".

It was in 1985 that Japan's fabled industrial guidance system, led by the Ministry of International Trade and Industry (MITI, now the Ministry of Economy, Trade, and Industry, or METI), began showing clear signs that it was unable to "pick the winners", as it had done for many decades. And the problems came from a similar place to China's present ones: a change of direction in innovation towards IT, software, and biology, together with the advent of global market standards. Daniel Okimoto was the first to describe the difficulties this shift created for Japanese government policy.[1] Japan's growth kept up a fast pace – until it collapsed in 1991 under the weight of a huge stock market rout. The US largely recaptured the lead, although Japan's industry still has healthy innovation, and the economy is now troubled more by factors such as financial policy and demography – something that will have become a problem for China by 2030.

Our authors emphasise the heavy hand of government in managing China's stock market. First, the government encouraged the market to rise to unhealthy levels, leading to a crash. Then, it intervened so strongly on the buy side that it "[defeated] the very purpose of the market and [went] too far in controlling its ups and downs". Again, parallels can be drawn with Japan: the stock market crash of 1991 was brought on by the unsustainable market levels allowed by Japan's iron triangle – government, politicians, and big business. South Korea experienced a similar catastrophe in 1998, with sky-high price-earning ratios. Its PPP GDP per capita had exceeded $13,000 only a few years earlier, in 1993.

Our authors do not jump to the conclusion that China is entering the middle-income trap: they limit their observations to what they have evidence for. In one case, they discuss the sudden difficulties faced by industry and industrial employment in Dongguan – the symbol of China's assembly manufacturing industry, perhaps even more so than Shenzhen (which has moved past that level). The analysis is not always very current – for instance, blaming raw material prices for present issues, when in fact commodity prices have tumbled over the past two years – and can at times sound mechanical. But the authors correctly point out the exit of foreign investors in favour of other locations for low-value-added manufacturing, the issue of wages and currency levels, and, above all, export trends. "The country's dependence on international markets is also proving to be unsustainable." This is not a sudden turn of events – everyone seems to have forgotten that during the global financial crisis of 1997-1998, Chinese exports dropped by one-third (and Japan's by 50 percent). Places like Dongguan were hit worst of all.

Our authors' view of Chinese industry is unconventional, at least when considered in relation to the usual calls for reform and for a transition from investment to a consumption- and service-based economy. Our authors do call for an upgrade of the industrial sector, as the only way to remain internationally competitive, and for integrating services into industry. And they criticise "dominant positions and true monopolies", as nearly everyone does. But they also call for a renewal of industrial policy, citing the US, Japan, and occasionally Germany, for rewiring the economy in light of digitalisation, and also for the nurturing of skills, including traditional ones: upgrading industry "is also about 'perfection' […] about the importance of the 'craftsman's spirit' […]: these craftsmen have intangible knowledge that cannot be digitalised". This sounds more Japanese than Western, although France's luxury sector and Germany's premium car industry would certainly claim such values as well.

Once more, the plasticity of China's policies, and the will to borrow from several sources, is evident. But it is perhaps the punchline that is most striking. In a political climate in which, to say the least, public criticism of the government is not encouraged, our authors deliver a scathing critique of a reform process that has fallen short since the CCP's Third Plenum in November 2013. The word "reform", they say, is used cheaply, much as Barack Obama used the word "change". To successfully rebalance China's economy, in their view, reform is imperative – and reform implies transition pains. To be fair, some of this assessment is delivered by Mao Yushi – China's best-known liberal economist, who is now 86 years old and who has weathered many storms in the past – and his analysis appears in the Chinese edition of the Financial Times, a grey zone in terms of free expression.

We are thankful to Hongmei Ma, Alicia Garcia-Herrero, and Thomas Vendryes for their detailed and thoughtful analysis. But above all, we are grateful to Agatha Kratz, who has been the co-editor of China Analysis for the past two years. Agatha is moving on to new academic horizons, while remaining an associate of ECFR's Asia & China programme and, we very much hope, a contributor to China Analysis. She will be replaced as co-editor from the next issue by Jerome Doyon. Her work has been important in identifying, within a collective team, the right topics and sources for our coverage of China's most important policy issues and debates.

1 Daniel Okimoto, Between *MITI and the Market: Japanese Industrial Policy for High Technology* (Stanford: Stanford University)

1. China's manufacturing crisis

Thomas Vendryes

Sources:

Wu Zhenyu, "The leading industries' decline and the perspectives of the 'new normal' growth", *Zhongguo Fazhan Guancha*, No. 1, 2015.[2]

Huang Sheng, "The lost history of Dongguan: The tragic destiny of 'Made in China'?", blogpost on *Fengyu Xia Huangshan*, 13 February 2015.[3]

Liu Shijin, "The opinion that the industrial economy is 'outdated' is quite dangerous", *Xinhua Wang*, 28 August 2015.[4]

The Chinese manufacturing industry, which has been the growth engine of the "factory of the world" (世界工厂, *shijie gongchang*) over the past three decades, is in deep crisis. China's official discourse about the gradual convergence towards a "new normal" (新常态, *xin changtai*) growth regime is intended to be reassuring. But in fact, far from being a short-term cyclical downturn, the manufacturing crisis is evidence of the structural imbalances of China's past growth – and of the challenges ahead. With the 13th Five-Year Plan (2016-2021) now reaching the final stage of preparation, the three articles selected here are representative of the intense debate taking place in China about the country's development model and the future of its manufacturing sector.

