CHAPTER 4

How Can China Overcome the “Middle Income Trap”? 

Whether a country can overcome the “middle income trap” is a test of its governance capability. The above comparative analysis of the practices in various countries shows that tackling the “middle income trap” is only possible when certain conditions are met, which may be summarized as follows.

First, an effective market. Effective market is the prerequisite for effective resource allocation, which ensures that the potential productivity of all productive factors is tapped to the full extent and that labor and capital factors are effectively utilized, while creating a sound market environment for innovation, fostering highly motivated innovative players and continuous improvement in total factor productivity, thus enabling a country to achieve economic growth by unleashing the potential of human capital. An effective market is reflected not only in building a unified domestic market but also in active participation in globalization, fully leveraging on the external economic opportunities while effectively addressing negative economic impact from the outside. From the 14th CPC National Congress announcing the establishment of socialist market economic system to the 3rd Plenary Session of the 18th CPC National Congress with the statement of “enabling market to play a decisive role in resource allocation”, China has never ceased its efforts in institutional building for an effective market, which has laid a solid institutional foundation for its rapid economic growth in the long run.
Second, a harmonious society. The concordance of economic growth and social development is the guarantee for sustainable economic development. A common cause for social discordance is the severity disparity and opposition between social classes resulting from the marginalization of certain members of the society in the growing economy, of which achievements fail to be shared among all members of the society. The accumulation of malaise in society tends to result in social upheavals and political instability, eventually leading to disruptions in economic prosperity. In 2004, a clear statement was made to “continuously enhance the capacity of building a harmonious socialist society” during the 4th Plenary Session of the 16th CPC National Congress; in October 2006, *Resolutions of the CPC Central Committee on Several Critical Issues in Building a Harmonious Socialist Society* was approved during the 6th Plenary Session of the 16th CPC National Congress, proposing the goal to build a harmonious socialist society by 2020. Since 2000, major achievements have been made toward this goal as China is gradually improving its social security system with socialist characteristics.

Third, a positive government. A positive government plays a key role in effective market operations and harmonious social development. First, a positive government builds up a market economy system by perfecting the legal and regulatory framework, hence safeguarding a fair and competitive market environment, inspiring the creativity of market players and facilitating domestic and overseas market growth, industrial restructuring and upgrading as well as technological innovation and so on; second, a positive government guarantees the stability of the macro economy through effective administration and provides public products (such as infrastructure) for market entities and public services for its people (such as minimum social security, pension scheme, healthcare and education); third, a positive government ensures the dynamic adaptability and prospectiveness of development strategies by formulating and implementing strategic plans such as five-year plan and mid- to long-term plan aiming at achieving long-term national development goals.

Obviously, in light of China’s track of growth, the development path is a typical case of synergy of effective market, harmonious society and positive government. The goal of “modernization of the national governance system and governance capacity” proposed during the 3rd Plenary Session of the 18th CPC National Congress is also seen as the “top-level design”
of further coordinated progress of the three factors. With the three pre-
requisites—effective market, harmonious society and active government—
ensured, China ranking among high-income countries is just a matter
of time.

Yet as a country with a population of 1.38 billion and significant dispar-
ity in regional development between urban and rural areas, China must
undergo a process before ranking amongst high-income countries, and by
no means will this goal be attained automatically without lifting a finger. The
key question is: will China effectively address the current challenges
as a middle-income country and achieve economic growth of higher qual-
ity and social development featuring more equality, justice and harmony?
Besides, even if China becomes a high-income country, there is still a big
gap in per capita income between China and developed countries, and
supassing the “middle income trap” only represents a new starting
point for China to narrow the development gap between China and devel-
oped countries. Therefore, in supassing the “middle income trap”, China
should consolidate the foundation for its development to continuously
reduce the development gap with the developed countries, thereby achiev-
ing stable and sustainable growth of its gigantic economy. This, to a large
extent, will depend on how China plans to address the various challenges
in its current stage of development.

This chapter aims at answering the following question: how will China
effectively respond to the various challenges as a middle-income country
in the current stage and stride over the high-income threshold by fully
leveraging on the favorable conditions. Distinct from the analysis frame-
work rooted in traditional Western economics, this chapter provides an
analysis framework based on political economics and, through an in-depth
elaboration of characteristics of the middle-income stage, proposes that
only by properly removing the constraints that impede the development of
social productivity and circumventing from various possible traps, all
guided by the Five Development Concepts, will China be able to effec-
tively eliminate the systematic risk factors in economic development.
Besides, it is argued that the strongest cornerstone for China’s transition
as a middle-income country requires continuous efforts in deepening
reform and modernization of the country’s governance system and govern-
nance capacity, so to ensure a steady long-term economic growth in China.
4.1 Breaking Out of the Middle-Income Trap Through the “Five Development Concepts”

Since the implementation of the reform and opening-up policy, China has maintained nearly four decades of rapid economic growth, rising from the world’s 10th economy to the 2nd,\(^1\) from the 29th biggest trader of goods to the biggest trading country in the world\(^2\) and from an extremely low-income country to an upper-middle-income country. China’s success in avoiding drastic slowdown in economic growth during the middle-income stage and its subsequent entering into the development phase of high income are critical for China’s goal of building a moderately prosperous society in all respects by 2020 as well as for the world’s economic landscape. A blueprint for China’s development goals by 2020 was sketched during the 5th Plenary Session of the 18th CPC National Congress with the proposition of five new development concepts by the CPC Central Committee, namely “innovation, coordination, greening, opening-up and sharing”, aiming at addressing the “middle income trap” with clearly defined target as these concepts are the basic approaches to overcome such trap as well as a foundation for China to continue on the healthy track of development afterward.

Why are the “five development concepts” clearly targeting the “middle income trap”? In drafting the 13th Five-Year Plan, the CPC Central Committee made a clear statement of “overcoming the middle income trap”; it is hence exactly on this basis that the CPC Central Committee innovatively proposed these five development concepts, which are clearly target-driven as well as problem-driven featuring pragmatism: innovation focuses on the momentum for development, aiming at maintaining mid-to-high-speed economic growth toward a mid-to-high level; coordination aims at addressing the disparity in development and focuses on strengthening the integrality of development; greening highlights the harmony between mankind and nature and building a beautiful China with blue sky, green grass and clear water; opening-up focuses on the interaction between

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\(^1\) According to World Bank Database, China was the world’s tenth biggest economy in the world in 1978; in 2010, China overtook Japan to become the world’s second biggest economy.

\(^2\) National Bureau of Statistics: China Statistical Abstract 2015, p. 178, China Statistics Press, 2015.
internal and external factors in development and greater openness in econ-
omy; sharing underlines social equality and justice for continuous improve-
ment in people’s wellbeing and upgrading China’s economic and social
development. In light of China’s current phase of development, we have
identified at least five types of traps, namely the total factor productivity
(TFP) trap, urbanization trap, environment trap, dependence trap and
inequality trap.

And what are the possible solutions? Obviously, no readily executable
answers are provided in the textbooks of Western economics from a theo-
retical perspective; while in practice, no country could offer China off-the-
shelf experience as a reference. China’s development since the reform and
opening-up shows that instead of sticking to one development theory,
China’s efforts in development proceed from the objective circumstances
in different stages, adhering to the key principle of people and develop-
ment for the people; with integration of respect and encouragement for
local practices for development with macro-coordination by the central
government, China is gradually exploring into and constantly enriching
the theory of socialism with Chinese characteristics, which is reflected in
the plenary sessions and development plans of the CPC Central Committee.
The five development concepts proposed by the CPC Central Committee
during the 5th Plenary Session of the 18th CPC National Congress aim to
address the above five traps that confront China in mid- to high-income
stage, providing important ideas and fundamental approaches to break
through the five traps. Therefore, with the five development concepts as
the basic theoretical framework, we suggest the following solutions to
tackle the five traps.

4.1.1 Avoiding the Total Factor Productivity Trap Through
Innovation-Driven Development

Overcoming the “middle income trap” is essentially a matter of economic
growth—a matter of economic growth in the middle-income stage.
Generally speaking, economic growth for countries in this stage is mainly
driven by economic restructuring and transition in the engine of economic
growth, both of which have an impact on the growth of total factor pro-
ductivity (TFP). From a longer-term perspective, increase in TFP is the
key to sustainable growth. As is emphasized by Eichengreen et al. (2011,
2013), the core of transformation in the economic development pattern
fostered by economic restructuring and innovation is enhancing the
contributions of TFP to economic growth, which is a prerequisite for successfully overcoming the “middle income trap”.

We have studied the experiences of middle-income countries in 1960 and grouped these countries into three types determined by whether they have passed through the middle-income stage by 2010: countries that have successfully crossed the threshold, countries remaining in the middle-income stage and countries reduced to low-income stage. Calculations of their performance in narrowing down the TFP gap with the U.S. (see Fig. 4.1) show that only countries that have passed through the middle-income stage show a narrowed gap in TFP, that is, a relative improvement in TFP level, while countries failing to cross the threshold have suffered a relatively reduced TFP level in various degrees. Therefore, failure in middle-income transition boils down to falling into the TFP trap. Furthermore, based on a relative standard, if China fails to improve its

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3 Eichengreen, B., Park, D., & Shin, K. When fast growing economies slow down: international evidence and implications for the People’s Republic of China. *Asian Development Bank Economics Working Paper Series*, 2011 (262). Eichengreen, B., Park, D., & Shin, K. (2013). *Growth slowdowns redux: New evidence on the middle-income trap* (No. w18673). *National Bureau of Economic Research.*
TFP against the level of the U.S. in the future, or experiences TFP decrease, China will find itself in the TFP trap.

Long-term growth of TFP is the key to economic growth rate; in particular, catching up with the relative TFP level of leading developed countries (such as the U.S.) is the key in the transition from a catching-up country to an innovative country as well as the main driving force in the ascent from a middle-income country to a high-income country. It can therefore be safely stated that the sustained growth in TFP is a necessary condition for China to overcome the “middle income trap”; while the key to avoiding the TFP trap is to replace an economic growth model dominated by factor input with an innovation-driven growth model, and to increase the contribution of TFP to economic growth.

