CHAPTER 2

China's Four Decades of Reforms and Development

Abstract This chapter gives an overview of the major socio-economic transformations that occurred in China for more than four decades. They include transitions from a centrally planned to market economy, from a closed to an open economy, and from a manufacturing and export-driven to a more consumption- and innovation-led growth path. It also describes the main features of the socialist market economy with 'Chinese characteristics' including the gradual 'step-by-step' approach in the economic reforms in the different production sectors of the economy. In particular, the financial reforms that were given a major boost in the early 1990s and still require the necessary deepening of the current transition to a more sustainable economy are discussed. This chapter also elaborates on the adverse consequences of the rapid growth model and China's incomplete transition to a market economy. The traditional development model caused a huge depletion of natural resources, serious environmental pollution, which hindered the sustained economic development. Special emphasis is given to some current problem areas in the housing and stock market; the huge local government and increasing corporate debt; and the capital flight and excess capacity described in their relation with the current inevitable economic slowdown which could be seen as a breeding ground for new initiatives where the BRI can be seen as an important example and is central to this pivot.

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2.1 The Main Socio-economic Transformations from a Planned to Socialist Market Economy

In the past, after the Second World War, China was a closed centrally planned communist state. In this command economy with a socialist or communist economic system, where land and capital are collectively owned, all monetary means belong to the state who plans the allocation of resources; money, capital, and foreign exchange markets do not exist and interest and exchange rates are not determined by the market; central and commercial banking is combined ('mono-banking system'); and the domestic currency (RMB or yuan[1]) is not convertible into foreign currencies. During the Mao-era (1949–1976), the central planning combined with the removal of all property rights resulted in low productivity, a poor infrastructure, and famine. Since a command economy is also characterized by a barter trade system, whereby money is not used as a medium of exchange, China barely owned any currency reserves at the end of the 1970s.

The financial system in a market economy is fundamentally different from that in a command economy, in terms of both structure and the main goals of the system. In a command economy, the financial sector's main role is to support the implementation of the central planning's targets. It also takes deposits from individuals and makes loans, but the loans are not used for investments, but are used more to guarantee enough working capital. Investment decisions in China were made by central, provincial, and local planners and much of the financing came

[1]The Renminbi (RMB) or sometimes called 'redback' is the name of the currency meaning 'the people's currency,' whereas the Chinese Yuan (CNY) is the basic unit of account issued and administered by the PBC. While the banking sector uses the RMB for its settlements and the authorities for its internationalization objective, the values are denominated in CNYs. For many years, the RMB was pegged to the USD, but the RMB has now switched to a managed floating exchange rate with reference to a basket of foreign currencies. Depending on the macroeconomic circumstances, the authorities sometimes allow the value of the currency to float a little more and at other times to remain somewhat more stable.

directly from the government budget. In a market economy, the financial system mobilizes the savings after which this funding is used to lend to profitable investments. It is essential that the financial system is properly aligned with the real economy in order to minimize recessions and other macroeconomic imbalances. However, within different market economies there is an ongoing debate about how the financial system should be designed and managed. A common distinction is made between more bank-based financial systems such as in Germany and Poland and more market-oriented financial systems as in the USA or UK. The failure of the financial system in conjunction with the economic situation contributed to both the origins of the Asian financial crisis of 1997–1998 and the GFC which caused the severe world recession of 2007–2009. In the early 1980s, China created a market-oriented financial system by abolishing the 'mono-bank system' and replacing it with four state-owned commercial banks (SOBs) and a central bank, the PBC. This financial system, of which elements still exist today, is characterized by a so-called financial dependency triangle between the state council, SOBs, and SOEs. Similar as in the old 'mono-banking system,' when SOEs needed money, the state council instructed the SOBs to grant them loans whether or not they were creditworthy. Savers could either hoard cash at home or put their money in one of these commercial banks and receive a modest rate of interest. Interest rates were fixed by government approval for both savers and borrowers and done in a way to ensure the banks made a profit (Perkins 2018). Although many attempts have been made in recent decades to break through this 'financial dependency triangle,' ultimately this has never been executed entirely successful. This causes one of the biggest weaknesses of the Chinese banking system, namely that it lacks the ability to ration and allocate credit according to market principles, such as risk assessment and as a result created a 'bad debt' or NPL problem.

After the death of Mao and his Prime Minister Zhou Enlai in 1976, a new breed of Chinese authorities came to power with an increasingly pragmatic approach to combine the aspects of capitalism alongside government control of the economy. This socialist market economy with 'Chinese characteristics'[2] consists of a gradual transition from plan to

[2]This is the official term used to refer to the economic system of the People's Republic of China (PRC) after the reforms of Deng Xiaoping. According to Deng, socialism and capitalism need to be mutually exclusive. His pragmatic approach states that 'it doesn't

market without a 'shock therapy' as was the case with the radical more political rather than economic market-oriented reforms that took place at the 'big bang' transition from the Soviet Union to Russia in 1991. Basically, Deng introduced the market economy outside the power of the central planning.[3] Existing allocation mechanisms were retained; new ones were adopted at the margin on an incremental and experimental basis. Deng's gradual and pragmatic process of economic reforms can be referred to his advises of 'crossing the river by touching the stones' and 'hide your capabilities and bide your time' and motivated him to push forward the gradual implementation. It sought to identify which policies produced favorable economic outcomes (and which did not) so that they could be implemented in other parts of the country. Another feature of this socialist market economy was the dual-track system in which the command and market economy coexisted; transition was to be achieved through a gradual strengthening of the market and a step-by-step weakening of the plan. This approach created more opportunities for the development of the private sector, creativity, and entrepreneurship. Nonetheless, under the incremental reform strategy, whereby the private sector and the state sector coexisted in parallel, the dual-track pricing strategy for many products and services allowed those in power to reap huge personal gains and ultimately led to large-scale official profiteering and corruption which is currently perceived as one of the biggest plagues of the CPC. Deng's push to implement economic reforms was largely motivated by a belief that the resulting economic growth would ensure that the CPC stayed in power (Morrison 2018).

Since the end of 1978, China initiated the change from central planning to the introduction of market mechanism simultaneously with opening-up to international trade and investment. Both the domestic economic development and the participation in globalization have gone forward hand in hand. Deng initiated a new 'open door' policy to open the door to foreign businesses that wanted to set up in China

matter if a cat is black or white; as long as it catches mice, it's a good cat.' In essence, the 'black and white cat' stands for 'planned and market economy' and 'the one who is able to do a job properly will be hired for the job' (Fan 2016).

[3] Already in 1975, Deng and Prime Minister Zhou Enlai introduced the so-called Four Modernizations of agriculture, industry, defense, science and technology. From 1979 onwards, these modernizations were further introduced by Deng without satisfying the call for a fifth modernization of more political reforms or democratization.

which altered China's development strategy of self-sufficiency to one of active participation in the world market. In 1979, the central government decided to establish SEZs in Shenzhen, Zhuhai, and Shantou in Guangdong province and Xiamen in Fujian province. This signaled the start of China's opening to the outside world. Since 1978, there were both some economic and political motives for this 'open door' policy. The economic motives were focused on the promotion of market forces, foreign trade and foreign investments in order to attract foreign exchange reserves and high-tech technologies. The political motives consisted of the fact that the 'open door' policy has also been used by the People's Republic of China (PRC) as one justification for its demands that nations do not provide diplomatic recognition to the Republic of China (Taiwan). SEZs were set up in Deng's belief that in order to modernize China's industry and boost its economy, it needed to welcome foreign direct investment (FDI). Chinese economic policy then shifted to encouraging and supporting foreign trade and investment, and laws on intellectual property rights (IPRs) to stimulate innovation. It is the turning point in China's economic fortune that truly started China on the path to becoming 'The World's Factory.' The main objectives of the SEZs consisted of the transfer of hi-tech industries into these regions; becoming the showroom for high-tech, modern management and an efficient labor force; the creation of employment and export-oriented production in order to attract foreign exchange reserves for import of more advanced technologies; and the promotion of economic and regional development. The arrival of SEZs had both its pros and cons. Some of the advantages of SEZs are the limited or absence of interference of the local authorities; huge funds to invest in infrastructural projects; and special business preferences for foreign investors. On the other hand, as one of the first experiments of China's economic reforms, it soon became apparent that the SEZs turned out to be ideological controversial. Within the CPC, the conservatives and radicals strongly differ in their approach regarding the implementation of the reforms.[4] These two visions about political-economic reforms have always played a role in the transition from plan to market. Therefore, the authorities sometimes tightened the reins more, such as at the end of the 1980s, and in other times allowing the reins to loosen more toward more decentralization since the late

[4]A proverb of the conservatives is 'crossing the river step by step, while groping for the stones,' while the radicals state 'you cannot jump a chasm in two steps.'

1990s (Leonard 2008). However, with the arrival of Xi Jinping in 2013, these different views on the method and extent of economic reforms have been brought more to the background. Initially, another problem of the SEZs was that they hardly benefited from any high-tech capital inflow from Western advanced economies, while the vast majority of the capital inflow came from the region (Hong Kong, Taiwan, and South Korea) and consisted of low-tech consumer goods. However, much later in 1990s and early 2000s when China expanded its 'open door' policy into 'open coastal cities' in 1984 and a host of cities along the Yangtze River and interior border cities in the early 1990s, this pattern has changed drastically. Gradually, the domestic steps to open to the international economy were extended to global institutions with China's application to resume the status of a contracting party to the General Agreement on Tariffs and Trade (GATT) in 1986 and its accession to the World Trade Organization (WTO) in 2001 (Wu and Ma 2016).

China's entry to the WTO is accompanied by advantages and disadvantages. It was a milestone in China's integration into economic globalization, marking a new historic stage of reform and opening-up. Since its accession to the WTO, China has been a strong advocate for free trade and is now even the promoter of China's new style of globalization at a time when the current Trump administration has begun a new wave of protectionism. Foreign firms are no longer required to hand over technology in exchange for entry to China's market; China's WTO membership has increased the export growth and led to cheaper import of more luxury products; local banks have been more encouraged to offer more differentiated services to various degrees of foreign investments and last but not least the application of the use of WTO codes on IPRs and investments will be more guaranteed. It is obvious that China's WTO entry also has its drawbacks. For example, the reduction of tariffs on agricultural products has threatened the livelihoods of hundreds of millions of farmers. Also, there is a risk of more bankruptcies of SMEs and hence more unemployment and social unrest due to more international competition. Although WTO access will in principle lead to less trade control, in practice it has led to many antidumping cases, partly because many foreign firms feel they must compete not with Chinese firms, but with the Chinese state. However, after almost twenty years of membership China has comprehensively fulfilled its commitments to the WTO, substantially opened its market to the world, and delivered mutually beneficial and 'win-win' outcomes on a wider scale.