China's manufacturing industry: The stakes of the crisis

China became the world's industrial leader in 2011, taking the place that the United States had occupied since 1894. But Wu Zhenyu says that this achievement should not obscure the profound crisis that China's industrial sector is facing. A blog post by Huang Sheng on *Fengyu Xia Huangshan* uses China's southern city of Dongguan as an illustration of the overall national situation. According to the author, Dongguan is without doubt one of the "best students" (优等生, *youdeng sheng*) of China's reforms. At its peak, in 2007, Dongguan's total industrial output represented 1.2 percent of the national total, and it was ranked the 12th most important city in China.[5] But the 2007-2008 international financial crisis hit the city hard. In a single year, 1,600 Taiwanese and 2,000 Hong Kong firms left the city, and 1.5 million manufacturing jobs were lost. And this was not just a short-term downturn: between 2009 and 2015, more than 4,000 industrial firms went bankrupt. The situation in Dongguan reflects the problems of the country as a whole: at the national level, Western capital has flown out of the country, as have Taiwanese and Hong Kong-funded firms, which have shut down at an unprecedented rate.

There is real cause for concern about China's economic prospects. Although the "new normal" GDP growth rate of 7 percent per year may seem extremely high compared with the 2 or 3 percent achieved by other advanced economies, it is still 3 percentage points below China's decades-long average of 10 percent. This is a significant decrease, and it may indicate that China's economy is not undergoing a smooth and controlled stabilisation, but instead dealing with a worrying degradation of the country's past engine of growth: what Wu Zhenyu calls the three "tightly linked" (密切联系, *miqie lianxi*) "leading industries" (主导产业, *zhudao chanye*) of China's development, the electro-mechanic sector (机电类, *jidian lei*), the real estate sector (房地产, *fangdichan*), and the auto industry (汽车制造, *qiche zhizao*).

The crisis of China's manufacturing sector is both deep and far-reaching.

Wu says that the electro-mechanic sector represented 43.2 percent of Chinese exports in 2013. The industry's success was closely linked with increasing urbanisation and its effects on the auto industry. Wu cites official statistics to show that these three sectors contributed more to the 3 percent GDP decrease in the period from 2011 to 2015 than they did in 2000 to 2010. He notes that these simple calculations equate roughly to the decrease in the pace of growth between 2010 and today (from 10 percent to 7 percent), and they do not even take into account the "stimulating effects" (拉动作用, *ladong zuoyong*) that these sectors have on the rest of the economy.

So, the crisis of China's manufacturing sector is both deep and far-reaching. Huang Sheng emphasises the real risk of a catastrophic "domino effect" (多米诺骨牌效应, *duominuogupai xiaoying*), and Wu Zhenyu says that a declining manufacturing sector could lead China right into the much-feared "middle-income trap" (中等收入陷阱, *zhongdeng shouru xianjing*).[6]

A symptom of structural issues

The causes and roots of the crisis are as broad as the impact that it will have. Huang Sheng says that the crisis is the direct result of "abnormal" (畸形, *jixing*) growth dynamics. China has found its way into an unsustainable situation: Wu Zhenyu,

2 Wu Zhenyu is director and senior researcher at the Macroeconomic Research Department of the State Council's Development Research Centre.

3 Huang Sheng is a graduate of Peking university with a number of years of experience in the finance industry at Reuters, Phoenix TV, Central People's Radio, Shanghai TV, Shenzhen TV, Securities Times, China Secutiries Journal and other media outlets.

4 Liu Shijin is the former vice-director of the State Council's Development Research Centre.

5 The author does not say on what terms or according to which criteria.

6 The "middle-income trap" describes the situation of a country that has managed to grow out of poverty and escaped its low-income status, but seems to be stuck in an intermediary level of development – that is, in the "middle-income" range defined by the World Bank – without the growth dynamic that would allow it to achieve the standards of living of advanced economies.

Liu Shijin, and Huang Sheng are all very worried about the country's high investment rate, its ongoing real estate bubble, and its heavy reliance on external investors and export markets (as evidenced by the importance of the processing industry). Liu Shijin says that over the past three decades, "everyone was restless and fickle" (大家浮躁, *fuzao*) because of the many opportunities for growth, the easy availability of capital, and the strength of international demand. But as Huang Sheng says, this led to a dangerous over-exploitation of China's resources: the environment was sacrificed and the workers who enabled the country's cheap labour costs were exploited, in Dongguan as elsewhere. The country's dependence on international markets is also proving to be unsustainable. After 30 years of phenomenal growth and trade surpluses, labour costs began to increase, and the foreign exchange rate started to rise, as noted in the *Fengyu Xia Huangshan* blog post. As a consequence, companies began to shift their production from China to other, less developed countries. The blog post mentions as an example Microsoft's 2015 move of its Nokia factory from Dongguan to Vietnam.

China is undergoing a profound structural change, as shown by the fact that consumption and services represent an ever-increasing proportion of GDP, while the shares of investment and industry are declining. Liu Shijin says that an end has come to the period of purely "quantitative expansion" (数量扩张, *shuliang kuozhang*) and of "extensive cultivation for meagre returns" (广种薄收, *guangzhong bosou*). Resources are becoming scarce, and the limits of demand – especially on international markets – have been reached.

The future of China's industry

According to Liu Shijin this does not mean that China's manufacturing industry is completely "outdated" (过时, *guoshi*). Rather, Liu says that in developed as in developing countries, industry remains a key component of the economy, and of what is sometimes called "competitiveness" (竞争力, *jingzheng li*). This explains why the US and Japan express worries about the "hollowing out" of their productive industries (产业空心化, *chanye kongxin hua*), and have launched policies to re-industrialise their economies.