Placing China’s economic development in the current context of the “new normal”, the growth rate has switched gears from high to mid-to-high speed while the driving force of economic growth has undergone a transformation. Such transformation is the most critical factor in determining the progress and quality of speed adjustment and structural optimization; it requires fostering new driving forces, expanding space for growth, earnestly implementing the innovation-driven development strategy, pressing ahead with agricultural modernization, and innovating and improving modes of macro-regulation and control to maintain high efficiency in China’s economic growth.

Innovation as an important driving force of transformation of economic growth model is stated in the 13th Five-Year Plan where core indicators of innovation-driven development are explicitly listed. First, in terms of innovation input, the investment intensity of research and experiment shall increase from 2.1% of GDP in 2015 to 2.5% in 2020, higher than the average (2.37%) of OECD countries; total social expenditures on R&D shall increase from 1.42 trillion RMB to 2.32 trillion RMB, with an aggregate investment of 11.22 trillion RMB over five years, which translates into 1.93 times of total R&D expenditures of the 12th Five-Year Plan period (5.80 trillion RMB), closer or higher than the U.S.

Second, with respect to innovation output, a series of key indicators are listed in the 13th Five-Year Plan, including the one that patent ownership per 10,000 people shall be doubled, from 6.3 in 2015 to 12 in 2020 and the one that China’s total patent ownership shall increase from 1.19

4 Liu Yandong, On Earnest Implementation of Innovation-Driven Innovation Strategy, *People’s Daily*, November 11, 2015.
million to 1.68 million, of which the actual result is highly likely to exceed expectation, reflecting both the accelerated accumulation of technical innovation capital stock in China and the continuous enhancement of its domestic independent innovation capacity. Besides, the contribution of innovation to economic growth is also clearly mentioned in the 13th Five-Year Plan, where the contribution by science and technological advancement shall increase from 55% in 2015 to 60% in 2020.

Third, the significant role of digital economy in innovation as a driving force is highlighted in the 13th Five-Year Plan, which, in terms of boosting the growth of digital economy, states that the household penetration of fixed broadband shall grow from 40% in 2015 to 70% in 2020, with users increasing from 688 million to 980 million, while the penetration of mobile broadband shall grow from 57% to 85%, with users increasing from 780 million to 1.19 billion. It is expected that the universal penetration of internet will by and large become a reality in China by 2020, making it the world’s biggest internet economy with first-move advantage in new economies, new business models and new industries, while triggering restructuring and upgrading of traditional industries (such as labor-intensive and resource-intensive industries), expanding the geographical space for economy and penetrating the broader global market. A most typical example is the cross-border e-commerce of Alibaba, which, covering all provinces, municipalities and autonomous regions in China, has begun to establish a global footprint.

4.1.2 Avoiding the Urbanization Trap Through Coordinated Development

A key driver in a country’s transition from the middle-income stage to the high-income stage is urbanization, which simultaneously represents the in-depth transformation of the economic and employment structures. Urbanization in benign interaction with economic growth will contribute to the liberation of agricultural labor, hence optimizing the labor structure and boosting economic growth; meanwhile, such economic growth will create more jobs in non-agricultural sectors, and thus driving the urbanization momentum. Nevertheless, excessive urbanization may weaken the bearing capacity of urban regions for economic growth, causing “urban maladies” such as mounting employment pressure, insufficient urban infrastructure, environmental pollution and poor efficiency of urban governance, eventually resulting in a situation with “growing urbanization
accompanied by zero economic growth”, or, worse still, stagnated social development and aggravated social conflict—a fall into the urbanization trap.

Such commonplace situations in Latin America are what we are trying to avoid. For instance, some Latin American countries (such as Brazil and Mexico) are falling farther behind, rather than narrowing the gap with the U.S., despite their high urbanization rate (see Fig. 4.2). Although the urbanization level in many Latin American countries is on par with the average in high income countries, the urbanization development and economic growth in these countries fail to stay in a relationship of benign interaction; on the contrary, a malicious cycle of urban development and economic development is formed. Polarization of wealth has aggravated as cities fail to create enough jobs to sustain its residents, leaving many impoverished urban residents living in slums, where urban utilities and

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5 According to World Bank statistics, in 2015, the average urbanization rate in Latin America and Caribbean Countries reached 80%, close to the average in high-income countries (81%).
public services tend to be insufficient, resulting in disadvantages in income, accessibility to education and healthcare, social security and so on for the slum residents as manifested in multi-dimensional poverty and even intergenerational transmission of poverty.\(^6\) Besides, economic stagnation has put government in a position where it cannot afford to allocate sufficient budget to the planning and rejuvenation of slums, nor is it capable of effective social management of such areas; slums, as a result, have become the “tumors” for urban development.

The rapid development process of urbanization generates both economic gains and social challenges. Experiences of urbanization development in Latin American countries indicate that during the transition to the high-income stage, it is necessary to enable urbanization development in a steady manner and bring urbanization development into healthy interaction with economic growth, resolving conflicts and challenges incurred in the process of urbanization development by fully leveraging on the achievements of economic growth, and thereby fostering an efficient, inclusive and sustainable model of urbanization development. Otherwise, the risk of falling into the urbanization trap would be high.

China’s urbanization rate in 2015 stood at 57.35\(\%\),\(^7\) which is on par with the world’s average yet is visibly lower than the average of high income countries (81\% in 2015). In general, China has made great achievements in urbanization but improvement is expected in terms of quality. In 2016, urbanization rate for population with household registration was 41.2\%, significantly lower than the percentage calculated from permanent population as statistical caliber, with a difference of 220 million people. In this regard, China still runs the risk of falling into the urbanization trap if this problem is not resolved properly.

Aiming to address this issue, China has developed a scientific plan to promote a new model of urbanization, that is, National Plan for New Urbanization Model (2014–2020) formulated in 2014, which is the strategic and fundamental plan on the macro-level for guiding the healthy development of urbanization in China. This plan is no less than a top design for China’s new urbanization model aiming at efficient, inclusive and sustainable urbanization. The strategy of coordinated development proposed in the 13th Five-Year Plan is also a major move to circumvent

\(^6\)Wu Sun Pei-jing, Zhao Xuemei (2016), Poverty and Poverty Alleviation Policies in Latin America from Multiple Perspectives, *Journal of Latin American Studies*, Vol. 3.

\(^7\)Data source: National Bureau of Statistics, January 20, 2017.
the urbanization trap, including an emphasis on the new urbanization model with “urbanization of the people” at the core, deepened reform of the household registration system, full coverage of the residential permit system for permanent population without household registration in urban areas, increased coverage of employment services, and affordable housing and public services for migrants.

From a holistic perspective, the institutional mechanism for the new model of urbanization is gradually improving in China, and China’s construction for new urbanization is generally on a healthy track, which represents not only a driving force for economic restructuring but also opportunities for the social transformation and progress in China. The key to attaining these goals is the conscientious implementation of the new urbanization plan, which in turn requires highly motivated and creative local government on various levels to plan for the space of urban development on a scientific basis, focus on the integrated development of urbanization, urban infrastructure and industries and constantly enhance its social governance capabilities. Besides, agricultural modernization and new countryside construction must be incorporated into the context of facilitating the construction of the new urbanization model, with higher quality of rural planning, strengthened development of infrastructure as well as coverage rate and quality of public services in rural areas, improvement in investment mechanism for the development of rural areas, agriculture and farmers, a revolutionary transformation in the urban-rural dualistic development pattern and narrowed gap between urban and rural regions.

The coordinated development strategy proposed in the 13th Five-Year Plan also includes coordinated regional development, which requires improved overall strategy for regional development, down-to-earth implementation of the main functional zone strategy as well as population and economic growth that are compatible with the resource bearing capacity. Moreover, inter-regional coordinated development mechanism shall be built to boost development with unique competitiveness, coordinated and win-win development through the Belt and Road Initiative, Beijing-Tianjin-Hebei Economic Zone and the Yangtze River Delta Economic Belt, and hence creating new space for regional development.
4.1.3 Avoiding the Ecological Environment Trap Through Green Development

Developing countries tend to use natural resources in an exhaustive way, resulting in ecological damage. On one hand, development pressures compel developing countries to import industrial projects, causing severe pollution and mounting environmental burdens. The growth model featuring intensive resource consumption and high environmental cost is unsustainable and may lead to grave consequences. On the other hand, some of these consequences of pollution are very expensive to remediate or even irreversible. Therefore, economic development at the cost of ecological environment will likely result in a malicious cycle of economic development and eco-environment, which is known as the “eco-environment trap”.

China is a heavily populated country with limited resources, where ecologically vulnerable areas account for a considerable portion of the national territory. With urbanization and industrialization in progress, the environment has become an important indicator of urbanization quality but with people’s health and wellbeing at stake. In this sense, green development is the guarantee for the safety of ecological environment. The development trajectory of developed countries shows that although the development path characterized by “pollute first and clean up later” has eventually broken free from the malicious cycle between economic development and eco-environmental protection, the costs of this “old track” are by no means negligible. Therefore, from a long-term perspective, the development model of “pollute first and clean up later” is not only economically unviable but also incurs heavy burden on sustainable economic development. Related studies also show that the mechanism where environmental improvement automatically comes alongside national income growth simply does not exist; therefore, the model of development at the cost of environment may highly likely result in a fall into the “environmental trap”.

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8 White Paper: Ecological Protection in China publicly released by the General Administration for Environmental Protection for the first time in 2006 shows that ecologically vulnerable areas account for over 60% of China’s territory.

9 Such as Meuse River Valley episode in Belgium in 1930, Los Angeles photochemical smog episode in U.S. in 1943, Donora smog disaster in U.S. in 1943, Great Smog in London in 1952, water pollution incident in Kyushu, Japan, in 1953 and itai-itai disease in Toyama, Japan, that lasted 40 years (1931–1972).
Since the reform and opening-up, China has suffered continuous environmental degradation alongside its high-speed economic development, and environmental pressure has become a significant constraint for China’s economic growth. Although ecological environment was listed as a binding indicator in the 11th Five-Year Plan, the eco-environmental degradation has not yet seen a reverse. In 2010, cost of eco-environmental degradation throughout the country registered at 1.53895 trillion RMB, accounting for approximately 3.5% of GDP and an increase of 200.7% as compared to 2004, and the environmental loss has amounted to 5%–6% of China’s GDP, a further increase of the probabilities of falling into the environmental trap. It must be noted that the CPC Central Committee is conscientiously addressing the eco-environmental challenge for China’s sustainable development, and such an attitude is not only reflected in its development practices but has also become a principle upheld by China in its participation in international governance.