There is an ongoing debate around the world about how faithfully China has implemented WTO rules and practices, and there are certainly some Chinese practices that involve subsidies to exports or restrictions on imports that are inconsistent with WTO rules. Nevertheless, it can be stated that China has fulfilled the following WTO accession commitments: provision of non-discriminatory treatment to all WTO members; elimination of 'dual pricing' practices[5] as well as differences in treatment accorded to goods produced for sale in China in comparison with those produced for export; substantial reduction of tariff- and non-tariff barriers; price controls will not be used for purposes of affording protection to domestic industries or services providers; revision of existing domestic laws and enacting new legislation fully in compliance with the WTO agreement; and extensively reducing restrictions for foreign investments to enter the services market and fulfilling commitments on IPR protection. In principle, China will not maintain or introduce any export subsidies on agricultural products. However, the latter point has often led to trade disputes with other WTO member states since Chinese prices are considered to be too distorted due to significant government subsidies and intervention, for instance with key export products like solar panels, wines, and mobile telecommunication networks. According to WTO law, the EU may impose an anti-subsidy duty to remove the benefit of a foreign subsidy, or an anti-dumping duty when the imported product is sold at a lower price in the EU than the price in the exporting country, i.e., where there is international price discrimination (The State Council 2018; Perkins 2018).

Not only the 'open door' policy and WTO accession can be considered as two essential foundations of the current BRI since 2013, this certainly also applies to China's 'Going West' campaign or 'great western development' regional policy and its 'Going Global' or 'Going Out' policy initiated at the turn of the century. The BRI coincides with China's 'Going West' policy encouraged by former president Jiang Zemin to close the development gaps between coastal and inland China. The economic growth in Central Asian region will surely have positive effects for Chinese western provinces, whose development is a priority for the Chinese government in order to compensate their lag behind the eastern coastal area. In particular, the Chinese government aims at stabilizing

[5] Since the mid-1980s, a 'dual track' system of plan and market was set up with the aim to strengthen the SOEs with market forces.

the Xinjiang autonomous province, one of the most problematic areas due to the presence of the Uighur minority areas, having a strong separatist tendency with Islamist influence, which caused in the past social unrest. Xinjiang is a region rich in natural resources (it originates 22% of oil and 40% of the coal mined in China) and therefore represents an area of great importance for the economy of the country. Beijing government's strategy to reduce the risks related to the separatist aspirations of the Uighur minority has been to promote the development of this province, building infrastructures and promoting the establishment of new businesses. A drawback of China's 'great western development' is the fact that there is little emphasis on the Go West campaign on measures to alleviate poverty, while the government is obsessed with gigantic, and correspondingly expensive, infrastructure projects. One acute side effect of heavy state subsidies in these western provinces has been a high concentration of SOEs and low penetration of private-owned enterprises (POEs) (*The Economist* 2000).

The 'Go Out' policy (also referred to as the 'Going Global' Strategy) was an effort initiated in 1999 by the Chinese government to promote Chinese investments abroad. This policy has the following causes. First, China has amassed huge amounts of foreign reserves, thus putting upward pressure on the foreign exchange rate of the RMB; there has been much demand from the international community for China to float its currency. In order to deflate that demand, China seeks to employ its foreign reserves by acquiring assets overseas. Second, further acceleration of the WTO commitments has led to the situation that global competitors are now competing for business in the Chinese market, and so China is seeking to equip the domestic firms and their management with international experience so that they can take the competition to the home markets of the foreign nations and so that they can compete better at China's own domestic market. Finally, the 'Go Out' policy has led to programs launched by the Chinese government with the following goals in mind: to increase Chinese FDI; to pursue product diversification; to improve the level and quality of the projects; to expand financial channels with respect to the national market; and to promote brand recognition of Chinese companies in EU and US markets (Cai 2017).

China's rapid economic growth over the past four decades transformed it from a developing to an emerging economy and thus from a low to a much higher standard of living, which also has led to a greater income inequality. During the same period, China has also changed

from a rural to a more urban society. The unprecedented growth rates were (partly) due to the large-scale capital investment financed by large domestic savings and foreign investment and the rapid productivity growth. These two factors appear to have gone together hand in hand. Economic reforms led to higher efficiency in the economy, which boosted output and increased resources for additional investment in the economy. Also, the 'one-child' and current 'two-child' policy, implemented in 1979 and 2016, respectively, is beginning to have a significant impact on the current Chinese economy. First, China is beginning to lose a labor advantage, i.e., access to a nearly endless supply of low-cost labor. As the labor force shrinks, Chinese wages could begin to rise faster than productivity and profits growth, which could make Chinese firms less competitive, and result in a shift of labor-intensive manufacturing overseas. Second, this policy has also resulted in a rapidly aging society in China. With a declining working population and a rising elderly population, the Chinese government will face challenges trying to boost worker productivity (such as enhancing innovation and high-end technology development) and to expand spending on health care and elderly services. China's current '*hukou*' or household (population) registration card system also poses challenges to the government in terms of the control of internal migration, the management of social protection, and the preservation of social stability. The discrimination in favor of city dwellers, partly caused by '*hukou*,' has contributed to the increasing inequalities in recent decades. However, there is hope to delay this development by loosening the '*hukou*' in the future, given the economic growth in Central and West China, the higher wages of migrant workers and the reduced income disparities between migrants and natives in cities. This trend change can continue to take place depending on the '*hukou*' reforms that will enable all citizens to seize existing opportunities. The inability of migrants to gain adequate access to social protection is currently one of China's biggest obstacles in restructuring its economy to increase consumption-driven growth (Pradier 2018).

The current state of the Chinese economy is described by some economists as a 'middle-income trap' whereby growth in this upper-middle-income country tends to stagnate when GDP per capita rises above a certain level, as higher wages push up production costs. This phenomenon became more common in China since 2010, when double-digit growth rates begin to fall to a lower level as soon as the individual prosperity of a growing middle class starts to rise. This means

that a developing low-income economy is able to transform to a middle-income economy, but because it is unable to sustain high levels of productivity gains (in part because it could not address structural inefficiencies in the economy), it is unable to transform to a high-income economy (Morrison 2018, pp. 7; 29; 44–45). To a certain extent, China's 'middle-income trap' could be perceived as a result of China's rebalancing strategy to shift from higher-growth manufacturing to slower-growing services industries and in that sense is more a 'gap' than a 'trap.' In order to avoid or reduce the 'middle-income trap,' China's productivity growth needs to increase building up a more advanced technological and innovative production capacity. Also, investments in a highly qualified education system and a stronger focus on export upgrading can contribute to reduce the 'middle-income trap' (Shek 2019).

As part of the 13th FYP, the Chinese authorities are determined to restructure the economy in order to prevent the 'middle-income trap.' In that context, the BRI can be seen as a new initiative to facilitate the transition from middle- to high-income and from an emerging to an advanced economy by using Chinese capital and know how to drive infrastructure development overseas. The BRI offers new more upgraded import and export possibilities, creating new production value chains that can bring the development of the Chinese economy to a higher level.

2.2 The Ongoing Process of Gradual Financial-Economic Reforms

Since 1978, the reforms were introduced step by step in the various production sectors of the economy in a gradual and experimental way. First in agriculture, then in the mid-1980s in the manufacturing industry, and from the early 1990s the financial services were also reformed. The agricultural reforms consisted mainly of the household or contract responsibility system (HRS), a private farming in a market economy whereby each farm household was assigned a piece of land and was held responsible for delivering a given quantity of a specified product so the commune could satisfy its procurement requirement. After fulfilling the delivery quota, the farm household was free to keep the remaining output for its own consumption or for sale in the market. This reform immediately improved incentives for agricultural production by granting farmers autonomy over operations and rights to profits from more efficient use of their land and labor, which gave them motivation to raise

productivity. Due to the HRS, technological changes, market reforms, and agricultural investments mainly in areas of water control, roads, and communications, a more diversified agricultural growth and rising off-farm employment has dramatically reduced rural poverty. However, the food production has risen at the expense of the environment which has created tremendous challenges to achieving sustainable rural development with the BRI as a supporter and stimulator. Rising wages have increased the cost of food production and lowered China's agricultural competitiveness in global markets, while concerns about national food security are high. Despite steady growth in rural incomes, the rural–urban income gap remains large (see Sect. 2.3).