China needs to bring about a significant evolution of the industrial sector. It must push forward an "upgrade" (升级, *shenji*) from "quantitative" (数量, *shuliang*) to "qualitative" (质量, *zhiliang*) development. Liu Shijin writes: "not upgrading is not an option" (不升不行, *busheng buxing*). This upgrade will necessitate a shift to a growth model driven by innovation, a point that all the authors repeatedly stress. Existing industries and production chains must be upgraded, but new industries and processes must also be created and developed, making use of more sophisticated technologies and involving a higher value-added. Huang Sheng notes the new possibilities opened up by miniaturisation, 3D printing, and robotisation, which could transform manufacturing processes in Dongguan. These technologies could decrease entry costs or "thresholds" (门槛, *menkan*), and by doing so, could disaggregate the manufacturing sector, allowing firms to operate on a smaller scale. Ideally, Wu Zhengyu says, this kind of evolution would lead to the emergence of a new set of "interconnected leading industries" such as new energy vehicles, genetic engineering, satellite remote sensing, and non-conventional energy sources, which would have significant growth potential as well as far-reaching trickle-down effects on the Chinese economy as a whole.

Setting up a new economic context

To bring about these changes, China must promote an environment that enables "intensive cultivation" (精耕细作, *jinggeng xizuo*, a phrase that Liu Shijin uses several times) of the manufacturing sector.

The first step of such a cultivation process would involve more efficient use of China's labour and human capital resources, including better use of the seven million new high school graduates the country produces every year (a figure cited by Wu Zhengyu), as well as the people Liu refers to as the "skilful craftsmen" (能工巧匠, *nenggong qiaoqiang*) and "old masters" (老 师傅, *lao shifu*) of existing industrial centres. Workers' incentives should be increased, partly through better communication and mobilisation, but mainly through better pay and statutory recognition. Huang Sheng makes the radical suggestion of fully relaxing the *hukou* restrictions, and thereby granting full urban residency permits to migrant workers.

In terms of capital resources, Liu Shijin says that an innovation-driven manufacturing sector is characterised by a "high level of uncertainty" (高度不确定性, *gaodu bu quedingxing*). This means that capital markets will need to be enhanced and developed, since the current bank-based financing system may not be suitably equipped to handle higher and more diversified risks.

A dynamic and high value-added manufacturing sector also needs to be efficiently integrated with the service sector. Liu repeatedly claims that industry and services should be understood as complementary. But in China, service activities aimed at supporting industrial production are still under-developed, representing only 15 percent of the sector, compared to the usual 30 percent in developed economies. The country will need to take steps to address this imbalance.

Moreover, in this context of crisis and structural change, "cards are being widely reshuffled" (大洗牌, *da xipai*), as Liu writes. If new players are to enter the game and seize new opportunities, individual property rights – especially intellectual ones – must be better defined and protected. Meanwhile, steps must be taken to combat dominant positions and true monopolies, which Wu Zhenyu says are too prevalent in key sectors such as oil, electricity, and transport.

Finally, at an even deeper and more structural level, attitudes and behaviours, especially of officials and cadres, are crucial. According to Huang Sheng, the main reason for

Dongguan's past success was in fact the honest, dependable, and hard-working nature of its people – and, in particular, of its local cadres and authorities. Through these people's efforts, Dongguan was kept free of the "malpractice and abuses" (弊端, *biduan*) of "more central areas" (核心区, *hexin qu*). Therefore, the shift to a new model of development would also necessitate a favourable political and governance context.

China's manufacturing sector is facing a deep and lasting crisis. This crisis is not just a cyclical downturn due to the 2007-2008 international crisis; it is, rather, the result of the structural imbalances of China's past growth model, and, perhaps, offers evidence that the model has been exhausted. What is needed, therefore, is not merely a counter-cyclical economic policy, or even an industrial policy to support sectors facing difficulties; China needs a set of structural policies to change the country's growth model, and that means implementing far-reaching changes at institutional, social, and governance levels.

2. Made in China 2025: The dream of a strong manufacturing nation

Hongmei Ma

Sources:

Huang Xin, "Why must China's manufacturing industry be upgraded?", *China Economic Daily*, 22 May 2015.[7]

Liu Shijin, "The role of the government in the time of 'Made in China' and 'Internet Plus'", *China Development Observation*, No. 9, 2015.[8]

State Council of China, "Made in China 2025", 19 May 2015.[9]

Wang Xiwen, "A reading of Made in China 2025", *Caijing Magazine*, 7 September 2015.[10]

Wang Xiwen, "China's manufacturing industry: crisis is a threat and is also an opportunity", *Guangming Daily*, 15 September 2015.

On 19 May 2015, China's State Council published a new plan for the manufacturing industry called "Made in China 2025" (中国制造2025, *zhongguo zhizao 2025*), first mentioned in China's Annual Government Work Report in March 2015.[11] In this report, China's Premier Li Keqiang said that "manufacturing is traditionally a strong industry for China [and that China] will implement the 'Made in China 2025' strategy; seek innovation-driven development; apply smart technologies; strengthen foundations; pursue green development; and redouble our efforts to upgrade China from a manufacturer of quantity to one of quality." Since then, the phrase "Made in China 2025" has become something of a buzzword, but what is behind the decision to implement the new policy? What is its goal, and how is that goal to be accomplished?

The domestic and international background to "Made in China 2025"

One reason for the decision to launch the "Made in China 2025" plan was the government's thorough review and frank assessment of the main difficulties and challenges that China's manufacturing industry faces today.

Wang Xiwen points out that China's industry is under immense pressure due to the increasing difficulty of

7 Huang Xin is a journalist for *China Economic Daily*.

8 Liu Shijin is the former vice-director of the State Council's Development Research Centre.

9 The full text is available in Chinese at http://www.gov.cn/zhengce/content/2015-05/19/content_9784.htm.

10 Wang Xiwen is director of E-commerce Research at the Centre for International Economic and Technical Cooperation of the Ministry of Industry and Information Technology.