A strengthened prospective of green development is exactly a response to this trap, aiming at the harmony between man and nature and a beautiful China with blue sky, green land and clear water through pursuing green development. Generally speaking, China’s eco-environmental remediation is in the “braking” stage featuring significant slowdown in eco-environmental degradation and visible improvement in certain areas before it may “take a U-turn” on this basis, that is, overall improvement in eco-environmental, lowered ecological vulnerability and distinctive amelioration of ecological environment, hence circumventing from the environmental trap. In the long run, green development is not only a key topic on the agenda of the 13th Five-Year Plan period but also a mandatory path for long-term development for China’s socialist modernization undertakings. Arguably, without green development, China is likely to lose the momentum for further steps in catching up with developed countries due to eco-environmental degradation.

4.1.4 Avoiding the Dependency Trap Through Open Development

International experience shows that all countries that have successfully overcome the “middle income trap” are open economies. For middle-income countries, catching up with developed countries in economic
development level should, from an objective viewpoint, be based on full participation in economic globalization, with continuous adjustment of self-positioning in this globalization process, hence fostering new edge in global competition. Either refusal of economic globalization to protect national industrial development or participating in the global economy merely by exporting resources or excessive dependence on international capital will possibly result in the “dependence trap”. The failure of import replacement strategy which used to be universally practiced in Latin American countries proves that breaking away from international division of labor regardless of the reality of national economic development would unavoidably result in falling into the “middle income trap” with factor allocation deviating from the basic principles of comparative advantage, which in turn increases production cost and leads to worsened international balance of payments.

Southeast Asian countries provide another example from which much can be learned. Prior to the Asian financial crisis in 1997, these countries prematurely opened up their capital markets before their own industrial competitive edge was fully established, eventually resulting in massive international capital flight and grave devaluation of their domestic currencies, triggering a financial crisis that eventually evolved into an economic crisis. A typical country was Malaysia, which joined the ranks of high-income countries as early as in 1996 and yet never staged its comeback until now after being swirled into the Asian financial crisis in 1997.

Since its reform and opening-up, China has been gradually moving from the edge to the center of limelight on the international stage as it became the world’s second largest economy and the No. 1 trading country, with the share of China’s merchandise export increasing from 2.24% in the world in 1992 to 12.37% in 2014. Overall, China’s opening-up strategy has achieved significant success as it has become the external driving force for China’s economic growth. However, it should be equally noted that China is facing new challenges in its engagement in economic globalization. First, China urgently needs to generate a new competitive edge in innovation as the competitiveness of its labor-intensive exported goods is facing challenges with rising labor cost. Second, China must strengthen its resilience to external shocks as the impact of the international financial crisis is transmitted through external demand to China’s domestic economy. Third, the pressing need is felt for China to enhance the capacity of its participation in global governance if it is to remain active in future economic globalization. This requires China to assess its own
capabilities and act accordingly while making fruitful efforts and playing an active role in building new international development mechanisms (such as the Belt and Road Initiative and AIIB) in global climate change governance, coordination of international macroeconomic policies and participation in regional economic development organizations of various types. These challenges for China’s opening-up, indicating potential opportunities on one hand, may place China in a passive position, or even lead to a fall into the “dependence trap” if engagement in economic globalization is inappropriately handled.

Open development has clarified China’s strategy in participating in economic globalization and global governance in all dimensions in the future: on one hand, China must circumvent the “dependence trap” and create new opportunities for its economic growth; on the other hand, it will set an example and generate opportunities for “Southern countries” which shall have far-reaching and long-term implications on the world economy. Moreover, China’s open development contributes to building a future-oriented new international political and economic order by avoiding the Thucydides trap where conflicts would inevitably occur between rising powers and established powers—which is exactly the win-win concept emphasized by Xi Jinping.

In general, China possesses the capabilities to resist external shocks and risks and to avoid the dependence trap. First, China’s foreign exchange reserve of 3 trillion US dollars makes a sovereign debt crisis seen in some European countries impossible in China. Second, the numerous world-class enterprises in China have become another source of the country’s resilience to external crises. Moreover, China’s massive outbound FDI, of which resource projects constitute a considerable share, has secured the resources necessary for China’s future economic development. Finally, China has accumulated abundant experience in external shock response after surviving the Asian financial crisis in 1998 and the global financial crisis in 2008.

The world today is characterized by the ongoing complicated and profound changes in the external environment, with development issues and challenges in globalization remaining grave for all countries, which must therefore make concerted efforts for joint response. China finds it necessary to participate in global governance through better communication and dialogues while improving its domestic institutional foundation accordingly through deepened reform in order to avoid falling into a passive situation in future economic globalization and global governance.
4.1.5 Avoiding the Inequity Trap Through Shared Development

International experience shows that grave income disparity constitutes an essential threat to economic development during the middle-income stage, as it is highly likely to cause accumulated social malaise and economic stagnation, resulting in the “inequality trap”. As a typical Latin American country, Argentina saw its Gini coefficient hike from 0.428 in 1986 to 0.507 in 1998,\(^{12}\) causing the country to fall into both the “inequality trap” and the “middle income trap”. As for China, despite the aggravation tendency brought under control, the country is not to be blindly optimistic about its income distribution. According to statistics released by the National Bureau of Statistics, from 2003 to 2008, China’s Gini coefficient was on a continuous rise from 0.479 to 0.491, with the relative gap between average disposable income per capita for urban residents and average net income for rural residents escalating from 3.23 times in 2003 to a peak of 3.33 times in 2009. In recent years, the income disparity in China has been mitigated to some extent as the Gini coefficient of national average disposable income per capita decreased from 0.473 in 2013 to 0.462 in 2015, and the relative gap between average disposable income per capita for urban and rural residents narrowed down from 2.81 times in 2013 to 2.73 times in 2015.\(^{13}\) However, on an international scale, income disparity remains a prominent problem for China due to multiple reasons: urban and rural gaps, regional disparity, internal gaps within urban regions as well as within rural regions, and coexistence of the salary income gap and the capital income gap. Therefore, resolving China’s income disparity will remain a standing issue on its development agenda.

It must be pointed out, though, that Kuznets curve graphs the hypothesis that economic inequality is first increased and then decreased with economic development, yet international development studies show that income inequality will not automatically narrow down as the economy grows to a higher level. Therefore, income distribution policies are necessary in mitigating inequality in distribution. Shared development is an exact response to the “inequality trap” as sharing the accomplishments of development among people is the only way toward common prosperity, and crossing the threshold of a moderately prosperous society with

\(^{12}\) Data source: The World Bank.  
\(^{13}\) Data source: China Statistical Abstract 2015, pp. 57, 59, China Statistics Press, Beijing; statistics of 2015 are published by National Bureau of Statistics.
common prosperity represents the true essence of overcoming the “inequality trap” and the “middle income trap”. Sticking to shared development and highlighting social equality and justice, China shall make continued progress in people’s wellbeing and open up new horizons for its economic and social development.

In general, the key to circumventing the “middle income trap” is accelerating the transformation of the economic development model through economic dimensions, shifting from low-level development to high-level development, from low-quality development to high-quality development, from unequal development to equal development, from poorly coordinated development to well-coordinated development and from unsustainable development to sustainable development, which, for China, means the full implementation of the Five Development Concepts to overcome the multiple traps during the middle-income stage.

4.2 Supply-Side Structural Reform Is the Key to Overcoming the “Middle Income Trap”

China experienced prominent structural contradiction in 2011 with the implementation of the 12th Five-Year Plan and the phasing downturn of its economic growth. In this context, the Central Economic Work Conference in 2015 explicitly proposed supply-side structural reform, which was identified as the mainline of the 13th Five-Year Plan. Supply-side structural reform is an inevitable choice as China’s economic development enters into the new normal, and appropriate understanding and effective implementation of such reform would bear profound strategic significance for China to comprehensively build a moderately prosperous society in by 2020 and to overcome the “middle income gap”. Progressing with the supply-side structural reform requires not only a deep understanding of the in-depth structural problems prevailing in China’s current economic development but also a clear view of the structural characteristics of China’s long-term economic development. This in turn is built on clearly understanding the basic rationale of supply-side structural reform from a theoretical perspective as well as properly handling the critical relationships between supply-side structural reform and other reform measures in practice.

For supply-side structural reform, first of all, an understanding of the historical rationale, theoretical rationale and realistic rationale is
indispensable; second, the relationship between supply-side structural reform and macroeconomic regulation and control should be clarified in light of China’s current economic situation; last but not least, a practical approach for China to proceed with supply-side structural reform should be outlined based on the outstanding problems facing China’s current economic development and the mandate for economic development during the 13th Five-Year Plan period.

4.2.1 The Three Rationale Behind Supply-Side Structural Reform

First, we have to understand the historical rationale of the supply-side structural reform in the context of the overall process of China’s economic reforms since the reform and opening-up.

China’s economic reform is essentially an innovation of the practice and theory of Marxist political economy, which is oftentimes neglected. Communique of the 3rd Plenary Meeting of the 11th CPC Central Committee pointed out that achieving the four modernizations requires significant improvement of productivity, which inevitably requires a multi-dimensional change of production relations and superstructures that are unfit for the development of productivity, a change of all modes of management, activities and thinking that are unsuitable, hence is an extensive and profound revolution. Appropriate reforms must be conducted to change production relations and superstructures that are unfit for the rapid development of productivity.14

However, how to liberate and bring significant increase to productivity through reforms? How to bring production relations and superstructures in line with the rapid development of productivity? There were no ready answers to these questions in the beginning of the reform and opening-up, which, objectively, means that China’s economic reforms need to “feel its way forward”, allowing and encouraging local experiments, with continuous practice, continuous trial and error and hence continuous accumulation of experience, with continuous exploration into the top design for economic reform, continuous enhancement of conscientious awareness of the practice of economic reform, continuously enriching the theoretical construction of socialism with Chinese characteristics and continuously adding its value as

14 Communique of the 3rd Plenary Meeting of the 11th CPC Central Committee (approved on December 22, 1978).
guidance for China’s economic reform at the same time. From a holistic perspective, China’s economic reform features a dual-way interaction between “top-down” and “bottom-up” efforts.

