Chinese Rebalancing: Transitioning from the 12th to the 13th Five-Year Plan

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On the surface, it doesn't seem like the vaunted transformation of Chinese economy is going according to plan. The consensus view in the West is, in fact, one of great concern over the current state of the world's second largest economy. Those concerns are understandable at a very basic level: After 30 years of 10% growth, gains in real GDP have slowed to 7% in early 2015. The fear is that this is but a hint of a far more serious endgame – a progressive weakening in the Chinese economy that culminates in the long dreaded hard landing. Are these fears well founded? What do they imply for the United States and the rest of the world?

The simple answer to the first question is "no." The Chinese economy is in the midst of a long-awaited and welcome slowdown as it transitions to a very different, albeit ultimately more sustainable, growth strategy — one that essentially shifts the core focus of economic activity away from production toward consumption. The answer to the second question cuts both ways for the world at large. Those who have relied disproportionately on the Chinese production machine – especially resource economies and suppliers of industrial materials and components – will find a much tougher climate in the years ahead. Conversely, those who are well positioned to benefit from the emergence of the Chinese consumer will be able to uncover new sources of economic growth.

To be sure, Chinese rebalancing is a delicate and risky operation. Unexpected developments at home or abroad certainly have the potential to derail the transition. The growth compression of the Chinese economy in the early months of 2015 – together with the counter-cyclical policy actions such weakening has evoked – underscores those concerns. As China now moves into the final months of its 12th Five-Year Plan and its leadership puts the finishing touches on the upcoming 13th Five-Year Plan, a key challenge will be to stay the course of rebalancing and reform without suffering a major economic accident.

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Avoiding the Trap

History underscores the daunting nature of this challenge. China's per capita GDP crossed the $12,000 threshold in purchasing power parity terms in 2014 – nearing the zone when economic development is often arrested by the dreaded "middle income trap."[2] The current growth slowdown, coupled with widespread concerns over China's debt problem, property market excesses, and shadow banking risks, only underscores the mounting perils of just such a trap.

The good news is that China takes such risks very seriously and has the strategy, the commitment, and the tools to avoid such a dire endgame. This was foreshadowed by China's own rethinking of its development strategy nearly eight years ago. The genesis of this rethinking can be traced back to early 2007, when the Chinese growth model seemed all but invincible. But for Beijing that was not a time for complacency. Indeed, former Premier Wen Jiabao offered a now famous warning of an economy that beneath the surface was increasingly "unstable, unbalanced, uncoordinated, and ultimately unsustainable."

This critique of the "Four Uns" triggered intense internal debate over China's economic strategy. With the enactment of the 12th Five-year Plan in early 2011, the decision was made to change the growth model – shifting the structure of the Chinese economy away from manufacturing-led export and investment growth toward services-led growth and internal private consumption.

The new plan provided a coherent framework to enable this transformation – more job creation through development of an embryonic services sector, higher real wages via urbanization, and a reduction of fear-driven precautionary saving by building a secure social safety net (*see Figure 1*). The results were mixed. While there was encouraging impetus to services and urbanization, progress on the safety net front was disappointing. The enrollment in healthcare and retirement programs was expanded, but the funding of benefits was woefully inadequate. As a result, still cautious Chinese families remained on the sidelines – fearful of an uncertain future and unable and unwilling to commit to discretionary consumption.

That shortcoming is now being addressed by the wide-ranging reforms ratified at the Third Plenum of the Central Committee of the 18th Party Congress held in November 2013 – especially those pertaining to the one-child family planning policy, the household registration (*hukou*) system, ceilings on deposit interest rates, and, most recently, deposit insurance for Chinese savers. At the same time, the government has tackled the safety net funding issue by proposing to raise taxes on state-owned enterprises from 15% to 30% by 2020 and earmarking the proceeds of such newfound revenue toward a woefully underfunded social security system.

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[2] See Barry Eichengreen, Donghyun Park, and Kwanho Shin, "When Fast Growing Economies Slow Down: International Evidence and Implications for China," NBER Working Paper 16919, March 2011.

These reforms should go a long way toward assuaging the deep sense of insecurity that has long gripped Chinese households and constrained progress on the road to consumer-led rebalancing.

Moreover, China's leadership has gone one key step further in transforming the growth model – it has sharpened its focus on implementation. A new "Leading Small Group on Comprehensively Deepening Reforms" has been empowered to dislodge the power blocs, special interest groups, and corruption that have the potential to stymie the most ambitious of strategies. In doing so, China is embracing a revolution in governance that could well be the most decisive aspect of its structural transformation (*see Figure 2).*

China's current slowdown needs to be seen in the context of all of these developments. In one sense, the downshift to 7% GDP growth in early 2015 is actually an important step in the right direction. In large part, that's because it reflects an impressive shift in the mix of GDP toward services. When enacted in 2011, the 12th Five-Year Plan targeted an increase in the services share of the Chinese economy from 43% in 2010 to 47% by the end of 2015. That transformation is now well ahead of schedule. In 2014, with a year still to go on the 12th Five-Year Plan, services actually rose to 48.2% of Chinese GDP – not only surpassing the year-end 2015 goal but also far outstripping the 42.6% combined shares now going to the manufacturing and construction sectors, combined (*see Figure 3*).

