

## Answers to Questions before National People's Congress

1. *What are your views on President Xi Jinping's ideas and practices on the governance of China? Including the comprehensively deepening reform, economic reform, rule of law, ecological civilization, culture development, social administration and reform, national security, anti-corruption and Party building etc. (Attention: this is the biggest concern, your ideas on this question will be highly appreciated.)*

Many of the goals that President Xi has set for China --expanding the middle class through economic reforms, use of markets, leadership on climate, inclusive growth, development of social safety nets, anti-corruption, focusing on consumption-- are widely supported in China and overseas. As always in China, there are too many urgent requirements. Identifying priorities among the priorities remains complex. Here are three of the most urgent and most beneficial tasks that I see.

First, China is getting old before it gets rich. The development of social safety nets, health and retirement systems remains critical. Some of the experiments in cities with healthcare and retirement plans are in fact quite interesting and successful; the challenge will be how to spread these rapidly throughout the country. The challenge that the leadership has identified --rebalancing China's economy to emphasize consumption by households rather than state enterprise activity-- will support these new systems. For families, interest rates have been kept artificially low for too long and investment markets have proven opaque and unreliable. Many are invested in real estate, but prices are falling. It is important to give families a better chance to build for their future retirement. Savers deserve to become investors with guarantees and assurances for their long-term investments.

Second, inequality of income and access to services remains an issue for many. Inequality takes many forms: between public and private sector employees, between provinces, between workers who can reside in cities and those who cannot, and inequality of access to education and health for their children. In many cases, these are political as well as economic distinctions. Many will require extra funding to solve. Inequality is also built into the current structure of China's economy which still favors certain groups and regions above others. Those with jobs in state enterprises, particularly at the top, and those in coastal provinces have more opportunity. Private entrepreneurs have large prospects, but only if they are careful not to run afoul of government officials and state owned firms. Regulations prevent competition by private investors in many sectors. Corruption exacerbates social and economic inequality by favoring the privileged over the poor. Thus, the government can reduce inequality by freeing up competition, reducing the scope of government intervention, using market disciplines for all firms whether state owned or private, allowing workers and investors a better share of corporate earnings and ensuring more transparency through stock market rules and corporate governance. All these steps can build public confidence and spread economic benefits more widely.

Third, despite the current anti-corruption campaign, corruption remains a major issue, as it has been at one point or another in all our countries. Corruption undermines the reputation of the ruling party, results in poor schools and services, especially for the poor, and victimizes the most vulnerable in society. Most of us welcome the strong action that is being taken against those who steal from the public for their own personal gain. In addition to punishing the wrongdoers, however, it remains important to design systems of transparency and accountability so that opportunities for corruption are

eliminated. Removing multiple official forms and approvals for doing business, improving the transparency of fees and services, putting government procurements online, moving to a merit based promotion system, allowing more press reporting on projects and financing, holding officials publicly accountable to the public and press --all these steps and more can give the public better services and help build trust in government. Otherwise the system will bog down with complicated procedures and officials who fear to make decisions and take action because they don't understand the limits of their authority.

## *2. What do you think of China's economic development status and prospects?*

China's current economic situation is bumpy. The key task --rebalancing the economy away from investment-led growth to household-led growth-- appears to be proceeding but not at a pace that is fast enough to rebalance the economy and cap the growth in debt. China's year-end 2015 statistics show this.

First, I think it's important to get away from the obsession with GDP growth, and the fascination with whether GDP growth is 7% or 6.9% or 6.8%. Overall growth should no longer be the headline. What really matters for the ordinary Chinese family is how fast household income is growing, whether the family has more money to spend on their children and their needs. Even if GDP growth slows, as long as household income is rising faster --hopefully, much faster-- families will be better off and the economy will rebalance in their direction. In 2015, household disposable income growth was 7.5%, while GDP growth was 6.9%. So, there is some rebalancing happening. There are other good signs: the growth in the services sector to 50.5% of the economy, for example. However, the rate of change is slim. Families benefit by about .5% more than GDP growth depending on how the numbers are compared. At this rate of change it will take many years, much longer than the government hopes, to achieve a balanced, consumer-focused economy.