In retrospect of China’s economic reform since 1978, nearly 40 years of reform practice has been a typical example of “supply-side structural reform” in itself. In a sense, supply-side structural reform is a summary of China’s economic reform trajectory and quintessence of development that include three key words in organic linkage.

First, reform as the backbone. A fundamental view in Marxist political economy is that productivity determines production relations, and that the development of productivity inevitably requires adjustment in production relations, which, nevertheless, do not automatically initiate a self-adaptation process in consistence with the development of productivity. Instead, production relations that fail to adapt to the development of productivity may survive for a considerably long duration until the contradiction between the two accumulate sufficiently to trigger a passive and drastic adjustment of production relations. Reform, on the other hand, takes the initiative to adapt to the objective demand of development of productivity through active adjustment of production relations, which is essentially adjustment of production relations through continuous institutional improvement to liberate productivity.

Second, supply-side as the keypoint. The essential goal of reform is to facilitate the liberation of productivity, of which improving the efficiency of factors of production such as labor, capital, technology, knowledge and information is the pre-condition; these factors are on the supply side. Besides, the development of productivity has a positive impact on the supply of factors, for instance, by increasing savings and boosting human capital.

Third, structure as the distinctive feature. The history of economic development is a history of structural transformation, and economic development is inevitably accompanied by structural transformations of various kinds, including changes in industrial structure, employment structure, consumption structure, ownership structure, urban-rural structure, and so on. These structural factors, being the results of economic policy impact of the previous stage, may influence economic growth as structural factors. In a sense, various structural factors do not necessarily opt for the optimized track for evolution in economic development, since irrational economic policies in the previous stage may cause certain structural factors to deviate from the optimal track for evolution, or to trigger
structural problems in factor allocation on the supply side, eventually hampering the growth of total factor productivity.

Since China’s reform and opening-up, reforms in different phases of development with distinctive characteristics and differentiated key areas of each phase have been implemented, which facilitated structural changes while influencing the allocation of factor resources, though the term “supply-side structural reform” was not yet used at the time. Master plans of economic development targets of each phase as well as overall planning and corresponding measures for deepening the economic institutional reforms were proposed during the five “3rd plenary sessions” of the CPC since China’s reform and opening-up which fully reflected the characteristics of the “supply-side structural reform” corresponding to each phase.

The decision of the 3rd Plenary Session of the 11th CPC Central Committee began the first round of reform and ignited the engine of China’s economic structural reform. This period featured very low average income per capita and a pressing need to alleviate extreme poverty as the population was struggling below the subsistence level. During the 3rd and 4th Plenary Sessions of the 11th CPC Central Committee, Decisions on Certain Questions of Accelerating Agricultural Development was issued, promulgating 25 policies to launch reforms in rural areas and implement the household contract responsibility system on a full scale, which, as the key institutional system in rural economic reform, drastically boosted the economic growth during this period. First, the rural population saw an unprecedented high growth in average income per capita. Between 1978 and 1985, at constant prices, the average net income per capita increased by 2.7 times for rural residents, with an average annual growth of 15.2%. Second, a major decrease was seen in population living in extreme poverty. Based on the poverty threshold in rural area in 1978, the impoverished rural population registered at 250 million in 1978, which reduced to 125 million in 1985, and the occurrence of poverty decreased from 30.7% to 14.8%. According to the poverty threshold of 2010, impoverished rural population in China amounted to 770 million in 1978, which decreased to 661 million in 1985, and the occurrence of poverty reduced from 97.5% to 78.3%\textsuperscript{15}; moreover, rural enterprises created many new jobs, with total employment increasing by 1.47 times from 28.27 million in 1978 to 69.67 in 1985.

\textsuperscript{15} China Statistical Abstract 2016, p. 70, China Statistics Press, Beijing, 2016.
Decision of the second round of reform was made in 1984 at the 3rd Plenary Session of the 12th CPC Central Committee. China was struggling in extreme poverty and had to prioritize subsistence for its population as the country was at the starting point of full-scale reform. According to the task of “systematic economic structural reform” proposed during the 12th CPC National Congress, Decision on Economic Structural Reform was made by the CPC Central Committee, which drafted a blueprint for multi-faceted reform, proposing a planned commodity economy based on public ownership to build a dynamic socialist economic system. This Session opened a new chapter of overall economic restructuring focusing on urban area though the reform was still conducted in the framework of planned economy to address the issues of “insufficient incentives” or “absence of incentives” in the existing institutional system. From this point on, the central government gradually shifted its main approach to managing enterprises from direct control to indirect control, significantly reducing the scale of the planned economy. Mandatory plans, guiding plans and full market-based regulation were implemented based on actual situation and a “dual-track” system was put in place for pricing and other issues. Active measures were taken to diversify ownership models including ownership of the whole people, collective ownership and private ownership, leading to a boost in the private sector. China’s opening-up pattern was preliminarily defined with strategic priority given to the coastal regions to take a pioneering start in development. It can be safely stated that China’s economic reform in the mid-1980s was a transitional phase toward the socialist market economic system.

The third milestone was the 3rd Plenary Session of the 14th CPC Central Committee in 1993, which released the clear statement that the direction for China’s economic reforms was “to build a socialist market economic system”. At this time, China was in a development stage featuring low income and pursuit for a moderately prosperous society. Based on goals and fundamental principles defined in consistence with the 14th CPC National Congress, Decisions on Certain Questions About Building Socialist Market Economic System containing 50 articles were released, identifying key tasks including building a modern corporate system, building a universal and open national market system, shaping and improving macroeconomic regulation and control system, constructing an income distribution system and social security system and so on. These decisions became the fundamental framework and key pillars for the new system and have been inherited by the reforms in later periods. It has to be pointed
out that an important international context for the 3rd Plenary Session of the 14th CPC Central Committee was the collapse of the former Soviet Union and drastic political and social changes in socialist Eastern European countries. China’s brave proposal to build a socialist market economic system against such historical background demonstrated China’s confidence in its path to reach a system of socialism with Chinese characteristics.

The fourth important session was the 3rd Plenary Session of the 16th CPC Central Committee in 2003, ushering China into the phase of “improving the socialist market economic system” as well as the development stage of building a moderately prosperous society as a lower-middle-income country. *Decisions on Certain Questions About Improving Socialist Market Economic System* was released. The document containing 42 articles became the guideline for China’s reform in the first decade of the twenty-first century, greatly boosting the growth and dynamism of market players. In 2002, market players in China (including private enterprises and individual business owners) totaled 32.11 million, which jumped to 54.26 million in 2012, with the proportion of total population increasing from 2.42% to 4.00%. Among these, the number of private enterprises increased from 2.64 million to 10.86 million, an annual growth rate of 15.2% on average; the number of employees increased from 19.99 million to 75.57 million, an annual growth rate of 14.2% on average. This sufficiently demonstrates this period’s significant growth of diversified market players who became the key actors in boosting the economy and trade volume as well as creating new jobs.

The fifth one was the 3rd Plenary Session of the 18th CPC Central Committee as China was entering the stage of “comprehensively deepening reform”, development for building a moderately prosperous society and ranking among upper-middle-income countries. *Decisions of the CPC Central Committee on Some Key Questions About Comprehensively Deepening the Reform* contained 16 parts and 60 articles. It comprises 336 key moves, proposing the guiding philosophy and principles for comprehensively deepening the reform, mapping out the overall target for comprehensively deepening the reform and milestone targets up to 2020, planning for the “five-in-one” reform and institutional reform in national defense and military forces as well as reform in the Party’s construction systems, laying out the strategic highlights, priorities, key directions, working mechanisms, implementation approaches, timetable and roadmap. An example of commercial affairs system reform shows that by 2015,
the number of market players in China (including private enterprises and individual business owners) increased to 77 million, accounting for 5.62% of the total population, an increase of 23 million compared to 2012. Among these, private enterprises employed 111.8 million people and individual business owners employed 78 million people, that is 190 million in total. Up to 2015, according to rural poverty line, the number of impoverished rural residents decreased to 55.75 million, with the poverty occurrence rate falling to 5.7%. It is expected that poverty would be fully eradicated by 2020.

These five third plenary sessions show that China’s reform and opening-up has highlighted three key themes from the very beginning: effectively improve the factor input and allocation on the supply side through reform to facilitate restructuring and optimization in various areas in China. In 2015, China’s per capita GDP registered at 13,571 international US dollars (PPP, international US dollars in 2011), merely 25.7% of that of U.S. (52,704 international US dollars), representing a major gap compared to the U.S. Narrowing down such gap would eventually depend on continuous improvement of productivity. Therefore, supply-side structural reform is the only way to facilitate China’s moderately high growth over the long term, and more importantly, to enable constant structural optimization in various dimensions. This shall be manifested in the continuous decrease of the proportion of agriculture and continuous increase of the percentage of the service sector in GDP, and visible decrease (since 2006) following an increase in the proportion of industry and manufacturing. The population and urban-rural structures will see continuous decrease in rural population and rural workforce and continuous increase in urban population and urban workforce, constant increase in the average years of education for the working-age population as well as in productivity level. Additionally, comparative productivity across different industries shows a tendency of convergence. Despite the differences in TFP growth across stages, China still maintains a high growth from the global perspective despite being lower than some developed countries in relative contribution. Currently, a major constraint for China’s TFP growth is the structural contradiction in its economic development that must be solved

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16 China Statistical Abstract 2016, p. 70, China Statistics Press, 2016.
17 The 13th Five-Year Plan for Economic and Social Development of the People’s Republic of China, March, 2016.
18 Data source: World Bank Database: [http://data.worldbank.org/indicator/](http://data.worldbank.org/indicator/).
by addressing the structural problems in factor allocation on the supply side, which further requires eliminating the low efficiency in factor allocation due to structural contradictions through deepening reforms in all areas, so as to achieve sustainable economic growth and maintain relatively high growth.