One of the most significant implications of this development is that services require about 30% more workers per unit of Chinese output than do manufacturing and construction. This points to a more labor-intensive mix to the economy, which means that means services-led China now has the potential to hit its labor absorption objectives (i.e., employment growth and poverty reduction) with much slower GDP growth than has been the case in the past (*see Figure 4*). Recent employment trends bear this out. China's urban workforce increased nearly 13.2 million, on average, in 2013-14, well above the government's annual target of 10 million for each of those years – a target that has just been reaffirmed for 2015. In the end, employment will be the acid test of China's transformation and its ability to cope with a slowdown. So far, it has passed that test without a major problem.

That certainly doesn't mean the recent deterioration in the Chinese economy should be taken lightly. The last thing China needs is a cumulative weakening in its economy. Many worry that is exactly what is now happening in early 2015. Fortunately, a decomposition of the sources of the recent slowdown does not suggest that is the case. High frequency (monthly) data suggest that the growth compression has been most acute in the core drivers of the old model – namely the industrial complex that underpins the Chinese export machine. This was underscored by a sharp deceleration in industrial production to just +5.6% (y-o-y) in March 2015 and a -15% (y-o-y) plunge in exports. This is consistent with the latest trends in the industrial mix of Chinese GDP growth – a sharp decline in

secondary sector output growth from 7.3% in the fourth quarter of 2014 to 6.4% in the first quarter of 2015.

Meanwhile the core drivers of the new model – namely services and consumption look relatively resilient by comparison. Tertiary sector output growth slowed only fractionally from +8.1% in the fourth quarter of 2014 to +7.9% in the first quarter of 2015. At the same time, there was only modest slippage in retail sales growth to +10.2% in March 2015 vs. 10.7% in the first two months of this year. Services and domestic private consumption are not immune to China's early 2015 growth compression, but they are certainly holding up much better than the traditional sources of manufacturing- and export-led growth.

In this important sense, the current slowdown highlights the delicate nature of China's economic balancing act – downward pressures intensifying in the old growth model with newfound support emerging in the new model. That only underscores the need for Beijing to shift away from an old model driven by external demand to a new model driven more by internal demand. With the world economy still quite weak in the aftermath of the crisis of 2008-09 – and likely to remain so for so time to come – this shift is all the more urgent.

At the same time, the continued softness of incoming economic data in early 2015 underscores the need for vigilance by Chinese policymakers. Recent monetary policy actions are very much consistent with such a cautious approach. With two cuts in policy interest rates and two reductions in bank reserve requirements since last November, the Chinese leadership seems to be drawing a line in the sand at 7% GDP growth. That means if the incoming data continue to weaken, additional policy actions can certainly be expected.

The good news is that if that turns out to be the case and growth risks tip further to the downside, there is still ample scope for further policy easing to contain the damage. That's especially the case for monetary policy, with both interest rates and reserve ratios remaining well above levels set in the depths of the Great Recession. That provides Beijing with an important cushion that should enable it to stay the course and avoid backtracking on the transformational reforms that are now under way. Ironically, such backtracking would expose China to the pitfalls of the middle-income trap at its point of maximum vulnerability – just the recipe for the hard landing that so many fear is now in the offing.

Opportunities in Services

While the China slowdown presents risks it also offers great opportunity. That's because of the shifting mix in economic activity highlighted above. For the first time in modern China's history, services-led growth is now the main engine of this powerful economy. And this nascent shift has nothing but upside. Consistent with

the structure of most modern upper middle-income economies, China's services sector should rise from 48% of its GDP in 2014 to around 60% by 2025.

The potential growth of China's now rapidly growing but still embryonic services sector is likely to be broad-based. Relative to the United States – the world's quintessential services economy – footprints in Chinese services are especially small in wholesale and retail trade, hospitality and leisure, and professional and business services; scale deficiencies are especially the case in the healthcare sector, where the need to expand is particularly vital for a rapidly aging Chinese population (*see Figure 5*). As China now focuses on building out its services sector, three important developments need to be stressed:

First, services are the infrastructure of consumer demand. The delivery of basic public services such as water and electricity, as well as healthcare, is the essence of a modern society's well being. Nor can households become active members of any economy without being connected to services-based retail sales and wholesale distribution networks. And they can't spend newfound labor income on discretionary leisure activity without transportation systems, hotels, and family-focused amusement facilities. China is woefully deficient on virtually all of these counts – to say nothing of lacking the more sophisticated professional service providers such as lawyers, accountants, consultants, financial analysts, software engineers, and the like.