From the mid-1980s, reforms were more focused on the manufacturing sector including some autonomy regarding the use of retained profits; production planning; sales of output; experimentation with new products and capital investment; payment according to productivity; increasing the role of markets; encouragement of collectively owned enterprises; and streamlining the administrative system at the local level for SOEs under local control, i.e., the SOE reform. Unlike the former socialist countries in Europe, SOE reform in China, in contrast to the reforms in agriculture, was hardly accompanied by privatization but mainly consisted of corporatization.[6] While the overhaul of the SOE sector from the mid-1990s occurred with a large-scale sell-off of loss-making SOEs, only partial privatization was pursued, as the government kept the majority stakes in large SOEs. Although the reforms were designed to tackle the obvious inefficiencies inherent in SOEs, they needed to be done slowly in order to preserve China's political and social stability and reduce the risks of falling tax revenues. Partly due to the aforementioned 'financial dependency triangle,' the SOE reforms as the core of urban reforms turned out to be more difficult to implement than that for agricultural production and had several aspects. One aspect is related to making SOEs viable market players, and began with the expansion of enterprises' autonomy, building up to corporatization. Granting autonomy to enterprises began with pilot programs in some cities since 1979. It was quickly extended to more regions and then to the whole country in the early 1980s. A second aspect involved redefining the

[6]As part of the SOE reforms, China's 'corporatisation without privatisation' measures are designed and implemented around a central target of establishing a competitive market, leaving the ownership structure basically unchanged.

relationship between SOEs and government. Early reforms in this area featured the state sharing profits with enterprises through a host of measures aimed at introducing market discipline and accountability. The third aspect was the introduction and then the encouragement of POEs. SOEs generally operate less efficiently than POEs because the government provides them 'soft budget constraints', and therefore, SOEs were subject to various 'moral hazard' problems. However, since the property rights were reformed to allow a wider range of POEs, the competition between enterprises with different kinds of (mixed) ownership helped to increase the efficiency of SOEs as well (Cai et al. 2018). Due to SOE reforms, the productivity of SOEs has been steadily increasing in the past two decades, although at a slower rate than that of the POEs. Also, the relative importance of SOEs has been declining, and the effect of the state sector's performance on the growth of the entire economy is less important than before. However, SOEs remain a significant burden for the government and the economy, even though it remains a huge dilemma to completely reform them. The 'soft budget constraints' are a drain on government budgets and economic resources, but reducing the size of SOEs creates an unemployment problem and the risk of social instability. Several factors affect the economic efficiency of SOEs. There is a shortage of competent and well-trained managers and staff to operate a modern enterprise, along with a tendency to make management decisions based on personal relations and for personal gain at the expense of the enterprise. The system does not provide managers with appropriate incentives to work for the benefit of the enterprise; they are on a much lower pay scale than managers in similar collective enterprises. In the absence of a suitable governance system, many workers still subscribe to the concept of the 'iron rice bowl' which referred to the now-abolished system of guaranteed lifetime job security. China's transition from a centrally planned to a market economy has abolished the old government guarantees as much as possible. Millions of workers have been laid off as SOEs have been restructured or shut down. This has sparked angry protests from their workers, who complain they have been left without the welfare benefits they were once promised. This dilemma becomes even greater for the government, as it has increasingly become apparent that the equipment and technology of some SOEs need to be updated. One important condition favorable to the SOE reforms is the high degree of competition from collective and foreign enterprises in both domestic and foreign markets. The main challenge for continued reform of SOEs

in the late 1990s is to restructure them to shareholding companies and make them public limited companies (Chow 2018).

Since 2016, a new round of mixed-ownership reforms will put the SOEs in key roles of the BRI via 'win-win' projects in new sources of energy, telecommunications, and information technology, automation, transport equipment power, space technologies, and defense. Most of the recent SOE reform programs had a much wider coverage and emphasized the importance of corporate governance, risk management, performance appraisal, and strategic planning. As part of the BRI, the 'bringing in and going global' strategy will be encouraged more for SOEs to remain competitive in order to guarantee strong and sustainable growth (Nan and Shuiyu 2019). An example of an economic influence via the BRI on the privatization of foreign investments is the agreement between the Greek government and China's state-controlled ocean shipping company (COSCO) in 2016 to acquire 51% of the Piraeus port with the rights to operate the port until 2052 and the possibility to reinvest in the port infrastructure in order to be eligible for a further 16% stake. Although this investment has led to much local protests and EU resistance, from the Greek government's point of view this is seen as a way to alleviate the many years of austerity measures resulting from the euro sovereign debt crisis whereby Greece's budget deficit reached 15.4% of their GDP in 2009 and their 10-year bond rates surpassed 35% from 2010 to 2012. In the past decade, Chinese companies have acquired stakes in 13 ports in Europe, including in Greece, Spain and, most recently, Belgium, which handle in total about 10% of Europe's shipping container capacity. The takeover of the terminal in Zeebrugge, the second-largest port in Belgium, marks the first bridgehead of Chinese state-owned port operators in northwestern Europe. It clearly manifests China's ambitious plans to physically connect Europe via the maritime part of the BRI (Johnson 2018).

The Chinese government has also called on SOEs to play a critical role in achieving the goals of the 'Made in China 2025' policy[7] set up in

[7] In a way, the 'Made in China 2025' plan to use state direction to dominate high-tech industries has alarmed the rest of the world, USA in particular, and ignored the advice of Deng Xiaoping to 'hide your capabilities and bide your time.' Although the 'Made in China 2025' plan has not produced any results yet, with Xi Jinping's slogan' 'socialism with Chinese characteristics' a parallel is often drawn with the Maoist era in China (Shazada 2019).

2015 which aims to shift China's economy into higher value-added manufacturing sectors, such as robotics, aerospace, and energy-saving vehicles (Song 2018). This industrial upgrading strategy or promotion plan reveals China's future goal of belonging to a highly developed country by encouraging China's technology, technical standards, equipment and engineering know how. It has also become China's first two-FYP, including the 13th FYP (2016–2020) and the 14th FYP (2021–2025). It is also intended that 'Made in China 2025' is supported in part by the BRI through a deepening of international cooperation in the industry (Chen 2018).

During the 1990s, the Chinese banking system was facing a huge NPL problem which mainly resulted from the 'financial dependency triangle.' According to the commonly accepted definition, NPL is defined as a loan that is in default or close to being default. The Chinese authorities formally introduced a loan classification to the country's financial market regulation in 1995. Originally, the NPLs were divided into three categories, namely part-due loans, doubtful loans, and bad debts. In 2002, the country changed the classification and implemented the universal international standard with four categories of NPLs, i.e., special attention, sub-standard, doubtful, and loss (Tan 2014, p. 14). The Chinese approach, however, in some situations is still more liberal than the general approach. It means that a bank policy might determine the loans classification and the collaterals and guarantees may reduce the recognized risk of the borrowers. Additionally, banks are able to implement their own policies and procedures on recognition and assessment of collateral. It leads to a situation that although Chinese banks are obligatory to use the international loan classification system, banks have a lot of leeways or alternative options in deciding when a loan turns bad (Chen and Wu 2015). The situation in a particular bank might be worse than the official NPLs classification shows, and it is uncertain whether the banks' financial statements in fact meet the international standards or is different from the standards.

Technically, Chinese banks were almost bankrupt before the banking sector reforms started, but during the gradual reforms a downward trend in the 'bad debts' has been driven by the transfer of impaired assets (i.e., NPLs) to state-owned asset management companies[8] (AMCs) and

[8] An AMC is an investment company that buys outstanding debts and then manages and resells these debts in order to recover (some of) the funds. For each of the major state-owned commercial banks, there is one AMC which are funded by the MoF and a loan by the PBC. AMCs exchange bonds with the respective banks for NPLs.

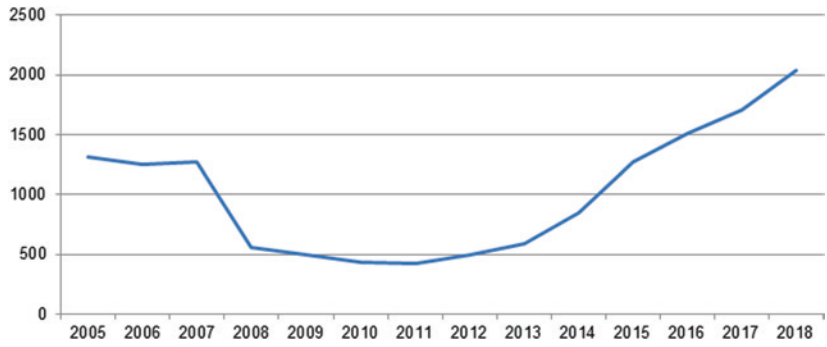

Fig. 2.1 Non-performing loans in China in the period of 2005–2018 (RMB bn) (*Source* Own elaboration based on CEIC database [accessed: 10.03.2019])

the banks were made solvent by simply paying these companies the full value of the loans (van der Linden 2010). In effect, the central bank printed the money and gave it to the banks. Since the launch of four national-level AMCs in 1999, the Chinese government has taken steps to gradually deregulate the sector with the objective to attract more players (including foreign acquirers of NPLs). By the late 1990s, the banking system had begun a process of changing the behavior of those running the banks to make them behave more like commercial banks in a high-income market economy. Gradually, the banks began to make loans to POEs and mortgages to consumers. They began to pursue profits and to establish systems for properly appraising the creditworthiness of their borrowers. New credit instruments such as personal credit cards were introduced, along with a wide variety of modern banking practices from abroad. Many new smaller banks were founded, and government policy banks were established in 1994 to take over the government-directed spending functions of the four SOBs in order to remove politics from bank lending (Mehran et al. 1996, pp. 13–14). Modernizing the banking system in China has been an ongoing process, not a one-step radical reform. This has reduced the NPL ratio drastically in the period of 2008–2012. Since 2016, the practice of buying banks' NPLs at a discount and recovering them for a profit has grown rapidly even though it is becoming increasingly difficult in a slowing economy to dispose of NPLs, and as a result, the NPL ratio has gradually risen again (see Fig. 2.1). As the Chinese government continues to open up the financial

sector, it provides challenges for domestic AMCs to further explore opportunities overseas and to emerge as global companies with international standards and quality. This is in line with two ongoing trends in which the BRI can play a useful role, namely global investors' rising interest in China, the world's second-largest economy, as well as domestic investors' demand for a more diversified asset portfolio. Although the Chinese banking system takes over many practices from other market-oriented banking systems, the dominant banks (the 'Big-5' except the Bank of Communications) are still state-owned and so far there is no plan to privatize them.

The domestic Chinese stock market is very large; its A-share market is the second largest in the world in terms of market capitalization after the USA. However, it is characterized by a high degree of inefficiency and volatility, and it primarily serves the SOEs. The Shanghai and Shenzhen stock exchanges were formally started in 1990, but during the first decade they were mainly vehicles for selling shares of SOEs to private interests. Over time, the stock exchanges have listed more and more firms, including private ones. The China Securities Regulatory Commission (CSRC) regulates the stock market. Its regulations, like those of the China Banking Regulatory Commission (CBRC), are similar to those of high-income market economies. Despite the strong rise of China's shadow banking system from the start of the credit crunch in 2007, its current traditional banking system is still highly regulated because of ongoing direct state ownership of the largest institutions. Given that China avoided the major recessions caused by the Asian and the GFC, it has experienced only a few periods where there were some balance of payments concerns and inflation has been negligible for the past two decades. It is therefore reasonable to state that China's financial regulatory environment is functioning adequately. However, in the transition to a more sustainable growth model it is likely that China's supervision and regulation of its financial system needs to be adjusted (see Sect. 5.5).