Furthermore, the theoretical origins and development trajectory of supply-side reform must be fully understood and the theoretical logic of supply-side structural reform be clarified if such reform is to be correctly interpreted. A typical interpretation of supply-side structural reform is to relate it with the so-called supply-side economics, and to place China’s supply-side structural reform on par with the policies of Reaganomics based on supply-side economics. Therefore, it is necessary to introduce the main arguments of the school of supply-side economics as well as the background and consequences of Reaganomic policies if China’s supply-side structural reform is to be understood in depth.

Supply-side economics has its origins in classical liberalism advocated by French economist Say (1767–1832), who proposed Say’s Law, that is, demand is automatically created by supply, which is the most important statement on demand-supply relationship in classical economics.\(^{19}\)

Economic policies based on Say’s Law basically feature laissez-faire and non-intervention, emphasizing the absolute dominating position of the market, which is exactly the economic policy pursued by major capitalist countries in the beginning of the twentieth century. However, the Great Depression looming over the capitalist world from 1929 to 1933 posed a daunting challenge to economic policies based on classical liberalism. Unlike the idea of automatic market clearing emphasized by Say, Keynesianism with “insufficient effective demand” at the foundation gradually gained popularity in principal macroeconomic policies in capitalist countries.

Keynesianism emphasizes government intervention and control of the economy with demand management at the core. In practice, the New Deal implemented by Roosevelt since 1933 effectively addressed the economic crisis in U.S. through a series of economic policies characterized by

\(^{19}\) Say’s Law is of great significance in classical economic and neo-classical economic theories; it laid an important theoretical foundation for general equilibrium theory in later years. Neo-classical economics emphasizes the absolute effectiveness of the market, believing that automatic market clearing and Pareto optimality are possible.
demand management.\textsuperscript{20} In the wake of World War II, Keynesian economic policies gradually became the universally adopted means of macroeconomic management in capitalist countries.

After capitalist economies soared in the wake of World War II, up to the 1970s, “stagflation”, that is high unemployment rate accompanied by high inflation rate stirred up doubts about Keynesian economic policies, which, centered upon “demand management”, proved ineffective in addressing stagflation. The liberalism school even blamed the stagflation on government intervention of the economy, which inhibited the dynamism of market economy. As a result, supply-side economics represented by the viewpoints of Robert A. Mundell and Arthur B. Laffer was back in the limelight and became the theoretical foundation for the economic policies of the Thatcher administration in the U.K. and the Reagan administration in the U.S. Economic policies implemented by the Reagan administration, nicknamed “Reaganomics”, included supporting free market competition, deregulation for enterprises, reducing tax and public expenditures, advocating balanced budget, emphasizing combating inflation by controlling money supply. In general, the “stagflation” problem was resolved during Reagan’s presidency\textsuperscript{21} even though it remains disputable whether the alleviation of stagflation in the U.S. was a result of Reaganomic policies. However, the sequela of Reaganomics was quite visible. The U.S. fiscal deficit continued to aggravate during the Reagan administration and even became “normal” for the U.S. economy during Reagan’s presidency until the mid-1990s. Meanwhile, the income disparity was also worsening.

In essence, Reaganomics is neoliberal economics with “omnipotence of the market” at its core, which tends to label necessary and helpful governmental regulation as “distorting the market and creating inequality”; its

\textsuperscript{20}The contents of the New Deal include: reorganizing the financial system, rebuilding the banking and credit system, abolishing the gold standard, stabilizing agricultural product prices by government subsidy, launching public works as a relief for the unemployed, creating jobs and stimulating consumption, improving the social insurance system, formulating the Social Security Act and other acts concerning labor protection, reforming administrative institutions, emphasizing the budgeting function of the federal government.

\textsuperscript{21}The inflation rate in U.S. decreased from 10.35% when Reagan took office (in 1981) to 3.55% at the end of his first term of presidency (in 1985), and remained on a moderate level during his second term. The economic growth generally remained above 3.5% from 1983 to 1989 with the negative growth in 1982 as the only exception, indicating that the overall growth was better than the 1974–1980 period.
policies, opposing to government intervention, aim to boost the proportion and role of the private sector through free trade, open market, privatization, deregulation, tax cuts and public expenditure reduction. Nevertheless, in light of the transformation of Latin America, the former Soviet Union and East European socialist countries from the late 1980s to the early 1990s and the Asian Financial Crisis in the late 1990s, many failures of the “Washington Consensus” prescribed based on neoliberal economics have been witnessed in the developing world and the countries in transition. The eventual results of pursuing neoliberal economics are weakened macroeconomic regulation capacity of the government, market disorder, aggregation of systematic risks in economy, all of which will eventually result in economic crises and social turbulence. Even developed countries, such as the U.S., have failed to free themselves from the consequences of neoliberal economic policies as a matter of fact, with their economic development still troubled by aggravating income gap and soaring deficits. In a sense, the global financial crisis triggered by the sub-prime mortgage crisis in the U.S. indicates another typical failure of the adoption of neoliberal economic theory in the financial sector.

It has to be noted in particular that although supply-side economic theory as the basis of Reaganomics and the “supply-side structural reform” currently highlighted in China pursue a similar goal of revitalizing the economy and boosting economic growth, distinct differences do exist in policy goals and development stages between China’s supply-side structural reform and Reaganomics.

The first and foremost goal of Reaganomics is to curb inflation. The stagflation looming over the U.S. economy in the late 1970s was related to the energy price hike due to the blow on oil supply and the rising military expenses to a large extent, resulting in the stagnation of economic growth and inflation at the same time. Yet despite the minor inflation pressure, China is now burdened by severe structural overcapacity that is causing distortion in resource allocation. Besides, despite the slowdown in economic growth, China is still maintaining a moderately high-speed growth of approximately 7%, which is distinct from what the

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22 From 1973 to 1981, the U.S. economy entered into a period of continuous high inflation, with average inflation rate reaching 9%, marking a period of high inflation over a relatively long term after the Great Depression.

23 For example, CPI has been staying under 3% since 2012; while deflation is seen in PPI for a succession of 45 months since March 2012.
U.S. experienced in 1980 when the country was trapped in negative growth. This has created conditions for China’s supply-side restructuring from an objective perspective.

Concerning the development phase, the current economic structure in China shows clear difference from the U.S. economy during Reagan’s administration. In 1980, the urbanization rate of the U.S. was 73.74% and added value of the service sector in GDP registered at 63.57%, employing 65.70% of the working population in the U.S. All these indicators are typical of developed economies. In contrast, China’s urbanization rate in 2015 was 56.1%, with added value of the service sector accounting for 50.5% of GDP, employing 42.4% of the working population in China, and the income level of the Chinese population remains in the middle-income range.

The two differences illustrated above determine that China’s policies of supply-side structural reform must avoid repeating the economic policies implemented by Reagan in the 1980s, with Reaganomic policies highlighting tax cuts (especially for capital income and the rich) and deregulation in an effort to tackle stagflation. China, on the other hand, focuses on economic restructuring and transformation of the economic development model as the core of its supply-side structural reform, aiming to improve TFP by developing the adaptability and flexibility of the supply structure. Therefore, China’s supply-side structural reform is essentially distinct from the U.S. policies in the early 1980s based on Reaganomics in terms of policy target and development stage. In this sense, directly applying Reaganomic policies to China’s supply-side structural reform would be a mismatch and a misconception, hence China’s supply-side structural reform should by no means be taken as the Chinese version of “Reaganomics”.

Furthermore, a key contributor to China’s successful economic reforms is the country’s self-awareness and autonomy in implementing the economic reforms. From the perspective of self-awareness, during the implementation of economic reforms, China did not miss the right timing for reform and development due to overcaution in facing various possible

24 In 1980, the marginal tax rate for individual income tax in the U.S. ran as high as 70% at the maximum; while the maximum corporate income tax registered at 46%. Despite the visible economic recovery in the U.S. during the Reagan administration as compared to the mid-1970s and 1980s, many analysts believe that such recovery was not completely attributable to Reagan’s economic policies.
risks triggered by reform; while from the perspective of autonomy, China’s economic reforms are based on the reality of the country’s economic development with readiness to adapt to the objective trend of economic globalization rather than blindly copy the so-called international experience. For example, when making the decision to build the socialist market economic system, China refused to blindly adopt the approaches prescribed in the “Washington Consensus”. Likewise, the current supply-side structural reform in China also reflects the self-awareness and autonomy in pressing ahead with economic reforms.

Thirdly, as China’s economic growth enters into the “new normal”, supply-side structural reform has its rationale in reality. The downturn of China’s economic growth is not only a pressing issue of the current economic fundamentals but also has raised global concerns, as China is not only the second largest economy (in exchange rate) or the largest economy (in purchasing power parity) but also the biggest trading country in the world. Therefore, the future trend of China’s economy will have a direct spillover effect on 240 countries and regions in the world, which is especially true to 130–140 countries and regions for which China is an important trading partner. This is the biggest difference from the economic reforms from the previous stages. A clear understanding of the realistic rationale of the supply-side structural reform is, in itself, a correct answer to why supply-side structural reform should be identified as the backbone in the 13th Five-Year Plan period. Sticking to the backbone is to focus on the principal factors determining economic development and main contradictions to be addressed for future economic growth. Once these factors are clear, the details will fall into place. This in turn requires a clear understanding of two major questions facing the current economic growth: first, how to correctly interpret the economic downturn during the 12th Five-Year Plan period? Second, how to secure growth by restructuring during the 13th Five-Year Plan period rather than boosting domestic demand in 1998 and 2008 in the context of financial crisis?

