

**ST. PETERSBURG INTERNATIONAL ECONOMIC FORUM**  
**JUNE 20–22, 2013**

**CHINA CHANGING GEARS: NEW MODELS FOR GROWTH**  
**Caixin Media Televised Debate**

**JUNE 20, 2013**  
**18:00–19:15, Pavilion 4, Conference Hall 4.1**

**St. Petersburg, Russia**  
**2013**

**Moderator:**

**Wang Shuo**, Managing Editor, Caixin Media Company

**Panellists:**

**Damian Chunilal**, Chief Executive Officer for Asia, VTB Capital

**Pavel Grachev**, General Director, Far East and the Baikal Region  
Development Foundation

**Lu Hao**, Governor of Heilongjiang Province, China

**Li Jiange**, Vice Chairman, Central Huijin Investment Company Ltd

**Andy Xie**, Independent Economist, China

**Li Jiange:**

The way the model for future economic development in China is changing is extremely interesting. Of course, these changes in the economic development model are accompanied by reform. A plan for the structural reform of the Chinese economy over the next five to ten years is expected to be announced this autumn. What are these expectations based on? They are based on the fact that over the course of 35 years of change in China, a plan like this has been drawn up on average every ten years. A plan for reform appeared in China back in 1984. A reform plan was also published in 1993. In 2003, again, a similar document was drawn up. As a result, for the past two years it has been expected that a paper on economic reform would be published this autumn. In short, we know for a fact that preliminary work on this paper has already begun, but since this is a Ministry of Civil Affairs project, we have no idea how things are proceeding. However, I personally believe that you can expect that in this document, two key vectors will remain unchanged: firstly, the path of market economy reform approved by the Chinese Government 20 years ago, and secondly the direction of development of various sectors of the economy, in particular the private sector, established by the Chinese Government 15 years ago. I therefore suggest that it will be worth paying attention to these two aspects in the paper to be published this autumn. Thank you.

**D. Chunilal:**

What challenges is China facing, what must China do, and what is realistic? What can be done?

The challenges China faces, in line with the rest of the world now, include a cyclical slowdown, and I will not talk about that, I am sure we will discuss it later.

Then there are certain aspects of financial stress in China that are becoming very evident: the level of credit growth to GDP and, more importantly, the rate of change of that credit growth to GDP, the growth of the shadow banking

system, wealth products, trusts, recent liquidity concerns, and perhaps changes overseas which make the environment less favourable for the Chinese financial system. The question is: is China facing a Minsky moment? Thirdly, and I think this is the subject of today, there is the longer-term challenge: the middle-income trap. China has clearly reaped the benefits and executed superbly over many years the transition from an agricultural society to an industrialized society. There has been this great growth in productivity and export-based success, and it is a case study for many, many countries around the world.

But the evidence going forward, as China transitions from an industrial economy to perhaps an economy where consumption becomes more important, where services become more important, is not so encouraging. Of 101 middle-income countries – I think this was defined in the World Bank report as countries with a GDP per capita of USD 15,000 or less – only 13 made it to high-income. So China really has to move to more of a skill-based, knowledge-based society, become more specialized in some areas of its production, move from factor-driven growth to productivity-driven growth, and also, arguably, from centralized to more decentralized economic management. I think the government is aware of the issue and up to the challenge, but I think the paradigm for Chinese growth needs to change.

**A. Xie:**

China can grow the pie through rearranging resources at home. So as I see it, China needs to do two things. One is to rebalance on the demand side between consumption and investment, and investment is now 50% of GDP, and needs to go down to 30%. For a country with a per capita income of USD 6,000, 30% is a more appropriate level. So, this is where this transition process can make consumption lead the economy.

What we need is for the government to cut taxes, to give people more money to spend. This, to me, is a litmus test. Whatever the government says, talk is

cheap. We want to see real money changing hands. So when the government cuts taxes meaningfully, then China will be taking a step forward.

But demand rebalancing is only one side. On the other side is efficiency. If China's investment goes down to 30% of GDP, the current level of efficiency will not support a 7% GDP growth rate. The government wants 7% in the long run, as the Premier just said. At a 30% investment ratio, we need a significantly higher level of efficiency to achieve this 7% growth rate.