There are also contradictory signs. Investment in fixed assets, at 10% growth, grew faster than either the overall economy or household incomes. China is investing more but growing less: not what any economy or firm would want. China's debt levels have also exploded: over 200% of GDP now. In other words, China now takes on more debt and pushes it into more investment, yet sees very slow rebalancing and slowing growth. Not good signs. This doesn't mean China's economy will break down or crash. The government certainly has the means to restructure banks and debt and provide for national welfare, and indeed Chinese policy-makers have overcome similarly difficult obstacles in the past. What these numbers do mean is that China needs to push harder on reform in order to continue to improve the lives of Chinese people. Stronger reform of the financial sector and of the state enterprises, where much of the investment capital is building up, can move funds from state investment to household spending, letting consumption drive economic growth and giving families faith in their future.

There is one more related problem that China will have to overcome: the so-called middle income trap. Some countries have failed to move beyond China's current state of development, while others powered their way up the economic ladder. In my view, the middle income trap is less an economic problem than a political one. Economies become structured to produce a certain type of growth, in China's case, export led processing and government investment projects. Industries and groups that benefit from these structures gain influence and surround themselves with rules that protect them, by keeping out competition or favoritism in lending. In order to move beyond the current stage of growth, economies need to break through these protections and open up competition for new

industries. Fast growing economies, like Japan, Korea and Taiwan, have managed this transition. Now it is China's turn.

The government has identified the key element: market competition and discipline. For this discipline to be effective, markets will have to more open --without barriers to entry-- and market participants, including state enterprises, will have to operate as corporate competitors, not as protected government auxiliaries. Regulations must be rewritten to be more impartial between existing firms and new competitors.

However, markets alone won't lead China to the next stage of economic achievement. Modern, innovative economies need an innovation environment in order to push forward. An innovation environment is one where intellectual property --Chinese and foreign-- is respected. It is one where capital markets function energetically and fairly so that early investors can see a return on their investments. Innovation also requires an open information environment, for investors and developers, so that all investors, not just those with inside information, know the value of the firms. Open innovation also relies on open access to cross-border collaboration tools such as those offered by Google, Amazon and other firms. Without this innovation environment, China will have a hard time developing new products and innovating, even with more market competition inside China, and will continue to rely on subcontracting, government investment and value-chain exports for growth. Because of increasing debt and increasing wages, that is no longer a high-growth path for China.

### *3. Your understanding about the 13th Five-Year Plan of China.*

In many respects, the 十三五 (Yes, we've all seen the promotional video), outlines a dramatic and positive path for Chinese growth. Creating modern infrastructure, focusing on inclusive growth, adopting advanced technologies, encouraging competition, rebalancing from enterprises to households, cleaning up the environment and enhancing innovation will constitute the foundations of a new stage of national and social development for China.

Many of these tasks indeed fall to the government. For example, changing the hukou system to open up jobs in urban areas for workers and to provide education for their children can build equality and productivity. Fair and impartial enforcement of environmental and health safety regulations --without opportunities for polluters to bribe their way out of enforcement-- would bring multiple benefits to families in all parts of China. The government can also ensure fair regulation in finance and securities, and eliminate corruption so that market participants compete on a level playing field. Government investment and activities in these and other areas can produce better outcomes for the whole of Chinese society.

In other areas, like innovation and competition, government needs to clear the way for Chinese innovators and entrepreneurs. One example is that the government can remove restrictions on market access. In some sectors, this has already occurred; more can be done. Many elements of the economy will still require licenses and permits, even if the overall burden is reduced. Yet this process can benefit by providing on-line government licensing and services to eliminate delays and corruption, making government more efficient and cleaner at the same time.

In the end, as Chinese planners now say, the Five Year Plan has become a guide to the expected direction of the economy. Rather than an instruction for government investment and involvement, the plan identifies areas of policy where the government can clear the way and open up

the energies and creativity of the Chinese people and foreign investors. As such, the Thirteenth Plan is a good guide; thorough implementation will determine whether it succeeds.