The economic slowdown during the 12th Five-Year Plan period highlights the necessity for supply-side structural reform. China’s average economic growth stood at 9.6% between 1978 and 2015, on par with Japan’s average economic growth of 9.35% between 1950 and 1972 and higher than that of South Korea (8.6%) between 1961 and 1996. In terms of 25 GDP calculated in US dollars of 1990, data source for calculation: Angus Maddison, 2011, Historical Statistics of the World Economy: 1–2008 AD.
economic fluctuations, China’s rapid economic growth was not exempted from several rounds of temporary decrease (see Fig. 4.3), including the forced adjustment from 1978 to 1981 resulting in a slowdown from 11.6% to 5.1%, a second round of forced adjustment between 1984 and 1990 resulting in a slowdown from 15.2% to 3.9%, a fallback from 14.3% to 7.6% during the 1992–1999 period and a further slowdown from 14.2% to 6.9% from 2007 to 2015. In general, China’s economic growth shows more stability since the reform and opening-up, in particular, no major boom and bust characteristics of the planned economy occurred in China since 1992, indicating the country’s maturing capability of macro regulation and control. Overall, changes in the economic growth rate are the result of combined effects of external demand factors (or cyclical factors), internal structural factors and macro regulation and control. However, each round of adjustment involves economic restructuring that in turn lays the foundation for growth in the next phase.

China’s economic growth has entered into the “new normal” since 2011, with growth gradually slowing down from 9.5% in 2011 to 6.9% in 2015 (falling below 7% for the first time since 1991). An important viewpoint on such downturn is that China’s economy is impacted by cyclical factors, that is, its growth hampered by the slowdown (or even negative growth) of external demand. With regard to external demand, the 2008...
global financial crisis did deliver a heavy blow on China’s economy, which is directly related to China’s openness and deep involvement in the world economy. In light of the current world economic fundamentals and China’s economic growth trend in recent years, the sluggish or even shrinking external demand does explain, to a large extent, China’s economic growth downturn: during the 12th Five-Year Plan period, the proportion of China’s import and export volume of goods in GDP shrank from 49.16% in 2011 to 35.74% in 2015, which was even lower than prior to China’s entry into WTO (38.8% in 2001).

In the wake of the financial crisis, the world economy has been ushered into a period of fluctuation, transition, transformation and adjustment with clashes of old and new thinking modes, shift from obsolete to emerging driving forces, comparison of conventional and unconventional powers and alternation of traditional and newly established rules. In general, the world economy in recent years has been facing a new reality characterized by “low growth in trade, sluggish economic growth and high public debt” as it undergoes structural changes, generally turning for the better and yet facing tremendous uncertainties. On one hand, the role of emerging economies as an engine for world economic growth is weakening and disintegrating; on the other hand, the contribution of developed economies for boosting growth is too limited to enable a smooth recovery of the world economy. Moreover, uncertainties that may influence world economic growth should by no means be overlooked. For instance, the negative interest rate policy implemented respectively by the European Central Bank at the end of 2015 and by Bank of Japan in late January 2016 has confronted the stability of the global financial system with new uncertainties; economic growth in Europe is highly likely to suffer from the consequences of Brexit, which will in turn trigger a profound impact on the global capital market. Besides, Donald Trump’s vowing into presidency and the interest rate hike in the U.S. will also prove to be pivotal factors influencing the world economy. Altogether, the negative impact of the “reverse-globalization trend” emerging in recent years on the growth of

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26 Chen Wenling, Yan Shaojun, New Trends and New Characteristics of World Economic Development of Today [J], Nanjing Social Sciences, 2016 (5): 1–9.

27 In October 2014, Christine Lagarde, Managing Director of IMF, pointed out that the world economy entered the “new mediocre”, that is, low growth over the long term. In April 2015, she warned again that we must prevent the “new mediocre” from evolving into the “new reality” of lower growth today.
global trade and world economic growth inevitably constitutes an adverse impact on China’s economic growth.

Although the impact of external factors on China’s economic growth should by no means be overlooked, it would be too much of a one-sided view to argue, on this basis, that the major problem currently confronting China’s economy is a cyclical one, as the impact of structural problems on China’s economic growth is not to be neglected. The cyclical factors arising from the global financial crisis caused China to launch a massive economic stimulation plan from late 2008 to 2010 to “stabilize the growth”, which in turn aggravated the structural contradiction of China’s economy and became increasingly visible during the 12th Five-Year Plan period. Therefore, the sluggish external demand is the external and secondary cause for the economic downturn in recent years while structural problems prevailing in the domestic economy is the internal and primary cause.

A significant factor exacerbating the structural problem of China’s economy is the impact of real estate investment on economic growth (see Fig. 4.4). Prior to the global financial crisis, the nominal growth rate of real estate investment in urban China reached 27.4% between 2000 and 2007, close to twice the nominal GDP growth (15.1%). After the outbreak of the global financial crisis, the growth rate of urban real estate investment shrank to 14.1% in 2009 and bounced back to 32.8% in 2010. The beginning of the 12th Five-Year Plan period saw a significant decline

![Fig. 4.4 Urban real estate investment and growth (2000–2015). (Data Source for Calculation: National Bureau of Statistics: China Statistical Abstract 2016, p. 91)](image-url)
in urban real estate investment growth, hitting 0.38% in 2015, resulting in the economic downturn in recent years. More importantly, the sluggish growth in real estate investment directly led to declining demand growth in sectors closely related to real estate investment (such as coal, steel, cement, construction materials), hence constituting a key cause for over-capacity in coal and steel industries, and so on, resulting in the current pressure of de-inventory and de-capacity. Furthermore, in an effort to combat the international financial crisis, the economic stimulation plan launched in late 2008 encouraged banks to grant loans to real estate, steel, cement, and so on. With enthusiastic support from the local government, local financial platforms also received massive credit loans from the bank. The explosive expansion of trust loans between 2011 and 2013 resulted in mounting debts and continuously growing leverage of local governments, which has contributed to the de-leveraging pressure of today.

During the 13th Five-Year Plan period, supply-side structural reform has become the key item on the economic development agenda. Despite the economic downturn during the 12th Five-Year Plan period, visible achievements have been made in economic restructuring, which is in line with the direction of economic restructuring aiming at long-term economic growth. On a macro level, restructuring during the 12th Five-Year Plan period is mainly manifested in the following aspects: visible decrease of the proportion of the secondary industry and significant increase of the proportion of the tertiary industry. The proportion of the tertiary industry rose from 44.2% in 2010 to 50.5% in 2015, that is, an increase of 6.3 percentage points; while the proportion of the secondary industry dropped from 46.2% to 40.5%, that is, a decrease of 5.7 percentage points, both rates of change are significantly higher than all previous five-year plan periods. Furthermore, restructuring will inevitably trigger changes in the growth momentum, yet there tends to be a time lapse between the obsolete momentum phasing out and the new momentum playing its leading role. In the case where the recession of the obsolete momentum is much faster than the growth of the new momentum, economic growth would stay sluggish for a short term. Therefore, the economic slowdown is but a natural result of restructuring. A comparative analysis of the average provincial GDP growth and the rate of change of the secondary and tertiary

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28 The proportion of the primary industry only dropped by 0.6 percentage point from 2010 to 2015, much lower than other Five-Year Plan periods. In 2010, the proportion of the primary industry in GDP was 9.6%, which has basically entered into a period of slow change.
industries during the 12th Five-Year Plan period (see Fig. 4.5) shows, to a certain extent, a negative correlation between GDP growth and the change of the proportion of the tertiary industry as well as a positive correlation between GDP growth and the change of the proportion of the secondary industry, that is, in regions with sharp increase of the tertiary industry and sharp decrease of the secondary industry would see comparatively sluggish GDP growth. Therefore, considering the structural factors, the economic slowdown during the 12th Five-Year Plan period was reasonable and should not have prompted excessive pessimism, not to mention that the average economic growth during this period registered at 7.8%, which, although lower than 9.9% growth between 1978 and 2010, still exceeded the expected target of 7%.

In terms of comprehensive development indicators, the quality of economic growth improved significantly during the 12th Five-Year Plan period, as indicators of industrial structure, urban-rural structure, science and technology (except for the proportion of R&D expenditures in GDP), education and environment have basically achieved the expected goals of the 12th Five-Year Plan period. An evaluation of all previous five-year plans based on the method of goal congruence shows that the fulfillment rate was 64% for the 10th Five-Year Plan, 86% for the 11th Five-Year Plan and 96% of the 12th Five-Year Plan. Therefore, it can be seen that the
comprehensive fulfillment rate of the 12th Five-Year Plan was higher than that of the two previous five-year plans despite the economic downturn during this period, and this has created favorable conditions for moderately high economic growth and implementation of supply-side structural reform during the 13th Five-Year Plan period. Generally speaking, the structural changes emerging during the 12th Five-Year Plan period were fundamental; they were positive and benign long-term changes that were basically consistent with the long-term development trend of China’s industrialization (in the later stage of decrease of the proportion of secondary industry) and urbanization (in the stage of rapid growth of the proportion of urban population), with continuous upgrading in the consumption structure of residents (in particular, Engel’s coefficient for both urban and rural residents fell to 30% approximately, marking the attainment of a better-off level),\(^29\) this is in line with the fundamental direction of China’s economic restructuring and optimization over the long term.

Despite the remarkable achievements of China’s economic restructuring during the 12th Five-Year Plan period, the structural problems remain prominent and the restructuring efforts are far from sufficient, with the pressure of “stabilizing growth” and the challenge of “restructuring” co-existing, which, if not properly handled, would tumble into aggravated contradiction. On one hand, economic growth during the 13th Five-Year Plan period remains an important indicator measuring development during this period, as whether China would achieve its goal to double the country’s economic size by 2020 on the basis of 2010 is at stake. A well-grounded understanding of the economic growth during the 13th Five-Year Plan period must be based on a thorough evaluation of the potential growth of China’s economy, which refers to the achievable growth on the condition of effective allocation of economic factors that can be sustained over a considerably long term. Multiple evaluations exist for China’s potential economic growth in the future. For example, Cai Fang believes that the country’s potential economic growth during the 13th Five-Year Plan period is 6.2%,\(^30\) his main argument being the workforce shortage resulting from the aging population and the subsequent decline in returns on capital investment; Zhang Jun, on the contrary, argues that China’s

\(^{29}\)In 2015, Engel’s coefficient was 30.6% for all residents in China, 29.7% for urban residents and 33.0% for rural residents.