So what we need is better resource allocation. That will start with financial reforms. So far, the financial resources are overwhelmingly concentrated in property-related activities, and property is not a productive sector. So this is where fighting the property bubble is key with regard to China's future.

As I see it, short-term bond use is okay: I do not believe that what is going on with the GDP or PMI is significant – those numbers are not important in my view. China is playing in the big league. If China succeeds, China will become the world's largest economy in 10 years. There is no need for a 10% growth rate. China will become the largest economy in the world in 10 years with a 7% growth rate.

What we need is rebalancing and efficiency. So I believe that there are two things to do. One is to cut taxes; the other is to squeeze the property bubble. When you squeeze the property bubble, you will have some bad news in the short term, but that is okay, as it is very good for the long term.

**W. Shuo:**

You said tax cuts, right? In recent decades I think the tax revenue of the government has been increasing very fast, much faster than GDP growth. So what kind of tax cut are you proposing?

**A. Xie:**

The most important tax is value added tax, because that forms the bulk of the tax revenue. At 17%, it is not the highest in the world, but it is very high by emerging economy standards, so I think that it can be reduced to 13–14%. It

is a consumption tax cut. If you want to support consumption, you need to reduce the cost of consumption, so this is one thing that the government needs to do.

The other is the personal income tax rate. This is something that I have been advocating for a long time. The top margin tax rate is 45%, and it kicks in very early. Who is paying this 45%? It is really the middle class. Rich people own businesses: they do not pay 45%, they pay a profit tax of 25%. Whatever they spend, they spend through their businesses and the effective tax is 25%. The 45% is squeezing white-collar workers in China. China's white-collar workers are just starting to emerge. There is no point in kicking them down when they are just emerging. So I think that China needs to cut that to 25%, in line with the business tax rate.

That, I think, will encourage white-collar people from all over the world to move to China. I think that a lot of people say that China does not have innovation and so forth. In this global economy, you can take short cuts: you can attract people to your country, and move up quickly.

So I think that China is in a middle-income trap. Either you blow up, or you move up. There is no middle ground here. This picture where somehow we just stay where we are for many years – I do not see that. If China carries out reforms, capital and talent will all come to China, and China will become the world's largest economy in 10 years. If China does not reform and stays with the property bubble, China will have a major financial crisis in two to three years' time.

**W. Shuo:**

But what is really troubling is that the private sector, private business, has been hit especially hard. Why is that the case? And how do we revitalize the private sector, beyond tax cuts?

**A. Xie:**

I think that the private sector is mostly in competitive markets, unlike state-owned enterprises which tend to monopolize or have limited competition in markets. This is one instance where they have no protection. The second is that local governments have been promoting investment for a long time, giving incentives, so we end up with overcapacity in every industry. The business makes a profit only when the economy is overheating. Then high growth gives you some pricing power. When it slows down, you are over capacity and have declining margins.

I think the inevitable consequence of China's growth model based on local government promoting investment is that when the economy slows down, business profits will evaporate. It is an overcapacity economy.

How do you deal with that? Usually, you stimulate: you print money, stimulate, then that leads to more investment. In the short term, more investment creates demand and makes life a bit easier, but more investment down the road means more overcapacity, so life is even worse in the next cycle.

To break this vicious cycle, China has to stop. Basically, a lot of businesses have to go bankrupt. If you do not allow creative destruction to take place, the economy cannot move forward. So, bad economic news in the short term is good news for the long term. I think that that the financial markets are very near-sighted: when they see a bad PMI or a lower GDP, they all panic and the market gets sold off, but in the long run, it is good news.

If the Chinese government can stick to its policy now, despite the economic slowdown, does not increase the money supply, and targets money supply at a reasonable level, perhaps 12–13% a year, not low, and keeps it there, then I think that the economy will adjust.

We do not need to worry about the Chinese people. We need to worry about the Chinese government. Chinese people are very market-orientated. If the Chinese government gets out of business, the Chinese economy will boom, big time.