As we have seen, economic adjustment is not smooth or easy, especially when China has so many people and enterprises dedicated to the investment and export model. Unfortunately, sometimes during the transition when the economy falters or the markets sags, the government has been tempted to intervene, pumping up prices or protecting certain enterprises and industries. Other government proposals, on banking and software in particular, move backwards towards protection rather than competition. Maintaining a consistent approach without faltering --the path outlined in the 十三五 - would make investors and entrepreneurs more confident in the full implementation of the plan.

#### *4. What do you think of the “Belt and Road” Initiative of China?*

The One-Belt One-Road initiative expands opportunity for China as well as for countries in Central and South Asia, and all the way to Africa and Europe. China’s economy is one of the economic engines of the world. The Belt and Road Initiative will facilitate China’s imports of natural resources and export of consumer products, thus helping China secure supplies of raw materials and helping suppliers in Africa and Central Asia have steady and reliable customers in China. The initiative also provides an avenue for investment of Chinese capital, gives opportunities for Chinese construction firms as the domestic boom slows and enhances export routes to Europe and to consumers in emerging countries.

Many factors can maximize the benefits of the Belt and Road Initiative to developing countries. Chinese firms can improve the training and use of local labor, rather than relying on Chinese workers, in order to create a cadre of local people who can expand and maintain the networks that China finances. Open access to roads, pipelines, ports, railroads and communications infrastructure will help intermediate points exchange goods and services with each other, rather than just have a big flow in and out of China. For example, Iran and India should find that Belt and Road projects will increase their opportunities and trade with Central Asia and with Europe. Maintaining a tight control of labor conditions, corporate practices and, especially, anti-bribery efforts can ensure that the Chinese investment is well protected from the taint of corruption and from uneconomic distortions in prices and benefits.

The Belt and Road initiative can supplement existing communications links for China. Major channels today, within Asia or across the Pacific, will remain just as important, perhaps even more important, as China proceeds with Belt and Road projects. Other sources of funding, especially the World Bank and the Asian Development Bank, can participate in consortiums with Chinese lenders for the new projects to ensure linkage and compatibility with international standards and with the development needs of the nations involved.

#### *5. What do you think of RMB exchange rate?*

What is the perfect exchange rate for the Chinese yuan? Economists have written extensively on this subject, politicians have debated it. With the internationalization of the RMB and a variety of instruments available in places like Hong Kong, Singapore and London, this year we began to see clearer indications in markets of what value traders assign to the RMB. The upward pressure, towards

appreciation of the RMB, of previous years appears to have given way to downward pressure, causing the RMB to depreciate over the year.

On its face, this is a strange phenomenon. China still maintains a consistent trade surplus which amounted to over \$550 billion in 2015. The RMB, while increasingly used in trade transactions, still only amounts to less than 3% of global trade. Much of the trade surplus will thus result in currency trades. In principle, this surplus should drive the value of the RMB higher. Yet, massive capital outflows, which accelerated over the year, appear to have meant that much more money was leaving China through outward investment and capital markets than was coming into China through the trade surplus. These flows may be economic, as investors find better returns outside of China's slowing economy, or political, as money flees the scrutiny of the authorities. The flows may also surge temporarily as new channels are opened up for capital flows. In any case, despite the huge trade surplus, the RMB lost value.

What does this mean for policy? Any country which maintains persistent trade surpluses is going to have capital outflows; all the money being earned has to go somewhere: either domestically, resulting in inflation and appreciation, or internationally as capital outflows and investment. The rebalancing of China's economy and broader use of markets would decrease the surplus by providing more domestic opportunities for firms. More spending by Chinese households would help upgrade the level of domestic intermediate inputs for manufacturing and, if trade is not distorted, provide more opportunities for imports of goods and services for Chinese purchasers. Thus, rebalancing can help reduce China's trade surplus. At the same time, savers and investors lack safe assets in China, so they send money abroad to more reliable investments. More active and transparent markets in China can create domestic investment opportunities in private enterprises who wish to provide better goods and services for consumers. All these steps can help decrease capital outflows as they improve the quality of life for Chinese families.

As China continues implementing the reforms of the five-year plan, the temporary swings of the RMB's value, pressed by persistent trade surpluses and massive capital outflows, should smooth out and result in a generally stable rate for the RMB set by the market.