

## **Why Change of Growth Model is Easier Said than Done**

*The transformation of the role of government is essential for eradicating the institutional foundation of traditional growth model. The government should exit the economy and market, and focus on institutional reform and institutional improvement.*

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In the past decades, China's economic growth was solely propelled by the high investment rate. Now this model seems to end. Even if it still works to some extent, there is little potential left. The economic growth rate will inevitably slow down if nothing is changed.

Since China's reform and opening-up, the investment rate (fixed asset investment to GDP) had soared from 25% in 1970s to a record high of 40% in 2003. According to the National Bureau of Statistics, the GDP for 2004 was RMB13.6 trillion, while the total fixed asset investment reached RMB7 trillion! The annual GDP in this period grew around 10% in average. In other words, China had to base this high growth not only on high investment rate, but also on ever-escalating investment rate.

But there is a limit to this. Theoretically speaking, the investment rate can't be over 100%. In light of the experience of China and other countries, it seems that the upper limit of investment rate in practice is around 40%. Some argued that China can still maintain its high growth for another two decades. Based on historical data, this implies an investment rate of over 50%. It's hard to imagine that any country or economy can sustain that in today's world.

Let's look at Japan. During the reconstruction after the WWII, its investment rate increased from 20% in early 1950s to around 35% in 1970s. After then, the rate started to wind down gradually to 25% in 2003 as a result of the first oil crisis. South Korea was roughly the same. Its investment rate hit 40% during the peak period, slowed down in early 1990s, and remained stable at 30% in recent years.

The experience of major countries shows that economic growth simply fueled by investment is unsustainable. Sooner or later, the investment rate will drop. The developed economies have a much lower investment rate than the Asian countries. For example, the investment rate in the US is around 15% perennially. Obviously, sustainable growth relies on technology advancement rather than investment.

To overhaul the traditional growth model, the Central Economic Working Conference at the end of 2004 put forward the guideline of "rigorously improve restructuring and promote the shift of growth

model”. It emphasized that economic growth means growth not only in quantity but also in quality; growth should aim at efficiency instead of speed; growth should rely on technology advancement instead of input of resources; and investment in production capacity should give way to research and development. The key of the new growth model is higher resource efficiency, not larger quantity.

The previous government leaders all emphasized a lot on the shift of growth model. Even under the planned economy, there were debates about the models of “extensive growth” and “intensive growth”. But the investment rate kept rising and extensive growth remained unchecked. The overheated development didn’t show any signs of cooling down, instead it spread into more sectors.

The traditional model that suffocates the new growth model has persisted for many years, attributable to the long lasting institutional foundation. As long as the institutional foundation remains the same, China’s economy won’t escape from speed-oriented growth that simply relies on investment and consumption of resources. In that sense, the shift of growth model will only remain on the paper.

The central part of the institutional foundation of traditional growth model is government’s dominance in resource allocation, especially in such production factors as land, human resource and capital. As a non-profit organization, the government can not and should not pursue maximization of profits or efficiency in resource allocation, but its inherent motivation mechanism determines its pursuit of scale and speed. Considering the unparalleled position of economic performance in appraisal system, the government officials at all levels usually put GDP on top of the agenda. What’s more, the link between scale and personal benefits also encourages the officials and SOE executives to enlarge the scale. Bigger scale means more resources to be allocated, therefore higher grey income can be expected. Based on exactly these reasons, some economists in foreign countries have made the conclusion that the private sector maximizes profit, but the public sector maximizes budget. In other words, public sector prefers to spread out its reach and build as more projects as possible.

The decisive influence of government on investment is evidenced by the concurrence of investment cycle and government officials’ term of office. Allow for inflation, the fixed asset investment in 1993 increased by 35%, the highest level since reform and opening-up. Another peak occurred in 1998, registering a real increase of 14%, while the rate for 1997 and 1999 was only 7% and 6% respectively. Five years later, the fixed asset investment increased by 26% in 2003. In recent years, almost 40% to 45% of fixed asset investment was made by the state sector. If project approval, land and credit policies are also taken into consideration, the government plays a much bigger role in investment.

Another institutional foundation for investment propelled growth model is the price control of production factors. The nominally low costs of land and capital encourage over-investment and negligence of efficiency. The land and capital costs for “development zones”, “governor-head

projects” or “face projects” are manipulated at a very low level. Because of limited investment opportunities, large chunk of savings flow to the state-owned financial institutions. The depositors have no option but to accept the low official interest rate, the high price and low return on the stock market caused by limited stock supply. Reckless expansion of enterprises fueled by cheap capital already happened in Japan, South Korea and other Asian countries. The negative impact is still fresh in the minds of many people.

The weak protection of property, especially intellectual property gives strong impetus for short-term expansion by many Chinese enterprises, while neglecting long-term investment, especially R&D. The new products and new technology can be copied immediately after introduction and the market is swamped by copycat products. The companies are less interested in R&D because they can hardly recover the cost of it. The weak financial system only makes the situation worse. The new product or new technology companies can't get the support from venture capital funds. The reason is that these funds don't have formal legal status up to now. And the non-floating nature of corporate shares also prevents these funds from having an important exit channel.

After the analysis of the institutional foundation of traditional growth model, we can better understand why the Central Economic Working Conference emphasized the guideline of “rigorously improve restructuring and promote the shift of growth model”. To achieve this goal, the government should gradually retreat from the investment and financial sector. The percentage of SOEs in commercial projects should go down and government should no longer plan, initiate, finance or resume responsibility for investment projects other than public utilities. In the approval of investment projects, the government should only focus on the key indicators such as environmental protection and safety and dismantle all other forms of administrative approval and market access barriers.

Reform of the financial system should aim to abolish the control of capital price, liberalize interest rate, further increase benchmark interest rate, stop the administrative interference in the stock market and bring an end to the abnormal phenomenon of zero cost of equity capital. Price should be determined by market forces. In this way the price mechanism can really do its job in containing overinvestment. There's no doubt the key target of the financial reform is the banking industry. Banks should become independent financial institutions which take profit as the top priority. Loans should be made after evaluating the risk and profit of the project, instead of obeying government orders. So an important gate can be established to rein in overexpansion either by the government or the enterprises. Apart from the banks, the legislation process for venture capital funds and entrepreneurial funds should be sped up. The corporate shares should be floated as soon as possible in order to build an exit channel.

The transformation of the role of government is essential for eradicating the institutional foundation of traditional growth model. The government should exit the economy and market and focus on institutional reform and institutional improvement. That is the only way to ensure sustainable economic growth in China.

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