As I see it, the difficulty is that the Chinese government loves to get involved, and I think that all the trouble starts with that.

**W. Shuo:**

The state-owned enterprises (SOEs) have been the largest beneficiary of this misallocation of capital. So the reform of SOEs must be a key part of any long-term reform package. When we are talking about the reform of SOEs, we are talking about maybe property rights reform or privatization, the breaking up of monopolies, and equal treatment for all kinds of companies. Among all these choices, which is the most urgent? Or must we do them simultaneously?

**Li Jiange:**

First of all, I think that to describe the current situation in China using the concept of 'SOEs' (state-owned enterprises) – the term used abroad – or 'national enterprises' – the term used by the Chinese – is not quite correct. True 'national enterprises', in the full sense of the term, are steadily decreasing in number in China. To a large extent, these are public companies which are state holding enterprises. This was why I suggested at a recent meeting that the term 'national enterprise' should be used as little as possible, with preference being given in the future to the terms 'public state holding company', 'private company', or 'cooperative enterprise', and to using these legal terms to define enterprises. For example, in China we have the State-Owned Assets Supervision and Administration Commission of the State Council (SASAC). Previously, when I was a member of SASAC, I told them, "You are the State-Owned Assets Supervision and Administration Commission; you are the body which funds and manages state property, but you do not have higher authority over a company with shares that are admitted for trading on the stock market. This is because a company with shares that are admitted for trading on the stock market is a public company. It does not belong to you: you are just one of a number of financiers." If we abandon the concepts of 'national enterprise' and 'public enterprise' and use the term 'company', it may be possible to take a more comprehensive approach to many issues.



In my opinion, in the future we should develop the components of a diversified economy so that each component has creative potential. There are at least three points on which the textbooks traditionally focus their attention. Firstly, property rights must be strictly protected. Of course, our Constitution mentions both public and private property. In reality, corruption aside, public property is usually protected. But there are many problems with regard to the protection of private property rights in China. Private property is protected, in the strictest sense, only through the efforts of individuals.

Secondly (as I recently stated openly in the newspapers), there must be freedom to enter into contracts. It is essential that the spirit of the contractual relationship be widely upheld. No matter what the aspect of trade in question is, the parties must enter into a formal agreement, and do so voluntarily.

Thirdly, no matter what actions are taken on the market, those who take them must be answerable for their actions; no one else should be held responsible. This also applies to the state-owned property that we have just mentioned: the state should not use any special measures to protect it, regardless of what actions are taken on the market, and the possibility of monopolization should not arise. If we focus on these issues, it will be possible to fully establish market competition in all areas of the economy.

**W. Shuo:**

Mr. Jiange has made three very good points, but are these three points enough to solve our problems with SOEs?

**A. Xie:**

I think that it is very important to have competition. Without competition, I think that the SOE reforms may not be successful. I think the issue is around power. In China, political power can override many things. China's success over the last 30 years has been in reforming and opening up. And opening up is the driver for reform.

China is the largest export country in the world and has no significant free trade agreements, so China should try to strike a free trade agreement with Europe. That will bring competition to every industry in China, and there will also be an outside force to make sure that the rules are followed. There are no domestic forces powerful enough to offset the government's power.

I believe that globalization and opening up should be the foundation for domestic reform.

**W. Shuo:**

Andy's answer is that competition is the key, and Jiange's answer is that the rule of law is the key. So, Damian, my question for you on SOEs is this: SOEs have actually been instrumental in defining China's economy today, but have those giant SOEs outlived their usefulness to the Chinese economy?

**D. Chunilal:**

First of all, I do not think it is a zero-sum game. I think the SOEs and the private sector can coexist, as they do in many other economies. So I think the issue is not quite as simple as 'get rid of the SOEs and everything will be fine'. Secondly, I think that the government has actually done an awful lot with the SOEs over the last 20 years. We were talking about privatizing the Chinese banks, and one of my previous firms actually did the largest ever Chinese bank IPO at the time. It was impossible five years earlier, that is what everyone said, and the government got it done. They restructured the financial system, they put in place, in many cases, highly professional management, they addressed the bad asset problems. I think, Mr. Li, you must yourself have been involved in that.