Second, services are the key to slower and, by inference, more sustainable growth. All services-led economies grow more slowly than those fueled primarily by industrial activity. For China, this need not pose a threat to its daunting labor absorption imperatives. As noted above, the services piece of the Chinese economy requires 30% more workers per unit of GDP than does manufacturing and construction activity, combined. That means it would only take 7% GDP growth for China to achieve its labor absorption objectives with a labor-intensive services-led economy rather than the 10% GDP growth that was required by the old model more reliant on capital-intensive industrial activity.

The GDP report for the first quarter of 2015 underscores this important point. As noted above, the tertiary (services) sector expanded by 7.9% from its year-earlier level – fully 1.5 percentage points faster than the weakened 6.4% gain in the secondary (manufacturing and construction) sector. All the handwringing in the West over China's current growth slowdown focuses on headline GDP and misses the critical insight that the mix of Chinese economic growth is now shifting to labor-intensive services activity. Contrary to widespread perception, social stability in China is not imperiled by slower services-led economic growth.

Third, shifting to a slower growing increasingly services-led economy can help China make good on its promise to improve the *quality* of the growth experience. Significantly, services have a minimal carbon footprint compared with manufacturing – critical for reducing environmental degradation and pollution.

Moreover, history tells us that urbanization and services employment growth go hand in hand. This confluence is uppermost in China's mind as it moves ahead with an unprecedented urbanization strategy – with its latest plans calling for another 100 million rural citizens to locate to new cities by 2020, and a good deal more than that in the years beyond (*see Figure 6*).

The last thing China needs is to relocate rural workers to urban areas without providing gainful employment. Urban residents in China have per capita incomes that run roughly three times their counterparts in the rural countryside. It follows that new employment opportunities in services industries, in conjunction with this wage differential, should not only boost personal incomes and consumption, but could also go a long way in reducing inequality – a key objective on the quality agenda of the Next China. Services development effectively legitimizes the economic underpinnings of Chinese urbanization.

Notwithstanding the important domestic implications of services-led development in China, there are major global implications as well. My estimates suggest that the growth in the Chinese services could amount to approximately $12 trillion (in current US dollars) between now and 2025 (*see Figure 7*).[3] But unlike earlier examples of services-led growth and development, the Chinese strain is likely to be very different in one key respect: Services used to be thought of as "nontradables" – meaning that most activity in the sector was provided by domestic companies operating in relatively closed domestic markets. However, in an era of IT-enabled connectivity and an increasingly well-educated global workforce, a significant portion of services activity is now tradable and can be delivered by connected knowledge workers from offshore platforms.

That leads to a potentially powerful conclusion: Under the admittedly optimistic assumptions of ongoing services reforms, deregulation, and increased foreign access to domestic Chinese services markets, between $4 and $6 trillion of the coming expansion of Chinese services could be divvied up between foreign services providers over the next decade.[4] With the U.S. having the world's largest and most competitive services sector – currently accounting for 14% of global services exports, twice the share of the next largest competitor – America is well positioned to capture a significant share of the coming bonanza in Chinese services. From retail chains (i.e., Wal-Mart) and leisure (i.e., Disney) to domestic transportation (i.e., United) and healthcare's vast array of insurance and hospital systems, U.S. multinational services companies have precisely what China is lacking in terms of strategy, talent, systems, analytics, and quality-focused cultures.

Unfortunately, with all the hand wringing over the perils of China – from growth and debt risks to property bubbles and cyberhacking – there is a distinct possibility that

[3] See Stephen S. Roach, *Unbalanced: The Codependency of America and China*, Yale University Press, 2014.
[4] See Roach, *Unbalanced*.

the United States could fixate on the threats and miss out on participating in an extraordinary transformation of the Chinese economy. That would be a real pity. A shift to consumer- and services-led growth could create the world's greatest bonanza of new growth in aggregate demand in in the first half of the 21st century. Growth-deficient America can hardly afford to squander this opportunity.

For the United States, the timing is particularly ideal. With the U.S. economy mired in a sluggish post-crisis recovery largely because of lingering pressures on household balance sheets, America's growth agenda needs to tilt away from over-stretched domestic demand toward exports and foreign demand. The imperatives of China's services-led development provide just such an opportunity.

Seizing the Opportunity

Of course, it's one thing to dimension the opportunity. It's another matter altogether to seize it. Key in this regard is "market access" – namely, the ability of foreign multinationals to participate in the accelerating growth in Chinese domestic demand. This won't happen by osmosis. Both China and the United States have a long history of putting such limits on each other's cross-border investments through the caps on minority ownership stakes in joint ventures that nations typically impose on each other in efforts to protect their most sacrosanct industries such as services. That's especially the case in finance but also true of most nonfinancial services.

Fortunately, there is a mechanism available to address the conflicting agendas of the United States and China. The Strategic and Economic Dialogue (S&ED) was established nearly six years ago for one reason – to address the contextual issues playing on both nations while enabling them to develop a strategic framework for advancing what could well be the world's most important bilateral dialogue on both economic and security matters. Such negotiations take on added importance in the context of the ever-changing challenges bearing down on both nations. That is especially the case in light of the opportunities presented by China's unprecedented services- and consumer-led rebalancing.