The fast-growing bond market is currently the world's third largest, but is dominated by the banking sector as the main source of financing for private companies. Through advanced financial reforms, the opening of capital markets has led to more easy capital inflow and outflow. However, many of the controls over these capital flows were used to restrict openness in 2015 and early 2016 when capital outflows led foreign exchange reserves to fall by more than USD 700 billion in less than a year, before leveling off later in 2016. That experience suggests that, at

China's current stage of development, complete market-oriented reforms should probably not include full opening of its capital markets. It may be in the interests of financial institutions in high-income countries for China to fully open its capital markets, but it is not in China's interests to have to deal with more volatile huge short-term capital inflows and outflows or 'hot money.' China needs time to reach a more sustainable balance in its international capital markets before lifting capital controls entirely.

When assessing the state of financial reforms in China, it is important to take into account the fact that not all financial innovations in recent years in high-income countries have had a positive impact on those economies, as 2007–2009 made clear. The excessive use of risky and innovative off-balance sheet products by many financial institutions in advanced economies before the GFC have been a good lesson for China to be more cautious about it. Financial reform is a complex topic, but there is no doubt that China has made major progress in creating a modern financial system suitable for a market economy. Some of the older financial institutions such as the regulated banks are now quite sophisticated, while new institutions such as insurance companies and the stock exchanges are far away from the level where they should be. Progressing to an efficient financial system will take time, but, in most respects, the direction is clear and substantial progress has been made. One change that would make the financial systems of China more like those in most high-income countries, however, is not going to occur. The Chinese government and the CPC are not going to substantially reduce their role in controlling and directing that system. The development that is taking place in many advanced economies, but will highly likely not take place in China, is the removal of direct government control over the financial sector and leaving supervision to more indirect controls of monetary and fiscal policy (Perkins 2018).

2.3 The Incomplete Transition to a Market Economy

The status of China's economy has been very often taken into consideration during the last years. Many economists are searching for an answer to the question whether the country has become a pure 'market economy.' To answer this question, two points of view can be highlighted: first, a general assessment of the economy's development, and second, the formal market economy status (MES) as understood by

the international institutions such as the WTO. Both approaches do not lead to an obvious answer. The first approach does not give a clear answer because the Chinese economy is incomparable to other economies. During the past half-century, China has the most outstanding economic growth rates comparing to other emerging markets, but China applied its own way of development and this process is still unfinished. The country successfully increased its GDP, lifted hundreds of millions of its citizens out of poverty, and managed to be a global leader in some technologically advanced branches of industry, especially electronics, and IT. Currently, the country aspires to become the largest economy in the world (Ning 2018). On the other hand, there are many obstacles that China must overcome before the country is awarded a MES. The incomplete transition to a market economy is associated with the lacking of infrastructure in some parts of the country (or at least the great variety of access to infrastructure in different parts of the country) and a lack of human capital. Despite the acceptation by the government to stimulate the free market forces to help to grow the economy, the government still plays a primary role in the country's economic development (Morrison 2018, pp. 28–29).

The second point of view on the Chinese economy is its MES. This mainly plays a role in China's accession to the WTO on December 11, 2001 preceded to a 15-year transition period with the ultimate goal of achieving real status as a 'market economy.' The USA, Japan, Canada, and some EU countries still refuse to treat China as a market economy because of outstanding anti-dumping cases, even though they agreed to commit to MES recognition when China entered into WTO. According to these WTO member states, Chinese goods, especially commodities such as steel and aluminum, were not fully determined by the market and are still heavily underpriced because of subsidies and state-backed oversupply, giving Chinese exporters an unfair competitive advantage. China responds that its economy meets the generally accepted definition of a market economy in most anti-dumping cases. In addition to a large number of trade liberalization efforts, China has revised many laws and regulations at the central government level, and many more at local level, to bring the Chinese legal system in line with WTO standards. Chinese authorities also argue that the USA and other major trading nations agreed when China entered the WTO that the non-MES provision would expire on December 11, 2016. This date has passed, but the USA continues to label China a non-MES (Gao 2017). After four decades of

reforms, China has understandably not become a pure market economy knowing that those reforms have come a long way from central planning. Especially during the current US–China trade conflict, this is an unfavorable situation because it is easier to introduce trade barriers with a similar MES for all WTO member states (Griswold 2019). This situation deserves a solution within the WTO as it is currently very difficult to distinguish pure market economies in a time of a new protectionist wave under the Trump administration.

Although the Chinese economy is characterized by rapid growth during the last four decades, this extensive approach to economic development has been accompanied by many adverse consequences. Some of the most important consequences of the incomplete transition process are the following:

- huge inequality of income distribution;
- relatively low GDP per capita;
- corruption and social unrest;
- continuous rural migration ('urban-rural' gap);
- environmental and congestion problems;
- demographic problems and population aging;
- shortage of availability of energy and raw materials;
- government support for SOEs and inefficiency of the financial system.

Taking into account the economic perspective, the most important short-term problems are connected with the excessive state intervention, shortage of energy and resources, labor market inefficiencies, and financial market underdevelopment. In the long run, crucial will be demographic constraints and other social problems, like social unrest, inequalities of income, and the urban–rural gap. Another group of threats are ecological problems. One of the most visible aspects of the incomplete transition of the Chinese economy toward a market economy is the inefficient financial market in the country. The banking sector reforms can be divided into several phases, namely the stage of specialization (1978–1993), commercialization (1994–2002), ownership restructuring since 2003, and public listings since 2005 (van der Linden 2010). Since GFC, Chinese banking is also putting more emphasis on prudent risk management for maintaining financial stability. However, already from the start of the financial reforms the financial sector was treated

more as an important tool used by the authorities for their political aims than as an important intermediary between the different parties acting in the economy. Such approach leads to a situation that commercial banks have discriminatory lending policies, especially for SMEs. Due to the 'financial dependency triangle,' SOEs are able to get cheap credit; however, very often they are not able to repay the loans. As a result, the regular banking system was and still is rather inefficient and is making massive losses which led to the growth of NPLs (see Sect. 2.2) (Tan 2014, p. 9). On the other hand, the small- and medium-sized POEs are required to pay higher rates and often are not able to get loans from the SOBs.

The abovementioned circumstances led to the development of an unregulated part of the financial market alongside the regular banking system. The term shadow banking refers to a range of informal financial vehicles such as the Wealth Management Products (WMPs) with the principal purpose to attract savings funds that are seeking higher returns than could be achieved at the low state-fixed interest rates on deposits paid by the banking system. China's shadow banking system has developed especially in the last decade as a result of the immature Chinese capital markets and a shortage of funds provided by regulated traditional banks. Since the GFC, shadow banking became a very important alternative funding for the real economy in China, and in contrast to the shadow banking in the Western economies, the Chinese system established a strong interconnectedness between traditional 'commercial' regulated banks and the unregulated 'financial' institutions (e.g., trust companies, leasing companies, pawnshops, or microfinance companies) (van der Linden 2015). The commercial banks themselves initiated many of these products, but they were recorded separately from the banks' formal balance sheets and were unregulated by the CBRC. The central bank dealt with this in part by abolishing the state-set ceiling on deposit rates in 2015. In 2017, however, market interest rates in China as well as around the world remained very low, so WMPs remained attractive. Gradually, this led to a rather interwoven financial sector in China without a clear distinction between the regulated traditional and unregulated shadow banking system (Sheng et al. 2015; Sheng and Soon 2016, pp. 98–99). It is likely that both parts of the banking system will play an important role in the Chinese economy in the coming years. Since virtually all of the money is lent and borrowed by domestic individuals and institutions and the government has always been both able and willing to

bail out NPLs, it is unlikely that China's shadow banking, given its large and growing size, could lead to another major financial crisis (Perkins 2018). The danger from continuing bailouts, if they become necessary, is less a financial crisis and more the possibility of increasingly risky and poor decision making by lenders leading to slower long-term growth. Handling of NPLs has become a top priority over the past decade as they posed a threat to financial and social stability. The first regulatory activity was undertaken in 2010 when CBRC introduced regulations related to direct bank-trust cooperation and channel investments. Then were implemented further regulations related to bank's WMPs (2011 and 2013), trust companies (2014), and some interbank activities (2014). All of them imposed some prudential measures or prohibited risky transactions (Bowman et al. 2018). The next wave of regulations was implemented since 2016. President Xi Jinping has made the reduction of corporate indebtedness (see Sect. 2.4) a key element of his policy over the last two years (Weinland 2019). The PBC prepared a new set of regulations and other measures aimed at reducing the risks in the financial sector in the country. The policy makers are aware that any regulatory closing must be progressive, because rapid tightening is likely to hurt the economy. Policy makers must manage the frequency and intensity of regulations and apply some monetary policy toolkit to deleverage the economy without stymieing its growth. It means that the new regulations are interrelated with expansionary monetary policy aimed at averting any severe cash shortages and provide the necessary efficiency (*China Daily* 2017).

Another concern associated with the incomplete transition of China to a market economy is related to the labor market. Some of the problems occur in market economies as well, but in the context of the Chinese economy they assume a particular relevance. The labor market problem might be divided into two groups: wages problems and unemployment problems. The wages in China have been rising rapidly in recent years what triggered the erosion of labor cost advantage. As China's economy expanded, the wages in the country begin to grow. This creates a big problem for the future, because for decades cheap labor is considered as the main factor behind the economy's growth. The process of rising wages may erode China's low-cost manufacturing advantage very soon. As compared with developed markets, labor costs in China are still low, but compared with other emerging markets they are rising more strongly (see Fig. 2.2). It leads to a situation that China's manufacturing sector is

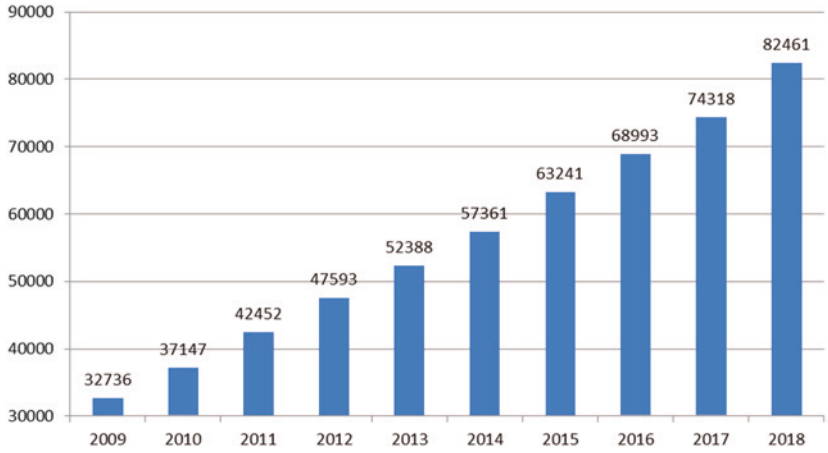

Fig. 2.2 China average yearly wages 2009–2019 (RMB) (*Source* Own elaboration based on Tradingeconomics.com [accessed: 26.05.2019])

under pressure with factories shifting labor-intensive production to low-cost countries (*The Economist* 2015).