I cannot tell everyone what a monumental task that was, and everyone said it could not be done. It was amazing what they did there.

So, a lot has been done. Ownership and management is being separated, perhaps not to the extent that certain governance experts in the West would like, but that is not really relevant for China. A lot of progress has been made.

The productivity of SOEs is very much related to the degree of competition they are exposed to. And clearly, some SOEs do perform a public sector role as well, which we must not forget. So the numbers are not quite as simple as that.

But having said all of that, I think for me, again, and I keep coming back to this point, the harm is done where SOEs and finance interact, because that is where resource allocation gets distorted, I think there is an element of crowding out for the private sector, perhaps because they are not able to compete in certain sectors in which one might argue they should be able to compete, if China is to develop intellectual capital, brands, service industries, et cetera going forward.

So I think there is more work to be done there. I think the second thing is, on finance and access to finance, we find that there are many private sector SMEs in China that are just not getting the degree of financing that really they ought to get, given the creative talent of the people, which is ultimately one of China's huge strengths. The reason I personally think, ultimately, that the middle-income trap will not be relevant for China, is that, ultimately, the factors of production that China has, the quality of its human capital, is exceptional.

So I think, overall, there are more reforms to be carried out; but let us not forget just how much has been done; and I think we are going to see this over time. I think, as Mr. Li has said, we are seeing progress; people are talking about what would not have been talked about five years ago. Again, though, the interaction between SOEs and finance, to me, is the problem. It is not necessarily the SOEs themselves.

**W. Shuo:**

While corruption, by itself, is not an economic issue, everybody understands that it is very important. My question is: how important is it for China's sustainable growth? Andy?

**A. Xie:**

The state-owned enterprise return on capital has declined by half over the last five years. If you look at the daily measurement of the per dollar increase in credit against GDP, this has also declined tremendously.

So, what do I see? Inefficiency has risen. A major reason for this inefficiency is corruption. What we see is that a lot of investment projects are driven by kick-back opportunities. It is not about how useful the investment itself is; rather it is about what opportunity it offers to the people involved.

I think that is the reason why it is very difficult to stop investment; that is why everybody wants the government to stimulate, to print money, to fund more investment.

The property bubble is also related to that issue. To what extent can the high property prices be supported? It is mainly because there is this grey income supporting these high prices. What is going on in China is that the income from corruption is recycled into the property market. So the exchange rate is stable, but efficiency is going down.

To deal with corruption: number one, burst the property bubble. For China, if we want to deal with whatever we want to deal with, if we want to move forward, we have to burst the property bubble. This is the monster in the room. If you do not kill this monster, you cannot move forward in any way.

In this way, I think we can talk about the details, the plans: we can talk forever. But in terms of immediate action, what you can do is pop the property bubble. It is very easy to do: you either raise the interest rate or you tax all these empty flats. If you do one of these things, the property bubble will burst. When the bubble bursts, the opportunities for corruption diminish tremendously.

**W. Shuo:**

The property bubble?

**D. Chunilal:**

I think the government is taking measures to address this. I think it is not so simple: if you prick the bubble, you can have unforeseen consequences, and I

think we need to think those through. Also, I think the reason that we have a property bubble is that people do not have anything else to invest in. There is not the same degree of financial freedom to invest in other financial assets in the economy, or, for that matter, overseas.

That is why bubbles are forming: because assets are going somewhere, because there is no escape valve. The escape valve is having other market-priced alternatives that allow people to put their savings – which are very high, as we talked about – elsewhere.

So, to me, the property bubble is just there because that is what people invest in, because there are no other appropriate sectors to invest in. It is as simple as that.

Various administrative measures are fine: you are addressing a symptom, perhaps, but the symptom is being caused by something underlying. You have got to fix the underlying issues: that takes time. The risk is that there is too much talk, but I think that these are the issues we have got to focus on.

Pricking a bubble is not necessarily going to solve the underlying problem. There are issues and consequences; it may need to be done. That is a different subject. What I am saying is fix the underlying issues. Again, this is how the financial markets work in China.