In recognition of the potential benefits that could be gained by relaxing restrictive foreign ownership requirements, nearly two years ago at the 2013 Strategic and Economic Dialogue both the United States and China entered into serious negotiations over a "Bilateral Investment Treaty." This is a fairly common arrangement between nations around the world. There are some 3,000 such BITs currently in effect, according to the Paulson Institute, that, among other things, allow for a significant liberalization of heretofore stringent requirements on foreign

ownership of domestic companies. [5] As common as such treaties are, no such arrangement currently exists between the United States and China.

Typically, BIT negotiations are framed in terms of a "negative list" – industries or sectors that one nation views as off-limits to foreign control. As these negotiations currently stand, China appears to have a very long negative list when compared with that of the United States. That, however, should not be viewed as discouraging. China started out with an equally long negative list when it began negotiating for entry into the WTO – a list that was subsequently pruned down dramatically prior to formal accession in 2001. The negative list construct is helpful in framing the debate and the agenda for subsequent negotiations.

The potential upside of a breakthrough on a U.S.-China BIT is huge. It would not only open up services trade between the two nations, but the compliance protocols of a BIT could also set the stage for China's participation in broader multilateral trade arrangements, such as the Trans-Pacific Partnership. That would be a major plus for the global economy.

Those of us who have been optimistic on an improved Sino-American relationship have been counting on further progress in BIT negotiations as a means to pry open each country's markets to the other. While the potential from such progress is enormous, it can only be achieved if there is a more constructive tone in the broader relationship between the two nations. The recent flare-ups over cyberhacking, geostrategic tensions in the East- and South-China Seas, and currency policy all risk sidetracking the agenda from its core objectives. These issues are important and should not be ignored – but they need to be set in context.

The Sino-American Trust Deficit

Notwithstanding the potential of a successful completion of BIT negotiations, the latest strategic and Economic Dialogue between the United States and China, held in Beijing in July 2014, was a major disappointment. It lacked strategy at a time when both countries face formidable challenges on many fronts. And what passed for dialogue was a series of speeches and tightly scripted talking points. But the biggest disappointment was that it failed to address an increasingly corrosive trust deficit that poses the most serious threat to Sino-American relations in 25 years.

Conditions were tough heading into the talks. The US Treasury was complaining yet again about the Chinese currency, which had depreciated by 2.4% against the dollar in the first half of 2014, after having appreciated by 37% over the previous eight and a half years. The US State Department and China's Ministry of Foreign Affairs were engaged in a war of words over mounting territorial and sea-lane disputes in

[5] See Daniel M. Price and Michael J. Smart, "BIT by BIT: A Path to Strengthen US-China Relations," Paulson Policy Memorandum, July 2013.

the East and South China Seas.

The darkest clouds were on the cyber front. Two months before the 2014 S&ED, the US Department of Justice indicted five officers of the People's Liberation Army (PLA) on 31 counts of charges ranging from computer fraud and hacking to identity theft and economic espionage. In response, China suspended its participation in bilateral military-to-military exchanges on cyber threats. Meanwhile, revelations of the pervasive scope of US cyber-espionage activities reverberated from Capitol Hill to Berlin, giving rise to legislation aimed at controlling America's largely unchecked National Security Agency (NSA) and casting a pall over the US-German relationship.

Charges and countercharges on the cyber issue have focused primarily on motives. The US has been quick to distinguish between commercial and military espionage. But for China, this distinction rings hollow. Chinese officials see little difference between the cyber threat posed by the NSA and that posed by the PLA, especially given that America's cyber intrusions have also been aimed at foreign companies, trade negotiators, and international leaders – all of whom are directly or indirectly engaged in commercial activity. In the end, moral hair-splitting is less important than the blame game itself – a visible manifestation of the deepening bilateral distrust wrought by the destructive phase of Sino-American codependency.

Against this backdrop, it was hardly surprising that the 2014 S&ED produced so little. Cyber exchanges between the two militaries were not restarted, and negotiations over the bilateral investment treaty were especially disappointing. Despite the encouraging breakthrough on such a treaty in 2013, there was a setback in 2014, as the onset of explicit negotiations over which industries would comprise the always-contentious negative list was deferred until 2015.

The problem with "kicking the can down the road" is that the road is leading directly toward the upcoming US presidential election cycle – a time when the debate over China always intensifies. Add to that a polarized and dysfunctional Congress, and the timeframe for concluding a US-China investment treaty is beginning to appear eerily reminiscent of the decade-long process that was required for Chinese accession to the World Trade Organization in 2001. That would be too bad for both countries, as each now faces urgent economic challenges.

In this context, the failure of both US and Chinese leaders to recognize the mutual benefits of a bilateral investment treaty is disturbing, to say the least. Going slow on such an obvious "win-win" reform suggests either that each country attaches little importance to their collective growth imperatives or that they are unwilling to address that urgency by facing up to the increasingly insidious trust deficit that divides them.