Another feature of the Chinese economy is the rising unemployment which is difficult to estimate since China's unemployment rate only measures the rate of unemployment of those with an urban registration in accordance with the urban '*hukou*' framework (see Sect. 2.1). In the past, China's unemployment problem mainly consists of structural unemployment due to a rapidly changing pattern of the structure of the economy. This problem could be tackled through supply-side policies (e.g., training and improving the state of technology) as part of the 13th FYP. However, since the inevitable economic slowdown China is also facing cyclical or demand-deficient unemployment which could be solved by (expansionary) demand-side policies such as lower taxes, higher government spending, or lower interest rates but conflicts with the social security taxation system. There are several reasons for the new situation of rising unemployment. Among the most important are the withdrawal of foreign capital, internal tax policy, and technological changes. Massive withdrawal of foreign capital as a result of international competition between China and other countries has undermined the labor market and has become one of the most important causes of the problems in the labor market. Additionally, the economy's growth rate has been falling

year-on-year and during the last few years achieved the slowest growth rate since the GFC. As the economic growth is slowing, the employment is declining. The problem is relevant in particular to the growing number of college graduates (Xing et al. 2018). Although China's official unemployment rate has been remarkably stable at roughly 4% for decades, which is rather surprising considering the more fluctuating growth rates of the economy over the same period, it is likely that unemployment is one of the prices that China may need to pay for future prosperity (Fidrmuc and Huang 2013, p. 21). An important contributor to the growth of unemployment (especially in the near future) plays the implementation of robotic production in manufacturing. In China, competition for jobs between robots and people is becoming stronger and this is leading to a reduction in employment for many companies. Another feature is the social security taxation system. The policy introduced on January 1, 2018 has led to an increase of corporate tax rate from 31 to 44% (the second highest in the world). While the burden on enterprises increases, especially the businesses of SMEs are forced to reduce their workforce (Quinglian 2018).

The problem of corruption is without doubt one of the biggest problems faced by economies, irrespective of their level of development. Although the relationship between economic growth and corruption in China is difficult to assess, it may be assumed that the scale of the problems caused by corruption is relevant, and the level of corruption in the country is far greater than that of most high-income economies. During the transition from a centrally controlled to a market-driven economy, the system was vulnerable to corruption. It has an impact on the economy in both ways, directly and indirectly. The first dimension embraces such mechanisms as tax evasion, money laundering, and other illicit activities. The second one leads to distorting market mechanisms, increasing the cost of business and daunting competition. High level of corruption leads to the lack of confidence among investors (especially foreign ones) and creates unpredictable conditions for business. It renders the economy inefficient to some extent and causes distortions and inefficiency for the market mechanisms. There are also some positive results of corruption in China. The regulations for business are too strict, and corruption is a way for firms to sidestep the requirements imposed by the government (D'Amico 2015). Additionally, corruption committed by firms enhances the growth of their sales income. This refers, however, to countries with a less developed financial market.

Some evidence suggests that corruption and financial development are substitutes to promote business growth (Wang and You 2012, p. 33). The substitution should occur automatically while market mechanisms play a stronger role. The market economy and the primary market force for allocating resources might lead to the constraint of corruption. The mechanism has also an opposite impact—breaking the corruptive relationships between the key players in the Chinese economy and separating the roles and responsibilities of the major parties (the Party, the government, enterprises, and banks) may be favorable and lead to the stronger market forces. It means that the elimination of corruption is necessary in order for China's economic growth to be sustainable in the future. This explains why fighting corruption as the CPC biggest plague is the main priority since Xi Jinping took office in 2013 in order to implement the BRI as successfully as possible.

Another important problem for the Chinese economic growth is the limited energy resources. The development of the Chinese economy during the last four decades was based on high energy consumption. Despite the simultaneous rapid growth in energy production during the last decades, energy supply and demand still lag behind the economic growth. Since the beginning of 1990s, China has become a net importer of oil. It is predicted that during the next years the oil and other energy sources will be further declining. To some extent, oil consumption might be replaced by gas and coal, but it is a solution for short and middle term. In the long run, the supply–demand gap for energy resources could be growing, and it can endanger the Chinese energy security and economic growth. Additionally, such a change undermines some parts of the market already based on this kind of energy source, e.g., leads to shortages of gas for households, etc. (Hornby and Zhang 2017). Without finding an alternative source of energy, the further Chinese economic growth will be undermined. Regarding the possibility, there are some important problems for enhancing the supply, e.g.,

- insufficient capital investment in the power industry;
- low energy efficiency;
- artificially low electricity tariffs.

All of these causes undermined market forces and simultaneously restricted the energy supply (Lam 2005). Except for the energy supply, there are some other problems with the energy consumption in China.

Among them can be enumerated: environment pollution and greenhouse gas emission, and energy supply in rural areas.

The environmental problems during the last decade become another challenge in the whole world, but for the Chinese economy it has a special dimension. The severe pollution and environmental problems are the consequences of an extensive use of energy in the country. The Chinese extensive economic model leads to huge problems with air and soil pollution and continuous problem with smog (Weidou 2007). All of them triggered the ecological degradation in the country and poses the question about the proper energy policy for the future. As a consequence of the environment degradation, the ecological policy became crucial political factor and the government initiated and implemented national large-scale policies. The ecologically oriented incentives were introduced since the 11th FYP (2006–2010). The energy was pointed as one of the most important causes of the pollution, and the measures were oriented on the limitation of the pollution (Jin et al. 2016). This is, however, another example of the state intervention into market mechanism.

In addition to the pollution, the model of the development of the Chinese economy has led to a shortage of raw materials in the country including minerals, water, timber, and energy sources. The need to find the resources necessary for the further economic development leads to high activity of the Chinese companies not only in its own neighborhood but also much further afield. The country spreads its influence and investments across Africa, South America, Arab countries, Asia, and other parts of the world (Vörös 2010). For stabilizing its import of new raw materials, China is determined to apply extensive national interventions. However, such an approach conflicts with the aim of more market forces and places the country at a greater distance from the MES.

China's economic boom has widened the wealth gap over the years despite the rapid growth of GDP per capita. The official statistics are very optimistic, but in reality they are not properly reflecting the situation of the society. It is often highlighted that China made a huge progress during the last four decades in the GDP per capita growth. In 1978, only 0.5% of the global population lived in countries with lower GDP per capita than China, while 73.5% lived in countries with a higher ratio. According to the IMF statistics in 2012 (a bit outdated, what about 2018?), only 30.2% of the world's population lived in countries with a higher GDP per capita than China, while 50.2% lived in countries with a lower one (Ross 2013). Such data show that in the analyzed

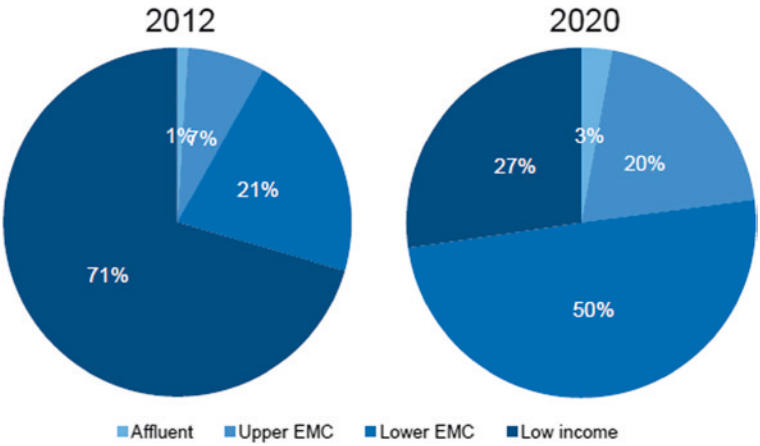

Fig. 2.3 China's emerging middle class (EMC) in 2012 and 2020 (*Source China Daily Asia*, July 21, 2019)

period, the Chinese GDP per capita raised almost 49-fold, lifting 800 million people out of poverty. It is estimated that China's emerging urban middle class totaled 125 million in 2012, and the number is expected to reach 356 million by 2020 (Fig. 2.3). In urban centers in China, poverty has been almost totally eliminated. The major problem is that the income per capita in the country is still below the world average, and there are huge income inequalities (Eckert 2016). Aaron K. Lee emphasizes, on the basis of calculations made by the Boston Consulting Group, that in 2008 less than 1% of China's richest households possed 70% of the total private wealth in the country, what seriously undermines the development of the Chinese economy (Lee 2015, p. 71). Such situation restricts the development opportunities and seriously undermines the development of the Chinese economy. The income inequality leads to a huge gap between productivity growth and the real wage rate growth, what impacts on the middle-class-income growth. Low GDP per capita reflects the fact that the retail consumer prices are very high for the majority of the society. The vast majority of wage earners in China are earning income slightly above subsistence incomes. In consequence, it impacts the retail demand. It must be highlighted that the huge responsibility for such situation remains with the SOEs. They have monopolistic positions and are main providers of basic goods and

services such as energy, telecommunication, and commodities what firmly impacts on the consumer goods prices and as a result ultimately undermines the MES (Lee 2015, pp. 71–73).

