Unleashing Structural Potentials Should Play Key Role for China’s Economic Recovery in the Next Step

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Abstract: Chinese economy has shown three important characteristics under the impact of the COVID-19. First, the export sector has proved resilient; second, the recovery of demand has been slower than that of supply; third, the trend of “digital living” may lead to the permanent reduction of demand for some economic activities. Now that the economy is already back on track, it’s time to rely on China’s structural potentials to boost growth. To this end, a “1+3+2” framework could be adopted, under which metropolitan areas and city clusters are the main engine driving economic growth, industrial and consumption upgrading is the focus of policy efforts, while digital economy and green economy inject sustainable impetus into the economy.

I. Three characteristics of China's economy under the COVID-19

The Chinese economy performed within or even beyond expectation in some respects in the first half of this year. It has displayed three important characteristics under the “stress test” of the COVID-19:

First, the export sector has recovered rapidly, returning to positive growth in June and achieving slight increase during the first half of this year. The competitiveness

1 This article is based on remarks made by the author at the 2020 Annual Conference of the China Finance 40 Forum on July 19, 2020.
of China's export sector has been highlighted by its "resilience" during the pandemic, another testament to China’s stature as a global "major exporter". But whether China’s export will come under pressure in the third quarter remains to be seen.

Second, demand has been recovering more slowly than supply. One possible explanation is that while firms dominate the supply side, there are more individuals on the demand side. Under administrative and market forces, firms tend to react faster, have stronger capacity for action and are more policy-driven than individuals, which has led to faster recovery of supply than that of demand.

Third, demand has picked up gradually recently, but whether it could return to the pre-pandemic level remains to be seen. Earlier former central bank governor Zhou Xiaochuan mentioned the trend towards “digital living”. Because of changes in people’s work and life styles, some demand may be permanently reduced in the post-pandemic era. For example, the demand for air travel, hotels and restaurants may be difficult to recover as online meetings are becoming the norm.

II. Macroeconomic policy adjustments need to pay attention to the flows of capital

China has trodden a fine line in its fiscal and monetary response to COVID-19 between maintaining sufficient liquidity and avoiding monetary flooding. But in June, both social financing and M2 growth reached their highest levels in recent years, significantly widening gaps with the growth of GDP. Continuously injecting liquidity during a crisis is a monetary easing measure oriented towards survival of the economy; but after survival is secured, attention needs to be paid to where the newly issued money flows to.

The recent surge of China’s stock market was clearly not supported by companies’ performance, and there are signs of housing price hikes in some cities. This has been even more evident in the US where some stock indexes have hit new highs with bubbles
in the stock market swelling faster than the spread of the virus.

From a monetary standpoint, it is difficult to drain liquidity from the economy once it is injected. In the medium and long term, we need to consider the potential risks associated with debt default, and in near term, we may need to deal with problems like rising bubbles and the flows of capital. For instance, while we want to prevent capital from flowing into such sectors as the housing market and the stock market, we hope to guide capital into the real economy. However, policy intentions and behaviors of firms and households may go in the opposite direction, which is a challenge faced by China’s policymakers now.

As long as the virus continues to exist, there will be additional prevention and control cost. Although the pandemic is still not over in the third quarter, the economy will be gradually returning to the normal growth trajectory, and macroeconomic policies also need to return to normal. However, macro policies should not be tightened significantly at present, though issues like bubble prevention and management of capital flows do need to be taken into account.

III. We need to fully tap into structural potentials of the Chinese economy

We can divide China’s economic growth since the COVID-19 outbreak into two stages. The first stage witnessed macroeconomic policies and measures being rolled out to support the economy and restore growth; and now we have entered the second stage, where the economy is already back on track, and it’s time to rely on its structural potentials to boost growth.

The so-called structural potentials are the possibilities that China has as a latecomer economy in technological advances, industrial and consumption upgrading, and urbanization, etc. There are two types of structural potentials. The first is the potentials to catch up. The per-capita income in China is about 10,000 USD, while the number
stands at over 40,000 USD in most advanced economies and over 60,000 in the United States. That leaves a gap of at least 30,000 USD. China’s catch-up potentials lie in what the developed countries have done that China should also do but hasn’t done yet. The other is the potentials to keep abreast of or even outpace advanced economies in emerging sectors such as digital economy and green economy.

China has a variety of structural potentials which are closely associated with each other. Here I would like to propose a “1+3+2” framework for tapping into these potentials. Under this framework, metropolitan areas and city clusters will provide the main growth engine; industrial and consumption upgrading will be the focus of efforts; while digital economy and green economy will inject sustainable impetus into the economy.