I suspect it's the latter. Leaders on both sides understand their countries' growth challenges. But neither seem willing to address the intensification of distrust that has arisen during the past year from the cyber issue. Here is where the blame game

belies the obvious: Both countries hack, and both have lost control over their hackers. Moreover, cyber-hacking itself is growing at an exponential rate in today's interconnected world. In other words, the cyber blame game is pointless.

Acceptance of shared responsibilities in coming to grips with cyber tensions is essential if the US and China are to re-engage on the other geo-strategic and economic challenges they both face. The failure of the 2014 S&ED was a serious warning shot, yet another indication that the bilateral relationship is headed in the wrong direction. Staying that course is not an option.

Two Risks

If it is successful, the rebalancing of the Chinese economy could well translate into one of the most important growth opportunities for the global economy in the 21st century. After decades of under-consumption, the world's most population nation is on the cusp of creating an enormous pool of middle-class consumers. Notwithstanding the benefits likely to arise from this transition, there can be no mistaking the risks that could prove problematic for China and the rest of the world. Two such risks are particularly noteworthy – Chinese currency policy and pressures on the world's commodity supply chain.

Steady on the Renminbi. Currency wars are raging worldwide, and despite the slight weakening of the renminbi in early 2015, China is bearing the brunt of them. The Chinese currency is up sharply over the past several years, exports are sagging, and the risk of deflation is growing. Under these circumstances, many suggest that a reversal in currency policy to weaken the renminbi is the most logical course. That would be a serious mistake.

Yes, on the surface, the situation appears tough for China. According to the Bank for International Settlements (BIS), China's real effective exchange rate – an inflation-adjusted trade-weighted average of the renminbi's value relative to the currencies of a broad cross-section of China's trading partners – has increased by 27% over the four years ending February 2015.

China's currency has, in fact, appreciated more than any of the other 60 countries that the BIS covers (apart from a dysfunctional Venezuela where the figures are distorted by multiple foreign exchange regimes). By comparison, the allegedly strong US dollar is up just 13% in real terms over the same four-year period. Meanwhile, China's emerging-market BRICs counterparts have experienced sharp currency depreciations, with the Russia ruble falling by 32%, the Brazilian real by 20%, and the Indian rupee by 11%.

This currency shift is, of course, the functional equivalent of a large hike in the price of Chinese exports. Add to that continued sluggishness in global demand, and the once-powerful Chinese export machine is suffering – underscored by the worrisome

15% year-over-year plunge in export demand in March 2015 noted above. In conjunction with recent signs of further weakness in industrial output, fixed investment, and retail sales in early 2015, further downward pressure in exports would hardly be an inconsequential development. After all, despite all the talk and hope of rebalancing, exports still account for about 25% of Chinese GDP.

At the same time, a stronger renminbi has made imports less expensive, putting downward pressure on China's price structure. Unsurprisingly, this has exacerbated fears of deflation, with the headline consumer price index (CPI) rising by only 1.4% year-on-year in March 2015, and the annual decline in producer prices steepening, to -4.6% over the same period. Nor are these trends being amplified by plummeting world oil prices; China's core CPI inflation rate (which excludes volatile food and energy prices) was also running at just 1.5% in March 2015.

Against this background, it is easy to see why many anticipate a tactical adjustment in China's currency policy, from appreciation to depreciation. Such a move would certainly seem appealing as a way to provide temporary relief from downward pressures on growth and prices. But there are three reasons why such a move could backfire:

First and foremost, a shift in currency policy would undermine – indeed, undo – the progress that China has made on the road to reform and rebalancing. In fact, a stronger renminbi is consistent with China's key objective of shifting from export-intensive growth to consumer-led development. The generally steady appreciation of the renminbi – which has risen by 33.6% against the US dollar since mid-2005 – is consistent with this objective and should not be reversed. It strengthens the purchasing power of Chinese consumers and reduces currency-related subsidies to exports.

During the recent financial crisis, China's renminbi appreciation policy was temporarily suspended and the exchange rate was held steady from mid-2008 through early 2010. Given that current circumstances are far less threatening than those in the depths of the Great Crisis, the need for another tactical adjustment in Chinese currency policy is far less acute.

Second, a shift to currency depreciation could inflame anti-China sentiment among the country's major trading partners – especially the United States, where Congress has flirted for years with the prospect of imposing trade sanctions on Chinese exporters. As noted above such tensions always seem to intensify around election cycles, and current developments are playing out very much according to this script.

Indeed, in February 2015 a bipartisan coalition in the House of Representatives introduced the so-called Currency Reform for Fair Trade Act, which would treat currency undervaluation as a subsidy, allowing US companies to seek higher countervailing duties on imports. Similarly, the Obama Administration recently brought yet another action against China in the World Trade Organization – this

time focusing on the legality of subsidies that China provides to exporters through so-called "common service platforms" and "demonstration bases." In this contentious climate, if China pushes its currency lower, US political support for anti-China trade actions would undoubtedly intensify, pushing the world's two largest economies ever closer to the slippery slope of protectionism.