To some extent, the very high level of income inequality in China might be justified by and seen as an inevitable consequence of the transition from a planned to a market economy. The unprecedented growth rates of recent decades have also been accompanied by massive urbanization with the result that the migrant's incomes raised dramatically and millions of people were lifted out of poverty. Although the total standard of living for both the urban and rural population has increased, the urbanization has also led to greater income inequality within urban areas, but especially between urban and rural areas (Shi 2016). While urban households have experienced significant income progress, a large part of the rural population lives in poverty and is still heavily dependent on the rather self-sufficient agricultural sector. Despite the economic progress, a large proportion of the urban population still has limited or no access to basic services such as health care, social security, and education. The rising income inequality gap not only relates to the distribution of consumption patterns, but also has a major impact on economic development as a whole through the limitations of investment in education for the poor and thus discouraging them from accumulating capital. In the long term, increasing income inequality will become an increasingly inhibitory factor for a sustainable society and therefore the development of social capital. Additionally, the income inequality gap might lead to social conflicts and may harm the economic growth (Ren and Chao 2018).

The export-driven growth model, on which the Chinese economic development is largely based, has also many drawbacks. The potential on which the ongoing Chinese development was based is beginning to fade due to the fact that other countries of the world are not interested anymore in buying all the cheap and low-quality goods which were massively produced in China. Nowadays, the country is forced to develop more technologically advanced goods, meanwhile suffering from other shortcomings, e.g., the high corporate debt (see Sect. 2.4) and trade conflict with the USA (see Sect. 3.1). The model of export-oriented economic development is negatively affected not only by the external factors (e.g., declining foreign demand) but also by the internal ones. The net surplus in international trade is strictly correlated with China's relative high national savings rate in comparison with other Western and Asian

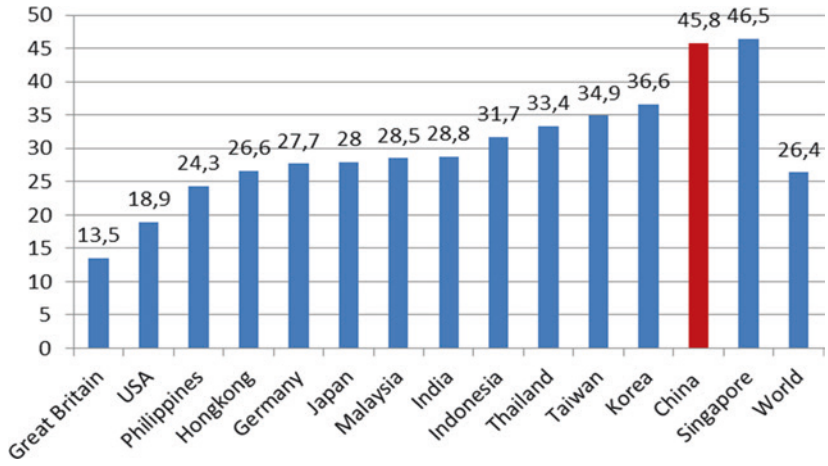

Fig. 2.4 China's national savings rate in percent of GDP in comparison with other major Western and Asian countries (*Source* Own elaboration based on Taylor [2019])

countries except Singapore (see Fig. 2.4). The savings in turn are responsible for excessive domestic investment, which leads to excess supply over demand together with low level of consumption. There is also a risk of a business cycle shock and its negative impact on the indebted businesses.

Since the introduction of an 'open door' policy, Chinese exports have been heavily dependent on imports and foreign needs, so that domestic economic growth has become increasingly linked to developments in the global economy. However, the traditional development model caused a huge depletion of natural resources, serious environmental pollution, which hindered the sustained economic development (Morrison 2018, p. 29).

The level of migration in China during the last twenty years has more than tripled. It is a result of the fact that since the beginning of twenty-first century the Chinese government has gradually eased migration restrictions including the following actions:

- loosening the household registration card system ('*hukou*');
- abolition of some fees charged from rural migrants;
- introduction of some social security provisions for rural migrants;
- increase access to public services.

Unfortunately, the migrations from rural to urban areas are the next challenge for the Chinese economic development. Human population movement process leads to the 'urban-rural' gap development and is interconnected with many problems, such as difficult working conditions and low wages, low social security coverage, poor housing conditions, and many difficulties in access to public services (e.g., education for children, health care, etc.) (Shi 2008, pp. 8–19; *Urban China* 2014, pp. 100–110).

The migration process is related to the problem of congestion in Chinese urban areas. A free flow of people to the big cities causes a concentration of a large number of people in relatively small areas with all kinds of transport problems and traffic jams as a result. Moreover, this congestion leads to problems with excessive carbon emissions that require a new development of communication infrastructure, which in the meantime can lead to more growth inequality in different cities.

China's 'one-child' policy was introduced in 1979 with the aim to control the size of population and this policy continued until October 2015, when a 'two-child' policy was introduced to address the aging problem in China. The 'one-child' policy has led to a demographic problem in Chinese society with two dimensions, namely an aging society and a declining labor force in the future. From the economic dimension, this situation will have a huge impact on the Chinese labor costs and the rise of the working age. In the long run, the economy may suffer from a shortages of unskilled workers and other significant problems such as lower housing prices, stagnation in domestic demand, and imbalance in public budgets (undermined by the expenses for social protection system to support the elderly) (Du and Yang 2015, pp. 25–44; Luo 2015). The demographic development is also an important determinant of decreasing savings because the reinforced social services will raise consumption at the expense of savings, and as a consequence, the income is becoming to be shifted away from corporates to households. All of the enumerated factors are leading to a conclusion that it is essential for China to find a new growth model because the country can no longer make an increasing use of its large low-cost labor force and huge savings surpluses anymore (Lee et al. 2013).

Another drawback of the transition from plan to market concerns the industrial overcapacity and over-investment on the Chinese market mainly due to the focus on fixed investments embracing plants and equipment building infrastructure during the last decades.

It regards especially such sectors as iron and steel, glass, chemicals, cement, paper, aluminum, solar panel, and power generation equipment, with overcapacity exceeding 30%, which is considered as a threshold value where deficits can occur in companies that have borrowed and subsequently seen their profits fall. The overproduction is partly caused by the vicious competition between local governments whereby they stimulate new production facilities by offering all kinds of financial subsidies. Moreover, local governments help companies to get cheap loans from SOBs. In this way, industrial overcapacity has become a ticking time bomb that threatens the Chinese economy because it has led companies to incur debts to repay loans. In order to move up in the value chain in manufacturing, the country must reshape its production plants and reduce the overcapacity. Avoiding the overcapacity problem is an essential part of the BRI. To combat this, strict rules must be drawn up for local governments that apply regular tax facilities. All government subsidies to private companies must also become more transparent. Since over-protection of failing companies has contributed to the maintenance of bad management and low efficiency, the authorities will have to encourage more bankruptcies, despite the opposition of local governments. In addition, the government must speed up the reforms of the financial markets. In the current financial system dominated by SOBs, companies focus more on quantity than quality growth leading to overcapacity. The excess capacity problem also regards the impact of the production plants on the environment. The heavy industry plants are associated with air, water, and soil pollutions, and the first place of China as the largest greenhouse gases emitter (Cheng 2015; Wildeau 2017).

2.4 The Major Problem Areas of the Controlled Market Economy

For decades, the Chinese government views a growing economy as vital to maintain social stability. Since 1979, the unprecedented double-digit GDP growth meant that the living standards double about every seven years. The fixed investment and export-driven growth strategy led to a very high level of national savings, investments, infrastructure development, and foreign exchange reserves. However, since 2009 the controlled Chinese economy is experiencing a turning point when there is a significant recession in many other parts of the world. The Chinese government spent a lot of money on infrastructure at a time where maybe less

government-led fixed investment was needed. The stimulus package kept the economy running at a higher level, but actually the debt rose to the point where it was too high relative to the rates of return available on these investment projects. China's controlled economy consists of too many production sectors with too much stimulation of investments by too many firms that are not or hardly profitable. Many of the POEs are kept afloat by cheap credit from China's SOBs which is not based on proper risk assessment, while the SOEs are mostly not creditworthy and still benefit from political privileges based on the 'financial dependency triangle.' With the transition from a middle- to a high-income advanced economy, the aforementioned drawbacks of the incomplete transition to a market economy will have to be tackled. The main problem areas of the current Chinese economy, especially increased since the GFC, have become an increasing burden in the transition to a new more sustainable growth model. The major interrelated economic problem areas consist of a real estate and stock market bubble partly as a result of too extensive credit growth which could undermine future growth by sharply boosting debt levels with an excess level of municipal debt. This has caused overcapacity in many industries (especially extending credit to firms that are unprofitable to keep them operating) and contributing to real estate bubbles (partly spread throughout the rest of the world and kept afloat through China's massive shadow banking system, see Sect. 5.2). This will reduce productivity by proving preferential treatment to SOEs and other government-supported entities. Especially, the rising corporate debt with unaffordable property prices creates the risk of a bubble that might burst. The Chinese government has maintained restrictions on capital inflows and outflows for many years, in part to stabilize the RMB against the dollar and other currencies in order to boost exports. It is argued that the Chinese government's restrictions on capital flows have greatly distorted financial markets in China, preventing the most efficient use of capital, such as over-investment in some sectors (such as real estate) and under-investment in others (such as services) (Morrison 2018, p. 32). Another potential problem is capital flight. There is a risk that capital within China, both foreign capital, but especially domestic capital, seeks to leave the country out of fear of the current economic problems and further economic slowdown. If the capital flight accelerates, as seen before during the Asian crisis of 1997–1998, this will actually make the current problem areas much worse (Cowen 2017). The biggest economic challenge for the Chinese authorities to find a new sustainable growth path with the help of the BRI in the

coming period is determined by addressing the aforementioned problem areas. As the interdependence between the real estate and debt problem and its consequences for further deepening of the financial reforms stand out here, this will be described in more detail in the rest of this section.