11 The full text of this year's Annual Government Work Report is available in English at http://www.npc.gov.cn/englishnpc/Special_12_3/2015-03/17/content_1909942.htm.

obtaining resources, increasing environmental constraints, and the ongoing rise in the cost of labour and raw materials.[12] China's comparative advantage of having low manufacturing costs is gradually dissipating. Huang Xin says that China's manufacturing industry is being "squeezed in two ways" (双向挤压, *shuangxiang jiya*): "high-end production is returning to developed countries" (发达国家"高端回流", *fada guojia "gaoduan huiliu"*), and "medium-end and low-end production is shifting to other developing countries" (发展中国家中"低端分流", *fazhan zhong guojia zhong "diduan fenliu"*). As a result, China's position as the workshop of the world is being challenged like never before. Huang cites Li Beiguang, vice-director of the Department of Planning at the Chinese Ministry of Industry and Information Technology (MIIT), who says that China's industry is facing a dilemma in which the country's "low-cost manufacturing advantage is rapidly eroding, while a new competitive advantage has not yet been developed" (低成本优势快速递减和新竞争优势尚未形成, *dichengben youshi kuaisu dijian he xin jingzheng youshi shangwei xingcheng*).

"Made in China" does not have compelling brand power, because the country lacks internationally influential multinational enterprises and globally well-known brands.

China's manufacturing sector also suffers from several bottlenecks. Huang quotes Mao Weiming, vice-minister of MIIT, who says that the problem with the Chinese industrial sector is that it is "large but not strong" (大而不强，*da er bu qiang*). Huang summarises the sector's main deficiencies. China has insufficient indigenous innovative capacity, because manufacturing is still concentrated at the medium and low end of the value chain. And when discoveries are made in research labs, the commercialisation of these innovations is not very successful. "Made in China" does not have compelling brand power, because the country lacks internationally influential multinational enterprises and globally well-known brands. China's industry does not yet have a rational economic structure: there are too many players in certain industries and too few in others. And finally, Mao also notes that China has not yet set up a market-oriented technological innovation system, in which enterprises are the main agents, but work in close cooperation with universities and research institutes.

Another factor taken into account when drawing up the "Made in China 2025" plan was the global context for manufacturing, which is undergoing a number of fundamental changes that have a direct impact on China's manufacturing sector. Wang says that China was inspired in by the industrial policies formulated in some developed countries, such as Germany's "Industry 4.0" plan or the United States' "re-industrialisation" policy.[13] Both plans are aimed at enhancing their respective countries' competitive edge in manufacturing in the wake of the financial crisis. They are based on the hypothesis that a fourth industrial revolution might in fact already be underway. Wang agrees with this idea, pointing out that digitalisation, connectivity, and intelligent manufacturing will most probably lead to deep changes in the paradigm of manufacturing and value chains. Therefore, China should also aim to integrate industrialisation and informatisation (两化深度融合, *lianghua shendu ronghe*) into its industrial plan so as to "leapfrog" (跨越, *kuayueshi*) others and quickly narrow the technology gap with developed nations – and even, if possible, to "overtake them" (弯道超车, *wandao chaoche*).

The strategic goals, tasks and priorities of "Made in China 2025"

"Made in China 2025", a dense ten-page blueprint, sets out a strategy and direction for the Chinese manufacturing industry in the new era. Its authors' goal is to turn China into a "strong[er] manufacturing power" (制造强国, *zhizao qiangguo*) by 2049. The document puts forward a three-step approach and nine strategic tasks and priorities to help achieve that goal.

China's first step will be to "join manufacturing powers" (迈入制造强国行列, *mairu zhizao qiangguo hanglie*) by 2025. The second step involves reaching "the mid-level among global manufacturing powers" (世界制造强国阵营中等水平, *shijie zhizao qiangguo zhenying zhongdeng shuiping*) by 2035. The third and final step will be to further consolidate China's position as a "manufacturing giant" (制造业大国, *zhizaoye daguo*) by the 100th anniversary of the People's Republic of China in 2049, thus entering "the top class of global manufacturing powers" (进入世界制造强国前列, *zonghe shili jinru shijie zhizao qiangguo qianlie*).

To achieve these ambitious aims, the "Made in China 2025" plan lays out nine strategic tasks and priorities. The first four focus on innovation and upgrading: China is to "improve the country's manufacturing innovation capacity" (提高国家制造业创新能力, *tigao guojia zhizaoye*

12 Wang's point about increasing raw material costs is in conflict with the very low level of international commodities right now, but as it is part of his argument, we have included the point here.

13 "Industry 4.0", the fourth industrial revolution, is a concept developed by the German government in 2011. It is characterised by intelligent and connected machines and workpieces, augmented reality, cloud computing, and big data ("informatisation"). Machines in "Industry 4.0" work, make decisions, and optimise quite autonomously in collaboration with humans. Production processes become more flexible, transparent, and efficient, and customers can feed their own wishes into the production of individualised bulk goods ("mass customisation"). For more information, see "'Industry 4.0': Will German Technology Help China Catch Up with the West?" China Monitor, Vol. 23, Mercator Institute for China Studies, 14 April 2015, available at http://www.merics.org/fileadmin/templates/download/china-monitor/China_Monitor_No_23_EN.pdf. Also in 2011, the United States government announced a new initiative, the Advanced Manufacturing Partnership (AMP), a national effort bringing together industry, universities, and the federal government to invest in the emerging technologies that will create high quality manufacturing jobs and enhance the US's global competitiveness.

chuangxin nengli), "promote the deep integration of informatisation and industrialisation" (推进信息化与工业化深度融合, *tuijin xinxihua yu gongyehua shendu ronghe*), "strengthen the fundamental capacity of industry" (强化工业基础能力, *qianghua gongye jichu nengli*), and "strive to make breakthroughs in key sectors" (大力推动重点领域突破发展, *dali tuidong zhongdian lingyu tupo fazhan*).[14] China's industry should also improve its global image, by "reinforcing quality and brand building" (加强质量品牌建设, *jiaqiang zhiliang pinpai jianshe*), and "raising the level of the internationalisation of manufacturing" (提高制造业国际化发展水平, *tigao zhizaoye guojihua fazhan shuiping*). Finally, China should "promote in-depth restructuring of the manufacturing sectors" (深入推进制造业结构调整, *shenru tuijin zhizaoye jiegou tiaozheng*), encourage "green manufacturing" (绿色制造, *lüse zhizao*), and "actively develop service-oriented manufacturing and producer services" (积极发展服务型制造业和生产性服务业, *jiji fazhan fuwuxing zhizaoye he shengchanxing fuwuye*).