The “1” refers to the development of metropolitan areas and city clusters that will serve as the major force driving China’s high-quality growth at a medium-to-high speed in the next step. Considering that metropolitan areas and city clusters usually have stronger agglomeration effects and higher factor productivity, in the coming decade they are expected to contribute to 70-80% of China’s economic growth potential. This trend has already been reflected in China’s population flows.

The “3” refers to the three weak links in China’s real economy to be improved at present: inefficient basic industries, small middle-income group, and weak capacity for basic research and development (R&D). First, China needs to encourage open and fair competitions in its basic industries and improve their efficiencies which have been low because of various levels of monopolies. Open competition will boost investments and reduce the costs of production and living across the society. Second, China needs to upgrade its consumption and industrial structures. With regard to consumption upgrading, it’s important to expand spending on goods among low-income groups and stimulate demands for services among middle- and high-income groups; with regard to industrial upgrading, China should phase out outdated and
uncompetitive capacities and sectors, promote restructuring and encourage innovation, move up along global value chains and increase total factor productivity. Third, in high-end fields, it’s critical to enhance R&D efforts and innovation capacities so as to lay a solid groundwork for technological innovation in the long run. Improving these weak links will be critical for China to achieve high-quality development and overcome the middle-income trap.

**The "2" refers to digital economy and green development.** Digital economy and green development impact all sectors of society. For example, WeChat payment is commonly used by fruit vendors on the street. This kind of "digital stall economy" actually reflects the systematic digitalization of the economy. Green development is also a very important field, which can produce new growth momentum.

Recently, the European Union, especially Germany and France, proposed the "two pillars" for economic recovery—digital technology and green development. **This suggests that they are new potentials for the entire world.** With more advanced theories and a super-large market, China has the opportunity to form new competitive advantages in digital technology and green development.

**III. Further deepening reform to tap structural potentials**

Unleashing structural potentials requires further deepening of reforms. In addition to the specific macro policies, it is also necessary to boost market confidence and expectations and take concrete actions to promote market-oriented allocation of factors and improve the socialist market economy.

Regarding the development of metropolitan areas and city clusters, two reforms should be highlighted. First, we must deepen the reform of the rural land system, promote the entry of collective construction land into the market, and create conditions for the orderly circulation of house sites. Second, we must promote the reform of spatial
planning and public resource allocation. In spatial planning (including urban planning), we should let the market play the decisive role in resource allocation and respect the market signals of population movement.

**Cities with the largest population inflows in recent years are Hangzhou and Shenzhen. This reflects the power of market forces.** Urbanization must adhere to the "people-centered" principle. The government should allocate land use quota and fiscal subsidies and update urban planning in accordance with changes in population distribution.

**To improve the three weak links, targeted measures should be introduced.** In the basic industries such as oil and gas, power, railways, communications, finance, etc., major moves should be made to relax restrictions on market access and promote competition. For example, in the oil and gas industry, import should be allowed and market access should be relaxed along the entire supply chain. In the communications industry, private capital or capital from non-communication industries (including state-owned capital) should be allowed to invest in one or two basic telecom operators. Such reforms can drive effective investment and, more importantly, reduce the basic costs of production and living.

Improve social policies, strengthen the reform and development of the public goods supply, and focus on improving the quality of human capital. Double the middle-income population would be an important strategy after the goal of building a well-off society is achieved. China has a super-large market. But where does the consumption power come from? We should put special emphasis on transforming consumption capacity into production and innovation capacity. The development of the digital economy in recent years has first been driven by the formation of business models based on China’s huge consumer market. It perfectly illustrates how income growth can facilitate the improvement of production and innovation capabilities.
China should not only become the world's largest consumer market, but also the most efficient, resilient and productive manufacturing base and innovation power. Transforming consumption power into production and innovation capacity is the key to taking advantage of China’s super-large market, and is a fundamental component of "domestic circulation".

China should set up high-level universities and R&D special zones in cities that boast high innovation capability and rich science and education resources, such as Hangzhou and Shenzhen, where pilot programs concerning student admission, personnel recruitment, project management, fund raising and intellectual property rights protection, among other aspects, can be carried out to break through constraints of the existing systems, mechanisms and policies. Westlake University is such an example. We should support and encourage more universities and research institutions of this kind to create an ecosystem that can attract world-class talents, encourage open research, facilitate major scientific breakthroughs, and make possible Nobel Prize-winning achievements.

Opening up requires more forward-looking measures. We should oppose unilateralism and protectionism globally, and prevent narrow-minded nationalism and populism at home. Faced with the pressure of technological blockade and decoupling, we should make good use of the advantages of China’s super-large market, and open up wider. When necessary, we should implement the "three zeros" (zero tariffs, zero barriers, and zero subsidies). China’s trade advantages have little to do with tariff protection. We must actively participate in international rule-making, promote cooperation and globalization, and charge a new course toward an open world economy.