The Chinese real estate market has experienced enormous changes over the last decades through the introduction of a system of land use rights followed by the privatization of the housing market which encourages a tremendous urbanization process. This development was not only combined with a great construction activity but also a significant increase in property prices and a mortgage credit boom. A rapid growth of income and rising urbanization, high price-to-income and price-to-rent ratios for property and the high number of unoccupied residential and commercial units throughout China contributed substantively to this credit boom. At the same time, the housing reform in the late 1990s, whereby the government announced that all vacant residential housing units built after 1998 were to be sold instead of allocated, helped to unleash the huge demand for modern commodity housing. While commercial and industrial properties have gone through comparatively stable price increases over the years, the prices for housing, especially in the developed coastal regions, have risen significantly. As a result, it has become more unaffordable to own a house in the major cities of China. However, among other things, the government tries to limit a potential overheating of the housing market through a mandatory 20% down payment on houses and a limit on the number of houses that one person can buy.

Besides a rapid income growth, a rising urbanization trend, abundant liquidity, low cost of home ownership, and low mortgage debt of households, there are several other fundamental factors which drive the property prices. The main cause of this real estate sector mania is that this is the most lucrative and safest investment option available compared to the alternatives. Firstly, the domestic stock market has been highly volatile since 2007 and has performed poorly recently partly due to the current US–China trade war. Secondly, the RMB is still not a fully convertible currency; therefore, capital controls still prevent domestic investors from investing abroad despite China's 'going out' strategy to encourage its enterprises to invest overseas. Thirdly, although the unfavorable bank saving deposits is not the main reason of resulting surging property prices, since the last decade a bank saving deposit is mostly not beneficial, and in some periods even below consumer price inflation rates. Since real estate is considered the most profitable alternative investment,

China's economy has a surplus of physical capital, infrastructure, and property evident in many new parks, highways and subways, sleek and empty airports, thousands of colossal new central, and provincial government buildings and ghost towns (*The Economist* 2011). Because China's economy is still heavily dependent on the real estate market, it remains to be seen to what extent the authorities are able to stabilize the housing market. This dilemma will become even more striking after the country's plan to build more affordable homes for targeted residents and its aim to put more emphasis on consumption than on export and fixed investment as the traditional main drivers of China's growth model.

A property bubble is characterized by increasing housing prices fueled by speculation. Housing bubbles usually start with an increase in demand, in the face of limited supply which takes a relatively long period of time to replenish and increase. Speculators enter the market, assuming that profits can be made through short-term buying and selling which further drives demand. At some point, demand decreases, or stagnates at the same time supply increases, resulting in a sharp drop in prices and the bubble bursts. In Hyman Minsky's model, more demand fueled by credit leads to more bank lending to ever more dubious borrowers, often creating new financial instruments to do the job. At the top of the market, banks are not able to meet its obligations. Losses on loans begin to mount, and the drop in the value of loans falls relative to liabilities, driving down capital which forces banks to cut back on lending. It's interesting to know if China's bank lending nears its so-called Minsky moment whereby the bubble is about to burst and banks are forced to pay off debts ('*deleveraging*'). Since 2016, the government has implemented a tightening of housing measures across China, particularly toward 'speculative' housing purchases, to moderate property price inflation. It has simultaneously implemented targeted, incremental measures to improve longer-term housing supply. Even so, construction activity has weakened and prices have continued to rise rapidly. However, if the authorities succeed in simultaneously maintaining relatively tight demand-side policies, while delivering on the government's social housing objectives, this would fulfill President Xi's aspiration that housing should be 'for living in and not for speculation.'

Several policy measures to reduce the property boom have not been very effective due to an ambiguous approach of the housing market reforms from state to market control and back again.

This is partly due to China's lack of property rights in land, all of which is owned by the government and leased out to POEs and SOEs

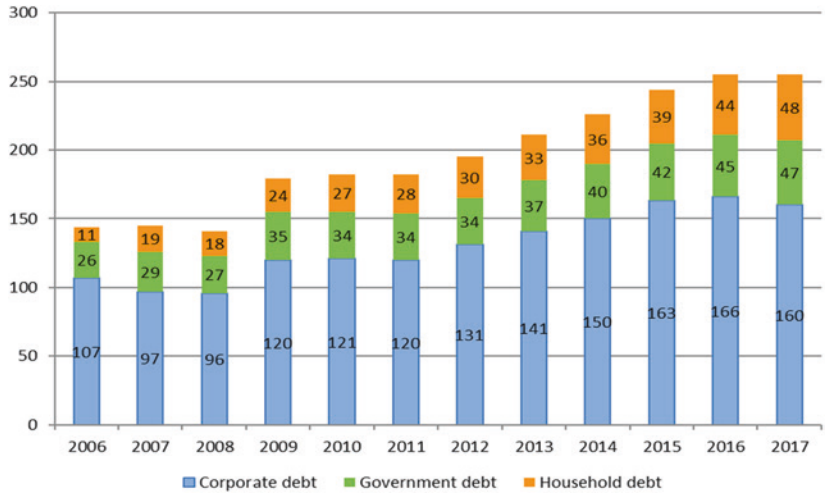

Fig. 2.5 Debt-to-GDP in China in the period of 2006–2017 (*Source* ChinaPower.csis.org [accessed: 27.02.2019])

through the land use rights. In turn, the sale of these rights constitutes a vital revenue stream for local authorities, providing powerful incentives for them to help spur the real estate boom. This contributes to another explanation to the ghost towns all across China. Many local governments will find themselves in economic peril as revenue dries up since around two-third of the purchase costs of property goes directly to the government. This explains the bias toward the construction aspect of urbanization whereby local governments have the tendency to urbanize suburban areas. Due to a narrow interdependency between property developers who buy land from the local government and generally enjoy a very high-profit margin, the firms and households (buyers of property), the SOBs who give loans to developers and home buyers and the fund-raising local governments (sellers of state land), the overall real economy gets disturbed (van der Linden 2013). In theory, local governments were supposed to run a balanced budget without borrowing money. In practice, however, they were encouraged by the central government to borrow money to spend on all kinds of infrastructure investments, which not only caused industrial overcapacity (see Sect. 2.3), but also a steady rise in mainly local government debt (see Fig. 2.5).

The central government had to rescue many local governments from bankruptcy by turning a large part of that debt into government bonds. One of the principal problems of the local government debt was that the central government had too little knowledge of how fast that debt was rising (Perkins 2018). Since many local governments are not able to pay back their loans, it is the central government that feels forced to bail out the local government debts (Cowen 2017).

One of the biggest challenges to be solved for the future sustainable growth path will be to control and reduction the rising debt problem. China's economic recovery after the GFC was supported by a rapid credit growth which could be considered as a natural consequence of strong underlying growth and a reflection of deeper financial reforms. Since 2011, more credit has been allocated to the services than the manufacturing sector but the credit is less efficiently used due to a continued allocation to less productive SOEs in mainly northeast provinces with a heavy exposure to mining sectors. Although the POEs in the services sector create more value added, overall the credit intensity has risen since more credit is needed to create value added in the manufacturing sector. The development of this 'credit binge' partly explains China's inevitable economic downturn. The recent rise in credit growth, partly reflected in China's total social financing,[9] is mainly due to the risk of a further escalation of the current trade conflict with the USA (*The Economist* 2019). In the short term, China's high savings ratio, current account surplus, and small external debt can help mitigate the immediate risks of necessary disruptive adjustments. However, in the long term, further financial deepening, a more efficient credit allocation and a 'deleveraging' policy is needed to break the negative spiral effect between slowing growth, excessive credit provision, and worsening debt service capacity (Chen and Kang 2018).

While credit growth has moderated to come in line with economic growth, the rapid increase and composition of China's total debt-to-GDP is certainly worrying. According to Bloomberg, China's debt buildup has been more than quadrupled since 2004 with a total debt-to-GDP (including corporate, household, government, and

[9] China's total social financing (TSF) is a broad official measure of credit and liquidity in the economy that consists mainly of bank loans and bond issuance, but it also includes off-balance sheet forms of financing such as initial public offerings, shadow banking credit such as trust loans, and bankers' acceptance bills.

banking sector) surpassed the 266% at the end of 2017 (see Fig. 2.5). Although the advent of the obscure high-yielding shadow banking and real estate-driven debt has boosted the Chinese economy through the GFC, it has also saddled it with a heavy repayment burden reflected in a high level of debt servicing ratio which made its banking system more vulnerable (Shih 2017). Therefore, several trends have become potential ticking time bombs and cannot sustain such a high pace of leveraging before another crisis will occur. First, half of all loans are linked to China's overheated real estate market; second, unregulated shadow banking accounts for nearly half of new lending (55% to GDP in 2017); and third, the debt of many local governments is probably unsustainable. Also, the credit overhang has caused overcapacity in many unprofitable government-supported industries. Much of the credit flowed to property developers creating an excess of unsold homes often displayed as ghost towns. As a result, many local governments are now finding it hard to cope with debts and tax receipts especially when land sales suffer from the slowing economy. In particular, the rising corporate debt with unaffordable property prices creates the risk of a bubble that might burst. Since around two-thirds of the corporate debt is owed by SOEs who are quite often indirectly involved in the construction industry, the turbulence in the real estate market will have a huge impact on the banking sector. This explains why the Chinese government is looking for a transition of a policy shift away from an economy fueled by non-financial sector debt, such as corporate debt and government stimulus, toward a more sustainable consumer-driven economy (Morrison 2018).

2.5 The Inevitable Economic Slowdown as Momentum for New Initiatives

After four decades of unprecedented growth since China started it economic reforms and more than six years since it launched its BRI, its current economy is exposed to several dangers which can undermine further development. Besides, the slow progress of the deepening of China's financial reforms, other possible threats for China's future economic development are the following: an inevitable economic downturn and related credit binge and debt problem; the international trade conflicts and a possible new role for the WTO with the BRI in the background, the unbalanced inward and outward investments patterns; and

the aging and overcapacity problem already described in Sect. 2.3. In 2018, the Chinese stock market fell by no less than 25% and the RMB has been falling since 2017. Although the current trade dispute with the USA is not the cause of these problems, it does not help to fight against China's economic downturn. China's hardest challenge as planned in its latest 13th FYP is to enter into the next stage of a high-income advanced economy whereby the GDP share of the services sector overtakes the agricultural and manufacturing production sector with sustainable lower growth rates with more focus on quality than quantity. Due to China's 'middle-income trap,' it is difficult to gain high levels of productivity with structural inefficiencies in its economy. Currently, China is the world's second-largest economy and the bigger an economy gets, the harder it is to keep growing at a fast pace, so a single-digit growth path has become an inevitable reality. China's economy has long been built on its manufacturing sector. Being the factory of the world is easy when you have a huge and growing population, but becomes harder when your 'one-child' and currently 'two-child' policy slows growth, ages your population, and creates a generation unwilling to accept the low-paid jobs of their ancestors. China's government is trying to move from a manufacturing and export-driven economy to a service and consumption-driven one, so exports are declining after decades of double-digit annual growth (Morrison 2018).