The key to becoming a "manufacturing power"

"Made in China 2025" puts forward several policy measures to realise these tasks. These policy measures provide a more concrete work plan for policymakers and business leaders. Policymakers are to deepen structural economic reform, create a market environment for fair competition, enhance financing and fiscal support policy, especially for small enterprises, and open the manufacturing sector further to the outside world. Business leaders must strengthen personnel training systems and shore up organisational enforcement mechanisms.

These measures reflect the central principle of "Made in China 2025": the transformation that the plan promotes should be both "market-oriented and government-guided" (市场主导，政府引导, *shichang zhudao, zhengfu yindao*). Liu Shijin focuses especially on the role of government. He argues that in the process of industrial transformation and upgrading, the government should change its policy priority from "focusing on [administrative and financial] support" (重扶持, *zhong fuchi*) to "focusing on creating an [innovation-friendly] environment" (重环境, *zhong huanjing*). Liu says that, in the past, when the government implemented special policies to support specific industries and enterprises, the results were disappointing. In the innovation-driven "Internet Plus" environment, many of those old measures might even prove obsolete.[15] Since innovation is a process full of uncertainties, the government cannot choose any one industry or enterprise to support, as it has tried to do in the past. Therefore, Liu argues that the government should not roll out any targeted roadmap in its "Made in China 2025" policies, because any such effort would only be an extrapolation from our present technology level. Liu says that the government should instead work to create the right environment for innovation to flourish. For example, it should try to protect intellectual property rights, encourage fair competition, enhance the quality of China's human capital, and strengthen the social security system.

Liu also warns against any naive idea that information technology will solve all the problems that "Made in China 2025" faces. He says that transforming and upgrading the manufacturing industry is not only about innovation, it is also about striving for "perfection" (精致, *jingzhi*). He talks about the importance of the "craftsman's spirit" (工匠精神，*gongjiang jingshen*): these craftsmen have intangible knowledge that cannot be digitalised. He also stresses that persistence is key to achieving perfection. Therefore, if China wants to succeed in transforming and upgrading its manufacturing industry, the government should create an environment that nurtures the "craftsman's spirit".

Conclusion

Faced with rising labour costs, worsening environmental degradation, and increasing competition from other countries, China's manufacturing sector has to move up to the next level. "Made in China 2025" is evidence of the Chinese government's determination to tackle the challenges that manufacturing faces and to foster a knowledge-driven economy. The results of the plan will depend on the capacity of the Chinese government to implement structural reforms, increase competition, and improve the functioning of market forces in the economy.

14 The plan proposes the development of ten key sectors: next-generation information technology, high-end numerically controlled machine tools and robots, aviation and aerospace equipment, ocean engineering equipment and high-tech vessels, advanced rail transport equipment, energy-saving cars and new energy cars, power equipment, agricultural machinery, new materials, and biomedicine and high-performance medical devices.

15 The "Internet Plus" plan was announced in this year's Annual Government Work Report by Premier Li Keqiang. It aims to boost the economy through digitalisation, and calls for greater adoption of the mobile internet, cloud computing, big data, and the Internet of Things to encourage e-commerce, industrial networks, and internet banking, and to help internet companies increase their international presence. These initiatives could prove very helpful in efforts to raise service-sector productivity by providing the necessary connectivity to make businesses more efficient.

3. The successes and failures of China's "market rescue"

Agatha Kratz

Sources:

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Wu Hongyuran and Zhang Yuzhe, "Stabilising the financial sector in the second half of the year", *Caixin Weekly*, 10 August 2015.[18]

Mao Yushi, "The stock market's intense unrest", *Financial Times (Chinese edition)*, 14 July 2015.[19]

This summer, a year of rapid and continuous appreciation in the Chinese stock market was interrupted by two violent correction episodes.[20] In mid-June and late August, the stock market plunged, triggering panic on Chinese and global financial markets. In July, after several weeks of market rout, the Chinese government decided to intervene to stop the fall of the stock market, putting together a "national team" (国家队, *guojia dui*) of banking, financial, and regulatory institutions to fight the downward spiral and try to restore trust. The intervention was successful in stabilising the markets in the short term, but it had a high cost in both financial and reputational terms – so much so that, when the market plunged again in August, Beijing chose not to intervene in such a direct way.

The Chinese authors selected here discuss the government's efforts this summer to "save the market" (救市, *jiushi*). The writers identify market-related and government-related causes for the market turmoil, and explain why the government's action was only partially successful. They also examine the meaning of the rout in the longer term, raising concerns about China's economy and its prospects for reform.