Finally, a reversal in the renminbi would undoubtedly lead to a sharp escalation in the global currency wars that have now broken out. In an era of unprecedented quantitative easing, competitive currency devaluation has become the norm for the world's major exporters – first the US, then Japan, and now Europe. If China joined this race to the bottom, others would be tempted to escalate their actions in response and world financial markets would be subject to yet another source of serious instability.

Just as China resisted the temptation of renminbi depreciation during the Asian financial crisis of 1997-1998 – a decision that may have played a pivotal role in arresting that virulent regional contagion – it must stay the course today. That's all the more the case in the potentially unstable climate fostered by the new strain of monetary policy known as QE, or quantitative easing. In the QE era, China's role as a currency anchor may take on even greater importance than in the late 1990s.

Downside for Commodity Producers. Chinese rebalancing also has profound implications for natural resource markets, where the so-called commodity super cycle has turned with a vengeance. The sudden collapse in the prices of oil, coal, base metals, and other natural resources is not an aberration. A number of factors are at work – those grounded in financial markets, especially currencies, as well as those on the real side of the global economy. Technology is also a factor, especially the so-called shale revolution and its eventual impacts on the supply side of world energy markets. But the most important development in shaping current trends in resource markets may well have been made in China.

That's because of the transitional shift in the mix of Chinese economic activity that has been stressed repeatedly above – a shift from unsustainable resource-intensive industrial activity to slower growing and more sustainable commodity-lite services. Add to that the reduced carbon footprint of services, and this structural rebalancing is also an important plus for China's horrific problems of environmental degradation and pollution. In short, services-led development may well hold an important key to successful implementation of China's longer-term sustainable development strategy. Yet for a world hooked on the legacy of China's hyper growth, and for financial markets addicted to the same outcome, this transformation has come as a rude awakening.

Oil is the most prominent example. Over the decade ending in 2013, surging Chinese oil demand accounted for fully 45% of the total increase in world oil consumption. Yet over that same period of time, Chinese GDP growth averaged 10.2%, with an energy intensity (total energy consumption per unit of GDP) that

was more than double the average of the developed world. With China now shifting to a slower, increasingly services-intensive GDP growth trajectory – where the carbon content of services is only a faction of that in energy-guzzling manufacturing – the major impetus to growth in world oil demand has suddenly hit a wall. The sharp plunge is world oil prices is hardly unconnected to this major development.

Coal is another important case in point. China derives fully 68% of its total fuel from coal – 3.5 times the 19% share elsewhere in the world. Yet coal is by far the most carbon-intensive source of energy – putting China's coal-fueled economy in the cross-hairs of its daunting environmental and pollution challenges. After years of handwringing, China finally appears to be making progress in addressing its excess reliance on coal. Recent data reveal significant drops in coal production (-2.5%) and coal demand (-2.9%) in 2014 – the first such declines in 14 years. While it is tempting to attribute this to the slowing economy, that interpretation is very much at odds with China's increased demand for both crude oil (+5.9%) and natural gas (+8.6%) in 2014. In short, China finally appears to be shifting the mix of its fuels away from coal – hardly a trivial consideration in explaining the nearly 50% decline in international coal prices that has been evident since 2012.

The same can be said for other segments of the commodity market – from base metals and industrials to foods and fibers. For example, according to research by Elizabeth Economy and Michael Levi of the Council on Foreign Relations, China's share of global iron ore consumption went from 30% in 2005 to 67% in 2010; for bauxite (the principal ore of aluminum), China's global share went from 7.5% to 17% over the same five-year period, whereas for soybeans the jump was from 11% to 25% over the 2005 to 2010 timeframe. [6] While Chinese demand for foodstuffs is unlikely to falter as it ups the ante on urbanization, the shift away from the manufacturing-led impetus to exports and investments toward services-led consumption should have important and lasting implications for China's seemingly open-ended demand for those segments of resource markets tied most closely to industrial activity.

This outcome should also prove to be a real jolt to two major constituencies in the global economy – resource-intensive economies, such as Russia, Australia, Canada, Brazil, and many African nations, as well as a host of institutional investors who have elevated commodities to the status as an asset class in their diversified portfolios. In both cases, the China-led commodity super cycle has been extrapolated well into the future – pointing to a resource consumption trajectory widely presumed to be underpinned by a Chinese economic juggernaut that basically stays the course of the past 30 years. By contrast, little consideration has been given to a China slowdown driven by a services-led, commodity-lite structural transformation. With such a slowdown now under way – and likely to continue for

[6] See Elizabeth C. Economy and Michael Levi, *By All Means Necessary: How China's Resource Quest is Changing the World*, Oxford University Press, 2014.

years ahead – both commodity-long investors and resource economies have been hit especially hard.