China's economic slowdown, stock crashes, and currency realignments are highlighting the downturn of the world's second-largest economy and the main driver of global growth. Apart from the differences in approach between the conservatives and radicals within the CPC (see Sect. 2.1), since the Asia crisis and later the GFC, there has been an increasing debate about the extent to which the foregoing model of Chinese development is approaching to a breakdown. Among the main arguments in such a scenario is that China's model of development is excessively unbalanced (e.g., as a relation to a personal consumption to the size of the economy) (Huang 2017, p. 8).

It is likely that in the coming decade the international financial markets, especially the foreign exchange market, will exert more influence on China's real economy. The Chinese authorities try to stimulate its economy and adjust the exchange rate to its own goals, sometimes against the external pressure on the change of RMB exchange rate in opposite direction. The recent attention of global markets was focused on China's exchange rate in August 2015 when the PBC announced a nearly 2.0%

devaluation of the RMB against the USD. Since then, China has devalued the RMB several times during the transition from the 12th to the 13th FYP, in which the Chinese authorities have established a clear and concise list of objectives on how they want to develop their 'new normal' economy and avoid a 'middle-income trap' in the near future.

The main characteristics of this 'new normal' growth model consist of a slower growth level with a higher quality and more emphasis on efficiency and social security with a strong role of the government; the ability to adjust in accordance with the current market circumstances; and opening-up of the financial markets and services sector as the current economy's primary driver of growth to offset contractions in China's traditional powerhouses of heavy industry and manufacturing. The aim is to keep a strict balance in restructuring China's economy, i.e., making sure growth in one sector offsets slowdowns in another in order to guarantee enough employment. One of the most crucial objectives as part of this plan is to induce an economic shift that will steer the country away from a reliance on exports and investments toward growth driven by domestic consumption and innovation. This is part of China's narrative to decrease its reliance on its global partners, a lesson learned from the GFC when China became dangerously dependent on debt-fueled investments in infrastructure, housing, and heavy industries with a significant overcapacity as a result.

The 'new normal' model of China's economy development should be more adjusted to the needs of contemporary world and the processes occurring on global markets. The crucial expectation is that the country will no longer be committed only to the single-minded GDP increase at all costs. The contemporary growth of the Chinese economy should be accompanied by appropriate structural adjustment and have a broader context than China applied in the past. The economy should be reoriented and transformed from the supply-side source of economic growth to a mixture of demand- and supply-side source of growth (domestic and external) and high-technology development. Among the most important changes might be enumerated:

- new technological transformation;
- change of businesses, processes and habits (orientation on private, very diversified business);
- more important role of services, especially financial services;
- more focus on environmental issues and a 'green' economy.

The need for a new technological transformation is the best way to combat the 'middle-income trap.' The goal of creation a group of high-value export industries that can help to combat the current problems with export might be such a solution. It stems from the fact that the current growth of Chinese economy can be sustainable mainly by technology-based sectors of industry. There are numerous scientific works highlighting the importance of a large share of high-technology exports in total manufacturing export for reducing the likelihood of growth slowdown. The current problem for the economy stems from the fact that China's main proportion of high-tech exports originates from foreign-owned enterprises, and the Chinese value-added to high-tech industries in the country are relatively low. From this reason, the technology development seems to be one of the most important determinants of growth, leading to the more mature stage of development (Glawe and Wagner 2019, p. 17). As part of the 'open door' policy, economic development has in the past been strongly focused on attracting foreign technologies, but especially this decade, China is increasingly transforming from a high-tech importer to a high-tech domestic producer. For instance, China's robot-makers want to dominate their domestic market, aiming to supply 50% of local demand by 2020, rising to 70% by 2025. On the other hand, it is not an easy step to become a technology supplier (see Fig. 2.6). Firstly, China is no longer the lower-cost labor market; secondly, the country is not the strongest player in the high-tech industry. In order to enhance its industrial capability, the country must foster its transition through some steps: 'made-in-China,' 'designed-in-China,' and 'innovated-in-China.' Additionally, there are some basic principles, which must be taken into account in the Chinese strategy (Li 2018, p. 69):

- enhance industrial capability through innovation-driven manufacturing;
- emphasize quality over quantity;
- achieve green development;
- nurture human talents.

All of these principles are crucial for fostering the development of hi-tech industry. The achievement of these objectives requires, however, an adequate work environment oriented on creativity and innovativeness.

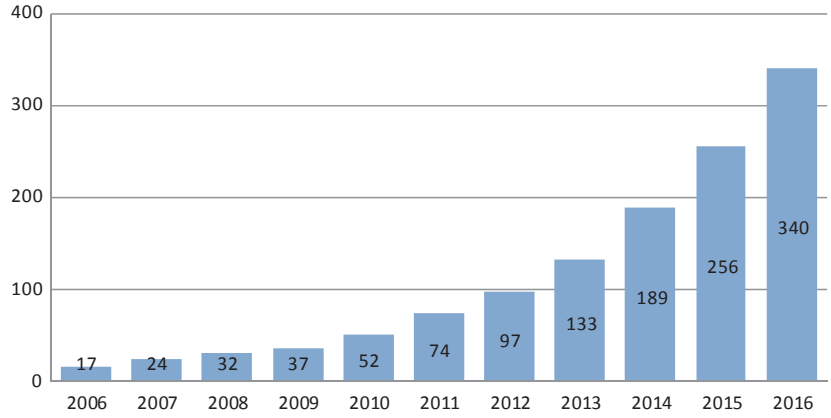

Fig. 2.6 Estimated operational stock of industrial robots at year-end in China (thousand of units) (*Source* Adapted from IFR International Federation of Robotics 2017)

Current technological developments including information technology (IT), digitization of services, the use of big data, robotics and artificial intelligence (AI) will have a crucial impact on future Chinese business strategies. The new business approach should be oriented on direct interaction with customers and accelerate data sharing throughout the supply chain, promoting customized manufacturing (Wei et al. 2017). Another trend in the future development model for China is the promotion of the private sector. In the past, it was common for a new development phase to allow the inefficient public sector to pave the way for the more efficient private sector, while it will be obvious that in the coming decade the private sector will play crucial role and there is no need to treat the public enterprises as the initiators of further changes.

In the current process of transition of the Chinese economy, services are playing increasingly more important role. The quality of offered products needs producer's change from product to service-oriented model (relationship-based model). Firms must adjust to consumer's expectations, which nature is more intangible. Such a change requires a radical transformation and setting up of new strategies, designing new offers and processes, restructuring organization and supply chain, and introducing new technology (Tan et al. 2019, p. 16). The core issue for such approach is to meet

customer's expectations. It requires good understanding of the market and the customer's needs, as well as the creation of channels of information exchange between the business and consumer needs. Producers should be oriented on the process of product-service integration.

Although the Chinese financial services have grown very dynamically during the last decade, the financial institutions mainly offer basic services as banking, insurances, payments, consumer finance, and stock investments. Over the years, the Chinese financial system has increasingly developed into one of the world's examples of financial inclusion. Despite the success in rapid transformation of the banking industry and development of the capital market, the new challenges are coming up. It is increasingly important to make the system more sustainable and closely aligned to the local expectations, which creates the need of:

- further development of financial infrastructure (especially in remote and rural areas);
- striking the right balance between the innovations and managing the risk arising from the innovations (development of well-tailored regulations);
- reducing the role of government as financial inclusion provider (strengthening the role of market forces in the process).

All of the enumerated challenges highlight the need to shift toward more market-based orientation in shaping the Chinese financial market (Chien and Randall 2018). An important challenge for the Chinese financial sector will be the opening-up for foreign investors. It means higher sophistication of the services. The market should become part of the international financial system and be prepared for foreign competition.

The rapid economic development of China is responsible for a number of negative environmental consequences. Among the most important are water and air pollution; cropland losses; and desertification and biodiversity losses. All of them pose a great threat to the sustainable development of the country. On the other hand, all of them are a side effect of the ongoing national policies, promoting high levels of economic growth. The new model of economic growth must consider and implement mechanisms leading to a reduction of the negative environmental problems. It means that China faces a dilemma to reconcile its economy, energy system, and environmental security. It is very difficult for the country to find easy solutions to the complicated problem

with accommodating the inconsistent goals, at least in the short run. In the coming decade as part of the 13th and most likely also the coming 14th FYP, China will have to find a good balance between sufficient economic growth for social stability and sufficient environmentally friendly sustainable economic growth to cope with its 'middle-income trap.' The authorities need to identify balanced policies that offer the best trade-off between these components (Tang et al. 2015).

In the context of the unbalanced economy, it seems that the Chinese current slowdown nature is not a cyclical, but it is a result of a structural changes in the economy. It means that the slowdown is inevitable and irreversible. The country's original growth drivers have been already exhausted. Now China must search for some other determinants of its development than it applied in the past, to overcome the current drawbacks. The most important factor encouraging the further economic growth is the BRI. It is considered the new engine of economic growth and an incentive to stabilize the aforementioned Chinese macroeconomic imbalances. The main intention of the initiative is to enhance cooperation between participating countries with the aim to foster their growth. The cooperation has many potential dimensions such as political dialogue, infrastructure development, trade, and interpersonal relations between people (see Sect. 4.1). It is likely that the cooperation will stimulate economic growth and bring other benefits for all the countries involved in the project (Kostecka-Tomaszewska 2018, p. 174). Very important added value of the initiative is that it has a broad dimension and is able to combine together the internal and external (international) factors, impacting on the economy. The international approach of the project is treated as an 'upgraded' version of China's Go Global strategy. The main role of BRI is to become an important vehicle shaped to develop the reforms intended to deepen further the Chinese global footprint (Yu 2018).

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