Explaining this summer's roller coaster

Chen Changhua, head of Credit Suisse's China Research Department, begins his article with an analysis of this summer's chain of events. The market increase over the previous year had been partly driven by several government-promoted "hypes" (炒作, *chaozuo*), including the "Belt and Road Initiative" and the "Internet Plus Plan". However, Chen says that it eventually became obvious that the market was overinflated and did not reflect China's economic fundamentals. For example, he says the Shenzhen innovation board, ChiNext (深圳创业板), showed price-to-earnings (P/E) ratios of 140 in June, compared to 30 at the end of 2012 despite the fact that the companies listed on the board were putting in performances that were "nothing to write home about" (乏善可陈, *fashankechen*).[21] He says that from 2011 to 2014, the profits of the 484 companies traded on ChiNext only grew by about 9 percent per year. But anyone familiar with financial investment research, says Chen, knows that P/E levels like those seen on ChiNext can only be achieved by companies that are growing more than 20 percent per year over a sustained period of time. The inflated valuations in this case came from increased leverage in China's financial markets, which "went out of control" (增加的失控, *zengjia de shikong*), overwhelming a helpless and inadequate supervisory system. Chen thinks this was the main cause of this summer's market rout.

Mao Yushi, a senior economist for Unirule, has a somewhat similar assessment. He first points out the purpose of stock markets: "putting [individuals'/investors'] money to use" (钱尽其用, *qianjinqiyong*) by channelling it to capable companies in exchange for dividends. So, buying a stock is an investment in a future return, and therefore it should be done with deliberation and care. In this ideal situation, long-term or "value" investors would not buy and sell shares frequently, but rather, would wait for dividends to be paid. Mao says that this is the key to a stable stock market. On the other hand, "speculators" (投机者, *toujizhe*) are investors who hope to obtain profits from share price evolutions rather than from dividends. To do so, they buy and sell shares more often than investors. By themselves, they do not disturb the proper functioning of the market. Because they pay attention to share movements, they can be good judges of the future value of a stock and of value increase potential, and in that way, they can serve as market price setters. But when speculators are too numerous, fluctuations in share prices can increase, and valuations can depart from company fundamentals. The stock market then becomes a "casino" (赌场, *duchang*). And in Mao's view, today's Chinese stock market has become a "casino": it has too few real investors and too many speculators.

Today's Chinese stock market has become a "casino": it has too few real investors and too many speculators

Mao does not believe that this in itself explains this summer's "financial roller coaster" (大起大落, *daqidaluo*). What caused this summer's extreme fluctuations was the tendency of Chinese investors to act not according to the value of companies, but according to "the overall trend

16 Zhu Haibin is chief economist for Greater China at JP Morgan.

17 Chen Changhua is head of Credit Suisse's China Research Department.

18 Wu Hongyuran and Zhang Yuzhe are journalists for Caixin.

19 Mao Yushi is a well-known Chinese economist, and honorary director of the Unirule Institute of Economics.

20 The Shanghai and Shenzhen stock exchanges indexes had increased by 150 percent and 175 percent respectively between June 2014 and June 2015.

21 The ChiNext market is a technology-focused index based in Shenzhen, sometimes referred to as the "Chinese Nasdaq".

of the market" (股市的总体趋势, *gushi de zongti qushi*). When investors rely on fundamentals, they very rarely all act in the same way. But if they follow trends on the market, they sometimes do. This means that everyone buys and sells at the same time and in the same manner, and the market becomes a "policy market" (政策市, *zhengce shi*), characterised by tremendous volatility.

So, Mao says, this summer's "roller coaster" was a direct consequence of government intervention in the form of favourable monetary policies, which created, in the words of Chen, "unidirectional" (单向, *danxiang*) expectations. Chen also argues that the government did not intervene early enough in what was clearly a bubble market. Instead, it let official media "pour oil onto the fire" (火上浇油, *huoshangjiaoyou*) by promoting a "bull market" (牛市, *niushi*) throughout the first half of 2014, even after the 4,000-point bar was reached on the Shanghai stock exchange.

However, Mao says that investors are also to blame. They should be basing their decisions on company information, not on economic policies or non-market-based signals. Chinese investors' limited expertise in investment means that they lack independent and informed decision-making capacity, and are inclined to "go with the tide" (跟风, *genfeng*). The author says that investors should choose instead to invest through professionally managed funds, whose staff have the proper experience in the markets and can avoid these kinds of mistakes. This would also encourage the emergence of value and long-term investors, who would have a stabilising effect on the stock market.

Government to the rescue?

Chen strongly criticises the government and the official media organs for the part they played in this year's excesses on the stock market. But he also recognises the contribution that financial authorities made to stabilising the A-share roller coaster, as do Wu Hongyuran, Zhang Yuzhe and Zhu Habin in their articles. Wu and Zhang, both financial journalists for Caixin, describe how, on 6 July, the government set up a "national team" to rescue the market, made up of financial securities corporations, securities brokers, and public financial institutions. Backed by China's main commercial banks, which committed RMB 1,200 billion of one-year loans to the rescue effort, and securities companies and brokers, who injected massive liquidity into the market, and used the newly created (outside the market) leverage to evacuate the excessive and destabilising leverage on the A-share market. So, part of the leverage was dissolved, part of it was evacuated, and by 10 August, when Wu and Zhang wrote their article, the situation seemed to be under control.

However, Wu and Zhang also note that this manoeuvre increased the risk exposure of the financial institutions involved. Moreover, it imposed on them a policy of "selling and not buying" (只买不卖, *zhimai bumai*), which, Zhu Haibin says, defeats the very purpose of the market and goes too far in controlling its ups and downs. Zhu accepts that the government's intervention was an "exceptional practice for an exceptional time" (非常时期的非常做法, *feichang shiqi de feichang zuofa*). But in taking this action, Chinese authorities "adopted quite a few strong administrative and supervisory policies" (不少行政色彩和管制色彩比较浓厚的一些政策, *bushao xingzheng secai he guanzhi secai bijiao nonghou de yixie zhengce*). These policies could in the future have a significant negative influence on the stock market's efficiency.
Chen says that in its intervention, the government has taken control of an abnormally large part of the stock market – close to 2 percent of its total value. Like Zhu, he worries that the government's action could have long-lasting negative consequences. Chen does not believe that foreign capital should be blamed for this summer's turmoil, but he notes that after the market rescue, the A-share market could become even more "domestically oriented" (内向, *neixiang*), as efforts to open China's stock market have been abruptly curtailed. Furthermore, this summer's events will most likely mean that the inclusion of China's A-share market in international indexes will be delayed, closing off one more road to internationalisation. As a result, the A-share market could well become marginalised, and its development trajectory could diverge from that of global markets.