Much has been made, of course, of new technological breakthroughs on the supply side of many commodity markets – especially the hydraulic fracturing (fracking) that has led to new sources of oil and natural gas. For the United States, fracking has been widely billed as the hope for energy independence – eventually enabling America to wean itself from an otherwise worrisome dependence on foreign oil. While there can be no mistaking the potential significance of this development – despite the pushback of environmentalists and the recent fracking ban in New York state introduced by Governor Andrew Cuomo[7] – these technological breakthroughs on the supply side of the energy equation are hardly a surprise. Markets have been discounting this possibility for years.

But as sharp recent declines in the prices of base metals and other industrial materials suggest, there is more to the sudden downturn in commodity markets than oil. The big story is China – specifically, fears that the slowdown now under way is but a prelude of the dreaded hard landing. While those fears are overblown, there is good reason to believe that the world's most voracious appetite for natural resources is now in the process of being tamed by a long awaited structural transformation. As China moves from resource-heavy manufacturing to resource-lite services, the commodity super cycle appears to have lost an important source of oxygen. And so, too, could the growth aspirations of commodity-intensive economies that have benefited the most of the old strain of Chinese economic growth.

Looking to the 13th Five-Year Plan

With the 12th Five-Year Plan nearing the end of its planning horizon, China's strategists and policy makers are now hard at work in drafting the 13th Five-Year Plan (2012-17). These plans are still important insofar as they frame the medium- to longer-term debate for Chinese policy – and often signal important shifts in priority and focus. As seen from that perspective, I do not expect the new plan to be radically different from the one that is now ending.

It is far too early tell, of course, but I suspect that the 12th Five-year Plan could well go down in history as one of the more pivotal developments in the evolution of the modern Chinese economy – comparable to the Fifth Five-Year Plan (1976-80) that ushered in the "reforms and opening up" of Deng Xiaoping and the Ninth Five-Year Plan (1996-2000) that featured the revolution in ownership triggered by the first wave of state-owned enterprise reforms. Both of these earlier plans were key milestones in the development of China's producer economy. The 12th Five-Year

[7] See Clare Foran, "New York State Moves to Ban Fracking," *National Journal*, December 17, 2014

Plan is equally significant, in my view, in laying out the broad architecture of the consumer economy. While it has had mixed success, as noted above, it has provided the basic framework that could well define subsequent strategic shifts on the road to China's consumer society.

In looking ahead to the 13th Five-Year Plan, the most likely outcome is that China will stay the course that was set in 2011 and further refined by the Third Plenum of 2013. And staying the course for an increasingly services-led economy underscores the likelihood that Chinese economic growth could continue to decelerate even further from a 7% average pace over the next five years to an underlying trend in the 5% to 6% zone in subsequent plans (*see Figure 8*).

There are, of course, no guarantees that such a transition will be smooth. In response to unexpected developments both at home and abroad, China's pro-consumption rebalancing strategy will need to be modified and adjusted as the economy transitions from the old model to the new one. Just as the Third Plenum was aimed at addressing many of the deficiencies of the 12th Five-Year Plan – especially pertaining to the social safety net – it seems reasonable to expect the 13th Five-Year Plan to offer similar strategic refinements to China's services– and consumer-led growth strategy. As such, I would look for the next plan to clarify China's strategic response to its safety net imperatives, its environmental degradation and pollution challenge, as well as provide a more detailed timeline for currency and other financial reforms.

Finally, I think it is safe to presume that the 13th Five-Year Plan will take special note of China's emerging global leadership role. China has long been dependent on the global economy for providing the sustenance of its powerful export-led growth accomplishments. But the shift in focus from external to internal demand puts China in a very different role – providing what could well be an increasingly important source of global consumption. Along with China's potentially powerful role in shaping global demand, comes a greater sense of responsibility and accountability to the global community. I suspect the 13th Five-Year Plan will also focus on China's role in addressing major global problems, including, but not limited to, environmental degradation, pollution, climate change, and global health.

The Chinese planning process has changed dramatically over the past 60 years. Gone are the detailed production targets of the Soviet-style plans of the 1950s. The current 12th Five-Year Plan only has a few broad macro targets – GDP growth, the services share of GDP, urbanization of the population, energy intensity, and environmental degradation. To the extent that China further embraces the market-based themes of Third Plenum reforms, the 13th Five-Year Plan is likely to follow suit by continuing to promote growth in the private sector and growth in the privatization of state ownership.

Targeting, itself, seems increasingly out of sync with China's newfound commitment to a market-based –system as stressed repeatedly in the Third Plenum of 2013.[8] As such, I suspect that the 13th Five-Year Plan will go considerably further in dismantling the planning process as it is currently embedded in the National Development and Reform Commission – China's modern day counterpart to the old State Planning Commission. The death knell of Chinese central planning could well become increasingly evident over the timespan covered by the 13th Five-Year Plan.

At the Crossroads

China is at a critical juncture on the road to economic development and sustained growth. So, too, is a still sluggish post-crisis global economy. In an interconnected world, shifts in one economy have important implications for other economies. That is especially the case for the linkages between the United States and China, where a powerful codependency has played a key role in shaping the character of both economies since the early 1980s.[9] In such a codependent relationship, changes in the behavior of one partner can be especially unsettling to the other (*see Figure 9*).