\(^{30}\)Cai Fang: Growth Potential + Reform Dividend—How to View China’s 7% Economic Growth in the First Half of the Year, People’s Daily, 2015-8-5(2).
potential growth rate for the next decade is approximately 7%–8%, mainly for the reason of the major per capita income gap between China and developed countries; Justin Yifu Lin, on the other hand, believes that China could achieve an 8% potential economic growth for at least another ten years, with similar argument that the per capita income for Chinese residents is on a relatively low level, hence will still benefit considerably from the late-mover advantage.

Based on a multi-dimensional consideration of the late-development advantage, the momentum of industrial restructuring, the driving force of urbanization, the aggregate effect and economies of scale of human capital and the innovation-driven potential, it can be reasonably and safely stated that China’s potential economic growth rate is likely to stay close to 7% in the next decade. The economic growth target established in the 13th Five-Year Plan is above 6.5%, which is the bottom line for economic growth but not without some margin of adjustment; it does not exceed China’s potential economic growth rate while leaving adequate room for restructuring. In the long run, structural factors remain the key determining factors for China’s potential economic growth rate in the future, which, if properly handled, would be crucial for aligning the actual growth rate with the potential growth rate for China’s economy in the future.

In terms of external demand, if the “new reality” becomes the “new normal” for the world economy, China would reduce itself to a passive position in “stabilizing growth” if we identify our hopes to overcome the current economic dilemma in improved external demand. Therefore, restructuring must aim at securing the initiative for stabilizing growth. China’s economic growth rate in the future will both depend on the external demand factor (or cyclical factor) and, more importantly, restructuring at a deeper level. Considering structural factors, a key driving force for China’s rapid economic growth since the reform and opening-up is the continuous optimization of the economic structure. Currently, the structural problem is particularly visible in the high inventory of real estate and over-capacity of certain industrial sectors with hiking leverage and soaring costs of business operation. From 2012 to 2016, China’s PPI (producer

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31 Zhang Jun: Potential Growth Rate of China’s Economy, The Financial Times (Chinese), 2013-10-28.
32 Justin Yifu Lin: China’s Economy Possesses Potential to Maintain 8% Growth for At Least Another 10 Years, The Economic Daily, 2015-3-22 (4).
33 On February 23, 2016, New Year gambling hints at Chinese entrepreneurial vigour published on The Financial Times cited BIS estimation that by the end of the second quarter of
price index) underwent deflation for a succession of four years, demonstrating that the major problem prevailing in China’s economy is on the structural level, with visible overcapacity in traditional industrial manufactured goods and capacity utilization rate of certain industries apparently lower than the international level. This shows that China’s traditional industrialization is running into a dead end and that the poor efficiency of factor allocation is highly likely to cause mounting financial risks. To solve these problems is the short-term goal of supply-side structural reform, which, nevertheless, is unlikely to be achieved within a matter of one, two or a few years’ time.

China is at a critical moment with its economic growth shifting gears, labor pains in restructuring and a process to digest the stimulation policies in the previous stage “overlapping” with one another. With profound transformation of the strategic window of opportunities, China is still facing daunting challenges in seizing and leveraging on this strategic window, especially considering that TFP improvement and steady economic growth are constrained by the outstanding structural problems accumulated over the long term. In this sense, pressing ahead with supply-side structural reform on a deeper level is not only a palliative to address the current structural contradictions, but also a far-sighted move to create strategic opportunities for sustainable economic development in the future. During the 13th Five-Year Plan and even a longer period, China will carry on with its restructuring efforts and its economic growth rate will be subject both to the impact of internal and external demand and to the actual allocation of supply-side factors, that is, structural factors to a large extent. Changes in China’s future economic structure will still be seen in the changing proportions of the secondary and tertiary industries. Therefore, identifying supply-side structural reform as the cardinal line of economic development during the 13th Five-Year Plan period is consistent with the realistic need of China’s sustainable economic development over the long term. Stabilizing growth through restructuring at a deeper level is on the top of the current economic development agenda.

The 13th Five-Year Plan has explicitly identified supply-side structural reform as the priority for development, indicating that it does not only
focus on addressing the highlighted structural contradiction currently facing China’s economy, but also aim at mid- and long-term economic development of the country. In terms of the short-term goal, the main tasks such as de-capacity and de-inventory identified during Central Economic Work Conference must be accomplished, not to ignore stabilizing growth and reducing risks. From a mid- to long-term perspective, the fundamental goal of supply-side structural reform is to accelerate the transformation of the economic development model and to improve labor productivity and TFP so as to stabilize potential economic growth. In particular, the 13th Five-Year Plan highlights green development while emphasizing restructuring. The Chinese government has pledged to achieve the peaking of CO₂ emissions around 2030 and to make best efforts to peak early. This shows that emission reduction and environmental quality improvement would be binding conditions for China’s long-term economic growth as well as important structural factors influencing such growth in the future. In this sense, structural issues are the long-term factors at play for China’s economic development.

4.2.2 Supply-Side Structural Reform Ushers in China’s New Normal

Theoretically speaking, implementing supply-side structural reform has three implications. First, on a micro level, it requires improvement of allocation efficiency of production factors on the supply side as well as higher TFP for the transformation of growth drivers. Second, on a meso level, it implies optimization of economic structure, reducing ineffective demand through de-inventory and de-capacity while expanding effective demand and innovating demand models through development of new industries and creation of new business models to rectify the mismatch between supply and demand, and hence enabling economic development to build upon the dynamic equilibrium between supply and demand. It must be pointed out, however, that supply-side structural reform is not a synonym of “shock therapy” of economic restructuring, which is the normal for

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34 On November 12, 2014, U.S.-China Joint Announcement on Climate Change was officially published by the heads of state of China and the U.S. On September 3, 2016, at G20 Summit in Hangzhou, Chinese President Xi Jinping and U.S. President Obama successively submitted documents of approval of the Paris Climate Change Agreement to UN Secretary-General Ban Ki-Moon.
China’s economic development and a long-term mission; instead, such structural reform must remain aligned with the objective demand of economic restructuring. Third, on an institutional level, synergy of reform should be built by in-depth execution of various institutional arrangements (such as decentralizing and organizational streamlining, facilitating new urban construction, deepening SOE reform, deepening capital market reform, accelerating the implementation of innovation-driven development strategy), with the market playing a decisive role in resource allocation. Meanwhile, the government shall play an active role where the market fails to function (e.g. environmental protection, poverty alleviation, provision of public services, anti-monopoly, basic research, etc.).

In general, supply-side structural reform was proposed in the context of China’s practice of economic development and reform and represents a new exploration of the CPC Central Committee into China’s economic development theory since the 18th CPC National Congress; it is gradually shaped based on the principal issues and milestone targets of China’s economic development both currently and in the future. The idea of supply-side structural reform is proposed in light of some prominent difficulties facing China’s economy in the current stage (such as excessive inventory of real estate, overcapacity, soaring debts, high costs burdening enterprises), the solution of which constitutes short-term goals for supply-side structural reform yet it would be unrealistic to expect such goals to be achieved within one or two years. Therefore, no once-for-all or instant

35First, “enabling the market to play a decisive role in resource allocation” was first proposed during the 3rd Plenary Session of the 18th CPC Central Committee in 2013, followed by President Xi Jinping’s statement in 2014 that China’s economy has entered into the “new normal”, whose main features are summarized from the aspects of growth speed, economic structure and growth momentum, that is, from high speed growth to moderately high speed growth, continuous optimization and upgrading in economic structure, switching from investment-driven to innovation-driven growth. Third, in 2015, the five development concepts described as “innovation, coordination, greening, opening-up and shared” development were first proposed at the 5th Plenary Session of the 18th CPC Central Committee, focusing not only on the transformation of the economic growth model but also on that the achievements of economic development should be shared by the people. Fourth, in 2015, President Xi Jinping stated that “efforts should be made to strengthen Supply-side structural reform” for the first time during the 11th Session of the Leading Group for Financial and Economic Affairs, which was further clarified at the Central Economic Work Conference. Furthermore, in the group study organized by the Politburo at the end of January 2016, “pressing ahead with structural reform, especially on the supply side” was identified as a strategic highlight in the 13th Five-Year Plan.
solution possibly exists for supply-side structural reform due to the long process of China’s urbanization and transformation of the demand structure, which corresponds to the stage of China’s development from a moderately high-income country to a high-income country. This, from an objective point of view, determines the importance, necessity and long duration of the supply-side structural reform.

From 2010, China has ranked among the upper-middle-income countries in terms of economic development level. The “new normal” during the 12th Five-Year Plan period featured a slowdown in economic growth, a change of gears, and in-depth economic restructuring, which have built a solid foundation for supply-side structural reform. In light of the current development state, China’s economy is at a critical moment of transitioning to the next phase: new urbanization construction has entered into the key stage, with urbanization rate in China reaching 56.1% in 2015, which is expected to exceed 60% in 2020 and approximately 70% in 2030. China’s economic restructuring in a post-industrialized society is also in a pivotal phase. With industrial structure upgraded from an industry-dominated one to a service-dominated one, it is expected to attain relative stability by 2030, with industrial output accounting for around 23% of GDP while the percentage of service sector in GDP exceeding 60%, making it a key period in overcoming the “middle income trap”. It is estimated that China’s national income per capita shall rank among high-income countries by 2025. A holistic overview shows that the period from now up to 2030 represents a critical stage for China’s industrial restructuring and transformation in the economic growth model driven by industrial and consumption upgrading, during which pressing ahead with supply-side structural reform on a deeper level bears strategic significance for China’s economy to evolve into a more advanced stage featuring more efficient models, more sophisticated division of labor and a more rationalized structure.