Accepting the pain of reform

Several of the authors connect this summer's rout to China's economic situation. Chen says that although some industries in China (such as the internet sector) are still growing, most Chinese industries are experiencing a substantial slowdown.[22] The government may have been hoping to use a surging stock market to shake up the depressed economy – and indeed, Wu and Zhang note that without the financial sector boom in the first half of 2015, growth would have been closer to 6.1 percent than to 7 percent. But if this is the case, the government bears even more responsibility for this summer's events. Zhu Haibin points out that the events mean that the perception of "Chinese risk" (中国风险, *Zhongguo fengxian*) by international observers has dramatically increased since this summer.

Zhu says that international concerns about "Chinese risk" are also linked to increased doubts about the prospect for reform. The government continuously repeats that it is dedicated to reform. However, Zhu says that the term "reform" (改革, *gaige*) – much like the term "change" in US President Barack Obama's campaign – is used "cheaply" (廉价地, *lianjiade*), in a "politically correct" way (政治正

22 As the head of Credit Suisse's China Research Department, he quotes a Credit Suisse survey of 300 Chinese enterprises, and notes that, this year, those companies reported that their profits for the first six months of the year fell by around 2 percent since the same period last year, and forecast that they would grow by about 5 percent in the second half of the year. Overall, they all note that growth in profits has slowed down dramatically compared to previous years.

确, *zhengzhi zhengque*), but without any basis in actual implementation. He finds the lack of concrete steps towards liberalisation surprising, in light of what was a very concrete and promising third Plenum.

Zhu offers one explanation for this reluctance to reform. Although the term "reform" has a positive meaning in written Chinese (meaning an improvement for the better), in reality, adjusting the economy can be very "painful" (阵痛, *zhentong*). So the determination of reformers depends on the country's "level of tolerance for the pains of reform" (改革阵痛的容忍度, *gaige zhentong de rongren du*). In the example of the stock exchange, he says that if the government wants to liberalise financial markets, it must be ready to accept short-term but potentially violent ups and downs.

The Chinese authors are critical of the role of the government in this summer's turmoil. They recognise the responsibility of investors and speculators, and the lack of maturity of China's stock market. But most of them believe that the government's intervention before the turmoil was one of the triggers for the rout, and that the government's intervention during the rout will have lasting and negative consequences on China's stock market. Finally, most of them point to the need to go forward with reform, so that China's rebalancing continues – which will itself provide more stability to China's economy, and to its stock market.

4. Three possible scenarios for China's growth in the next five years

Alicia Garcia Herrero

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Interview with Yen Chenshen, "International scene: Chinese yuan devaluation; 70th anniversary of the atomic bomb explosion; Racial conflict in the US", *Awakening News Networks*, 15 August 2015.[26]

China's economic growth has been slowing down since 2010, as the main driver of the economy, investment, decelerates. Meanwhile, domestic consumption has remained low, and economic growth is still quite dependent on exports. Over-investment in the past means that many projects are not productive enough, dragging down returns and creating massive overcapacity. In addition, the government got a wake-up call from two important events this summer, which gave some idea of where China could be heading unless action is taken. The first was the June stock market turbulence, which came on the back of a government-driven bull market in the second part of 2014. The second was an awkward mini-devaluation on 11 August, which sent shockwaves across global financial markets.

After a clumsy start, the Chinese government finally managed to rein in the situation just in time for the Fifth Plenum of the 18th Party Congress on 29 October, where the key priorities for the next (13th) Five-Year Plan (十三五规划, *shisanwu kuihua*) were discussed. That meeting has helped to clarify the rate at which Chinese authorities expect growth to stay for the next five years: at least 6.5 percent per annum. But the economy is facing strong headwinds, and several growth scenarios are possible for the next five years. The outcome will depend directly on the type of action the government decides to take to support the economy.

23 Zhang Shuguang is a researcher at the Institute of Economics of the Chinese Academy of Social Sciences (CASS).

24 Liang Haiming is a member of the academic committee at Pan-goal, a Beijing-based think-tank.

25 Xu Xiaonian is professor of economics and finance at the China Europe International Business School.

26 Yen Chenshen is a professor at the Institute of International Relations of National Chengchi University (NCCU).

The slowdown in China's growth is down to structural factors, so government intervention is required if China is to continue to grow. The government will have to implement fiscal and monetary policies on the demand side, and structural reforms on the supply side. The particular mix of the two that the government chooses will determine China's rate of growth for the next five years. The boldest scenario would be pushing growth through reform. Another way of proceeding would be what could be called the "bazooka" approach: seeking to drive growth through demand policies, without implementing real reform. The third and final option would be to "muddle through", carrying out no major structural reform and putting in place only a limited number of demand policies.

The particular mix of the two [supply- and demand-side policies] that the government chooses will determine China's rate of growth for the next five years.