And the United States is certainly unsettled over China these days. In one sense that should not be so surprising. History tells us that dominant powers have always struggled to cope with rising ones. In the same vein, China, burdened by 150 years of perceived humiliation by the West, does not take kindly to that reaction.

That leaves the world in a rather uncomfortable place. It's not just that China's economy is rising – and is likely to continue to do so if it successfully executes its long-awaited rebalancing It is also that America, the hegemon, finds the expansion of China's global economic footprint so disturbing. Borrowing from the nomenclature of ancient maritime and overland shipping routes, China calls this outreach "One Belt, One Road" – an ambitious multi-faced campaign to link the Chinese economy to the rest of Asia, the Middle East, Europe, and even Africa. Just as China has depended on external demand from the rest of the world to support the export-led phase of its development miracle, it is now forging a global integration strategy to augment the next phase of its rise.

Drawing on the lessons of reconstruction, recovery, and economic development in the aftermath of the devastation of World War II, China recognizes the importance of institution building as the means toward this end. As such, it has taken the initiative to establish two new lending institutions – the so-called New Development (BRICS) Bank and the Asian Infrastructure Investment Bank – both aimed at filling the daunting infrastructure and project finance gaps that must be overcome to bring

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[8] See Stephen S. Roach, "The End of Chinese Central Planning," *Project Syndicate*, March 27, 2014.
[9] See Roach, *Unbalanced*.

the One Belt, One Road initiative to life.[10] Washington views this is a threat – hardly surprising in light of its long standing dominance of the existing Bretton Woods institutions (the IMF and the World Bank). Beijing, of course sees it very differently – not just as a complement to existing institutions but also as a response to an increasingly isolated Washington that has balked at IMF reforms, which would give China a greater say in the governance of that institution.

All this is yet another highly visible manifestation of the tensions and frictions that lurk on the dark side of economic codependency. Codependent partners are simply uncomfortable when one strikes out on its own. Yet however uncomfortable it may seem, neither Washington nor Beijing can afford to lose sight of the rebalancing endgame. The preferred outcome would be a symmetrical rebalancing – China saves less and consumes more while America does the opposite by consuming less and saving more. Unfortunately, the more likely outcome is an asymmetrical rebalancing – with China pushing ahead on restructuring while the United States drags its heels.

For Washington, it is time to crack the denial and accept the likelihood of Chinese rebalancing. China's transformation is happening, whether America likes it or not. The strategic challenge for the United States is how to grapple with this development – quite possibly the most important realignment in the global economy in the 21st century. For America that means a long overdue focus on boosting domestic saving – weaning itself from relying on Chinese saving that is now being directed more at supporting the safety net of its 1.4 billion people rather than subsidizing the safety of the American people. Reduced government budget deficits, together with a restoration of household saving, must be at the top of America's longer-term saving agenda.

In the end, China's transformation raises profound questions: Is the shift to a services- and consumer-led Chinese growth model a threat or an opportunity – not just to itself, but also to the United States and the rest of the world? In theory, the answer is relatively simple. A successful transition is far more of an opportunity than a threat – it provides a more sustainable growth strategy to China as well as a new source of aggregate demand for the rest of the world. But in practice, there are clear ambiguities that can easily work their way into the equation through trade tensions, dislocations in currency and commodity and markets, and pressures on resource economies – to say nothing of the geostrategic ramifications of a rising China

At the same time, while the costs of structural adjustment are currently taking their toll on China – and are likely to continue to do so for some time to come – the

[10] A widely noted study commissioned by the Asian Development Bank and conducted by the Economist Intelligence Unit places the Asian infrastructure gap at $8 trillion (USD). See *The 2011 Infrascope: Evaluating the environment for public-private partnerships in Asia-Pacific*.

alternative is unthinkable. The perils of the dreaded middle-income trap imply that there can be no backtracking for China on the road to rebalancing and reform. Strategy has long been China's greatest strength. Time and again, Chinese officials have successfully coped with unexpected developments, without losing sight of their long-term strategic objectives. They should work to uphold that record, using tactical policy adjustments to address problems of excess leverage and property bubbles rather than backtrack on reform and rebalancing. This is no time for China to flinch.

The same can be said for the rest of the world – not only in dealing with its own structural agenda and the associated dangers of what some fear to be a "secular stagnation"[11] but also in coping with the repercussions of the historic changes now under way in the Chinese economy. That is especially the case for the United States, where Sino-American codependency will force the US to adjust to the Next China whether it wants to or not. There are great benefits if both nations seize this opportunity. There is mounting risk if they don't. Squandering such an historic moment would be the greatest tragedy of all.

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[11] See Lawrence H. Summers, " U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound," *Business Economics* published by the National Association for Business Economists, 2014; and Christine Lagarde, "Lift Growth Today, Tomorrow, Together," speech before the Atlantic Council, April 9, 2015, Washington D.C.