4.2.3 How to Promote Supply-Side Structural Reform: The Formula

As the country’s economy evolves to a more advanced phase, it has to confront a more sophisticated economic growth as well as more daunting challenges of industrial restructuring and upgrading at the core of this growth. Economic restructuring indicates varying growth rates among industries, some of which are in a fast-growing cycle while others are in
decline. Therefore, both “addition” and “subtraction” are seen in the industrial development trend. Besides, upgrading of industrial structure includes both continuous improvement in technical competence and capacity building for green development in various industrial sectors with effective containment of risks in different links of economic growth; thus, industrial structure upgrade requires “multiplication” and “division” as well. Based on the above analysis, deepening supply-side structural reform is a wise combination of “addition, subtraction, multiplication and division” in the industrial structure adjustment and upgrading by comprehensively leveraging on the policy portfolio for optimized economic structure and higher level of sustainable development in economic growth. The following formula shows how the arithmetic fundamentals—addition, subtraction, multiplication and division—are used to facilitate supply-side structural reform.

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\text{Policy portfolio} = \left[ \text{Increase effective supply} + \text{eliminate ineffective supply} \right] \\
\times \frac{\text{Innovation-driven}}{\text{Green development}}
\]

“Addition” refers to the expansion of new space for economic development, building room for basic sectors (such as agriculture) in the national economic system, and meeting the demand for people’s wellbeing and expectations for higher quality of life as well as building up the effective supply capacity. This includes higher levels of professional, scaled-up and modernized agricultural production and advancement in agricultural industrialization and market-oriented development to satisfy people’s demand for high quality agricultural products; facilitation of emerging industries of strategic significance and acceleration in industrial restructuring in the manufacturing sector to boost the development of new products, new industries and new business models; adaptation to the trend of higher proportion of the service sector in national economy and acceleration of its overall development through institutional innovation, lowering the bar for private capital to invest in high-end services to release the potential of private capital in boosting the development of the service sector, especially in areas related to people’s wellbeing and quality of life such as elderly care, health services, tourism, culture and entertainment and so on. Efforts should be made to promote coordinated regional development.
and to build a solid foundation for “new space” of regional development, pressing ahead with the three regional strategies, that is, coordinated development of Beijing, Tianjin and Hebei, the Yangtze River Economic Belt and the Belt and Road Initiative, conscientiously implementing the new urbanization strategy, quickening up the pace to enhance the urbanization rate for the registered population and exploring for various public-private partnership (PPP) models in infrastructure and public utilities.

“Subtraction” refers to the elimination of ineffective supply, obsolete productivity as well as institutional barriers restraining economic agents from active engagement and unnecessary government intervention of corporate activities, thereby stimulating the dynamism of enterprises as micro-agents. At present, efforts in de-capacity and de-inventory should continue, building on the basis of preliminary success in these areas. Discriminatory institutional environment placing private capital at a disadvantaged position should be reversed while regulations and practices impeding single market and fair play should be abolished, so as to eliminate institutional discrimination against private capital in its access to industries. Investment scope should be broadened for private capital by implementing measures to relieve tax burdens for enterprises and raise the taxation threshold for small, medium-sized and micro enterprises. Optimizing the development pattern of state-owned enterprises also depends on “subtraction” with the following key tasks identified: stripping non-core businesses with poor market competitiveness and low profitability which are not serving public benefit; eliminating “zombie enterprises” among SOEs and building up the scale, quality and competitiveness of SOEs by lean management and core capacity building.

“Multiplication” refers to shaping an innovation-driven development model in all aspects, with innovative development ranking first among the five development concepts proposed in the 13th Five-Year Plan and “innovation-driven” as a major indicator of economic and social development during the 13th Five-Year Plan period. In general, innovation as a driving force will impact all dimensions of transforming the economic growth model and produce a multiplier effect in industrial upgrading and economic growth quality improvement. The success of “multiplication” will depend on three pillars: first, building an innovation input mechanism in society with institutional innovation playing a steering role, while improving the national innovation system; second, reviewing the income distribution system with more incentives for those possessing science and
technology expertise, thus inspiring various stakeholders to innovate; third, allowing capital markets to function as a catalyst in translating innovation findings into application, deepening the reform of capital markets and shaping a capital market environment that encourages innovation and entrepreneurship, quickening the pace of transformation of scientific and technological achievements, thereby achieving a healthy development of innovation with application of science and technology. In general, as China strides toward the bar of high-income countries, the “multiplication effect” of innovation as a driving force would play a decisive role.

“Division” refers to the reduction of resource consumption, pollution and emissions per unit of GDP. For example, saving energy and water while cutting emissions of waste water, exhaust gas, solid waste and CO₂, essentially aiming to achieve green development and building capacity for sustainable development. An overview of the implementation of the 11th and 12th Five-Year Plans shows that targets related to natural resources and the environment have been by and large achieved; while 10 among 25 targets during the 13th Five-Year Plan period are under the category of natural resources and environment, all of them being obligatory, indicating that green development is promoted to a new height of overall national development. Success in “division” depends on both stronger social awareness of green development, the facilitation of which being integrated in every link of production and daily life, and the establishment of a set of strict “division” standards of energy saving, consumption reduction and emission cut as the baseline in production, which is to be conscientiously implemented without compromise. Additionally, guiding policies such as green finance (the strict implementation of green standard in government procurement) encourage green production by enterprises and green consumption by citizens. In general, the success of “division” is to facilitate green development, which influences every dimension in improving the quality of China’s economic growth and helps to consolidate the foundation of sustainable development, ensuring the steady and sustainable development of China’s economy.

It has to be pointed out that the application of these four “arithmetic fundamentals” in various fields are not isolated from one another; on the contrary, policy portfolios incorporating “addition, subtraction, multiplication and division” should be developed based on actual needs, leveraging on the synergy of different policy measures, adapting to and actively leading the new normal of economy. These policy portfolios include: (1) fully leveraging on “multiplication” for “addition”, for example, boosting
the development of new industries and business models with technological innovation, of which the currently thriving “platform economy” is a typical example. (2) “Subtraction” based on the standards of “division”. For example, “division” standards may be set for energy use, resource consumption, pollution and emissions of industrial sectors undergoing de-capacity, eliminating enterprises that fail to comply with the standards. (3) “Multiplication”-enabled “division”, that is, promoting energy saving, consumption reduction and emission cut among enterprises through technological innovation.

In addition, continuing with supply-side structural reform is not a risk-free move, especially considering the release of internal risks such as social risk triggered by unemployment due to restructuring in certain industrial sectors and financial risk due to various structural factors. In the meantime, changes in external economic environment (for instance, the impact of de-globalization on world trade growth) may also put pressure on China’s efforts to stabilize its economic growth and to optimize its structure, which may be regarded as external risks. Apart from active prevention and early identification of these internal and external risks, proactive countermeasures are also needed through macro regulation and control; that is to say, in pressing ahead with supply-side structural reform, various measures of massive regulation and control need to be taken, enabling fiscal policies, monetary policies, foreign trade policies and investment and funding policies to play their roles in stabilizing growth and alleviating risks.

In order to create a favorable social environment for the deepening of various reform schemes, internal risks such as social risks can be effectively circumvented and controlled by targeting the weaknesses. De-leveraging should be continued as a proactive measure to mitigate and prevent financial risks, which, to some extent, may create conditions for reducing costs. To tackle external risks, we should provide guidance for Chinese enterprises to go global, actively engage in various regional economic organizations and forums and firmly oppose the trend “de-globalization” in any disguise. External risk assessment and stress test should be strengthened in all areas such as international trade, outbound investment, regional economic cooperation, foreign exchange reserves and stabilization of exchange rate to avoid passivity. In a word, with deepening supply-side structural reform and increasingly sophisticated relationships between stabilizing growth, restructuring and controlling risks, it is necessary to stabilize growth by means of macro regulation and control in order to
prevent risks deriving from releasing too quickly, which may result in a more challenging situation of restructuring.

On the whole, the key to deepening supply-side structural reform is to adapt to the objective trend of China’s economic development, taking the initiative to adapt to the “new normal” and actively guiding it with policy portfolios of “addition, subtraction, multiplication and division” as well as effective containment of various internal and external risks. This will help facilitate China’s economic restructuring and transformation in economic growth model, enable its economic transformation and upgrading, with its growth momentum shifting from investment to consumption and its leading sector from industry to services, eventually making China’s economy better in steadiness, quality and sustainability as it moves toward a more advanced stage of development, enabling it to better fuel the world economic growth in a sustainable manner.

4.3 Supply-Side Structural Reform: China’s Practical and Theoretical Innovation

For the first time in history, “supply-side structural reform” was stated in The 13th Five-Year Plan for Economic and Social Development of the People’s Republic of China as the theme of the Five-Year Plan, epitomizing the three key words—“reform”, “supply-side” and “structural” since the reform and opening-up while functioning as the backbone for China’s economy to enter and lead the way of the “new normal”. A statement of President Xi Jinping explains this reform fully: “the key to supply-side reform is to liberate and develop productivity, promoting restructuring through reform, reducing ineffective and low-end supply while expanding effective and mid-to high-end supply, strengthening the adaptability and flexibility of the supply structure to changing demands and improving total factor productivity”. “In terms of political economy, the essence of supply-side structural reform is to enable China’s supply capacity to satisfy the people’s constantly rising, upgrading and personalized material, cultural and eco-environmental demands, so that the aim of production in a socialist economy can be achieved”. Supply-side structural reform is essentially the constant adjustment of production relations. It adapts to

36 Xi Jinping, Speech on the Workshop of Studying and Implementing the Principles of the 5th Plenary Session of the 19th CPC Central Committee for Key Officials on Provincial and Ministerial Levels, January 18, 2016, People’s Daily, May 10, 2016.
productivity while liberating and developing productivity, reflecting both the fundamental principles of Marxist political economy and China’s practices and theories in the context of China’s reform and opening-up today.

Primarily an interaction between China’s innovation in practice and in theory, supply-side structural reform is the guiding theme of the country’s future economic development and transformation of the development model, providing a theoretical foundation and a political consensus for the next step in practical innovation. As it is well said by Mao Zedong: correct ideas come from nowhere but social practice. Once correct ideas representing the advanced class are mastered by the mass, they shall transform into material forces to rebuild the society and revolutionize the world.37

37 Mao Zedong, Where Do Correct Ideas Come From? Selected Writings of Mao Zedong, Volume VIII, pp. 320–321, The People’s Publishing House, 1999.
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