The first scenario: Greater reform

China's Premier Li Keqiang said in September 2015 at the World Economic Forum that the Chinese economy is in the midst of a reform spree, and that the government has been wise not to print excessive money or to stage massive stimulus despite strong downward pressure.[27] And it is true that financial reform has moved relatively fast in the last few years. However, other reforms, such as the reform of state-owned enterprises (SOEs), have stalled. SOE restructuring is particularly important if market forces are to be unleashed and China's overcapacity is to be reduced. Most of this overcapacity has accumulated in sectors dominated by public ownership, and state-owned actors have a much lower return on capital than private companies. The issue, of course, is that SOE reform would imply the restructuring (if not the closure) of huge corporations, which would have a negative effect on investment. Since the Chinese economy still relies heavily on investment for growth, this would in the short term slow growth. However, any negative impact on growth would be turned around once the reformed corporations became more efficient and productive.

Zhang Shuguang and Liang Haiming both examine the feasibility of the government's proposed SOE reform: the "mixed-ownership model" (混合所有制, *hunhe suoyozhi*).[28] Zhang says that mixed-ownership reform offers no real benefit for private sector investors. It would be difficult for private investors to become major shareholders or take part in corporate decision-making within state-owned enterprises. Liang Haiming also highlights the difficulties for the private sector in a mixed-ownership model. SOEs are simply too large for private enterprises to even take a minority role in their direction, never mind to have any influence on the companies' corporate culture. Liang Haiming calls this "the snake engulfing the elephant" (蛇吞象, *xietunxiang*).[29]

Another concern is that the government's efforts to rationalise the SOE sector could create even larger monopolies, since mergers would probably also be encouraged. A good example of this is the recent creation of the China Railway Rolling Stock Corporation, the result of the merger of China's former top two train manufacturers, China South Locomotive & Rolling Stock Corporation Limited and China CNR Corporation Limited. Liang Haiming argues that the main objective of this merger was to "avoid same sector competition" (避免同业竞争, *bimian tongye jingzheng*) within the new strategy of "going out" (走出去, *zouzhuqu*).[30] Given all this, pushing reform further will be difficult.

The second scenario: The "bazooka"

If reform proves too difficult and if the country's economic performance continues to disappoint, more aggressive demand policies might be introduced to jumpstart growth. Given that monetary policy is already quite lax, the only two significant stimulus measures left to the government are either a massive fiscal package similar to that undertaken in 2009 or else a major devaluation of the renminbi. Most of China's academics have focused on the fiscal option. The scenario cannot be completely discounted, but most Chinese experts, including Xu Xiaonian, think it is very unlikely to take place. Xu argues that the new government does not have the capacity to conduct such "strong stimulus policies" (强刺激, *qiangciji*) under the "new normal" (新常态, *xin changtai*). The present Chinese growth model relies mainly on credit, so any such package would add a considerable amount of debt on top of China's existing high leverage. The "4 trillion stimulus plan" (4万亿刺激计划, *simanyi cijijihua*) of 2009 was supported by bank loans and printing money.[31] It stimulated short-term demand and boosted GDP growth, but it also led to a misallocation of resources that is now having a negative impact on the economy. Xu says that "what we lack today is not money, but profitable investment opportunities" (现在我们缺的不是钱，缺的是能够盈利的投资机会, *xianzai women que de bushi qian, que de shi*

27 "China Focus: Chinese economy grows on reform, not stimulus: Premier", Xinhuanet, 10 September 2015, available at http://news.xinhuanet.com/english/2015-09/10/c_134610962.htm.

28 Mixed ownership means diversifying the ownership of SOEs with private capital

29 The saying "a snake engulfing an elephant" implies a small enterprise trying to acquire or take significant stakes in a large corporation.

30 The "Going Out" strategy is the Chinese government's policy of encouraging corporations to expand overseas.

31 In 2009, following the global financial crisis, China launched a RMB 4 trillion stimulus plan to restart the economy, which took the form of massive investment in infrastructure and social welfare.

nenggou yingli de touzi jihui). So, a fiscal "bazooka" will not bring higher growth in a sustainable way. It can only create temporary growth, which will come at a high cost in terms of increased debt.

The second "bazooka", a substantial devaluation of the renminbi, would be good for exports. But again, its positive effects would be only temporary, because it would prevent China from moving up the value ladder. It would make it easier to export low-end goods through price competition (helped by the exchange rate), but not through increased technological competitiveness. Yen Chenshen accepts that a renminbi devaluation could enhance growth in the short run, but notes that more is needed to solve the root causes (rather than the symptoms) of China's economic problems (治标不治本, *zhibiaobuzhiben*). He believes that any devaluation should be coupled with capital expenditure to improve product quality. As an example, he cites the German success story in export competitiveness, which took place through continuous investment in product development.

The third and most likely scenario: Muddling through

Given the challenges inherent in the reform and the stimulus scenarios, China's economy seems set to keep its current course. This will likely entail a moderate but steady decline in growth. Xu Xiaonian seems to agree that this is the most likely outcome for the next few years, as the debt accumulated in the past needs to be cleaned up.

The muddle-through scenario seems even more likely in light of the fact that structural reform, and especially SOE reform, has been lack-lustre for many years. In other countries with a very large share of state-owned corporations, the system has tended to perpetuate itself until the countries' financial situation has become totally unsustainable – which is not yet the case in China. Zhang Shuguang says that historical experience shows that reform can only be pushed through during a crisis (历史的经验证明，任何一项改革的实施都是在危机当头, *lishide jingyan zhengming, renhe yixiang gaige de shishi dou shi zai weiji dangtou*), citing as an example the Chinese reform in the 1990s.

All in all, the authors seem to agree that China's economy will continue to muddle through in the next few years without any immediate or medium term boost to growth. Structural reform, especially in the SOE sector, is necessary if China is to avoid a rapid deceleration in growth. But the government is not yet in a situation where it desperately needs to reform SOEs, so it is likely to avoid doing so. It also seems unlikely that the government will implement radical measures such as massive fiscal stimulus or currency devaluation: either option could destabilise the system, an outcome that the Chinese government would prefer to avoid.

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