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# China's New Economic Policy - Theoretical Background and New Analytical Conditions for the Corporate Sector

Paper presented at the Chinese Economic Association's Annual Conference, hosted by the University of Duisburg/Essen, September 1 - 3, 2016

## *Abstract*

In the fall of 2013, the so-called Third Plenum of the Communist Party's Central Committee decided to start up a process of major economic and social reforms. Thus, the conditions for the analysis of China's economy are now undergoing changes, conceptually often backed up by well-known Western research. These changes are important. In this paper, I try to find modified or new analytical factors which corporations – but also specialized financial analysts – inside and outside China should increasingly focus on, despite or even because of statistical shortcomings. To my knowledge, few comprehensive efforts have been made so far in this specific direction.

JEL: A12, O 11, O12, O 53, P 25, P 26, P 46, P 48.

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In the fall of 2012, China saw a new political leadership, led by the President and General Secretary of the Communist Party of China (CPC), Xi Jinping, and the Prime Minister, Li Keqiang. They are formally and in reality the main representatives of the so-called fifth generation of China's political leaders after World War II. In November 2013, Chinese political leaders presented their plans for a partly new and partly modernized economic policy in a total of 16 main reform areas and 60 more detailed subareas. The first major checkpoint will be in 2020, i.e. the final year of the current five-year plan.

This is certainly not a long time horizon for many planned structural economic and social reforms. And already in 2022, it will be time for the sixth generation of political leaders to take over and find a new or strengthened legitimacy. The legitimacy of the current leadership seems to be clear: better social conditions for the Chinese people and a visibly improved environment – and simultaneously continued good economic growth in order to manage the reforms financially and to keep unemployment down. This is certainly a tough call.

The economic plans of the fifth generation are very ambitious and embedded in a substantial number of conflicts of goals. This new situation also changes the landscape – both in China and abroad - for China analysts in the non-financial corporate sector and in the financial sector itself. In this paper, I try to find out to what extent economists should modify their traditional country-analysis model for China, as necessitated by the new economic policy, and why they should look at more than just the traditional macroeconomic analysis approach that for a long time has been relying on GDP growth and a few other macroeconomic statistics.

## 1. China's new economic policy and the "new normal"

China's GDP growth has been decelerating in recent years, from double-digit numbers to below 7 percent in 2015, according to official statistics. At the National People's Congress (NPC) in March 2016 it was announced that the official GDP-growth objective for 2016 had been reduced to 6.5-7 percent for 2016 (from the previous objective of around 7 percent for 2015) and would be set at *at least* 6.5 percent on average until 2020 (Xinhua 2016, March 5).

This downsizing should, of course, not have come as a surprise if some of the most important contributions to GDP growth had been watched carefully in recent years. Here we could see low-wage supported exports running out of steam, a lot of investments in projects that were too prestigious, generously financed investments in state-owned enterprises (SoEs) without any chances of becoming profitable, speculating municipalities and – seen from another angle – too much industrial production which harmed the environment and the health of a considerable part of the Chinese population. All these factors – and many others – increased Chinese GDP growth to unsustainable and irrational levels in the first dozen years of this century.

These circumstances make it very unclear whether China really is "only" about to conclude its adaptation to more justified GDP-growth rates and/or de facto already has been locked in the so-called middle-income trap with declining growth and competitiveness. Researchers have different opinions on that (e.g. Eichengreen et al. 2013; Zheng Liu 2015). Whatever the view on this issue may be, Chinese GDP-growth rates have come down significantly in the past few years – in my view from exorbitant levels which are currently moving back to what political leaders have been calling the "new normal" since 2014/15 (e.g. Areddy/Lingling Wei 2015). It remains open to question whether we now should talk about the "new normal" as something inevitable based on the previous

exuberant situation (growth normalization at a lower level) or a more far-reaching structural downsizing (moderation) - or even a combination of these two alternatives. Possible answers to these questions are not elaborated in this paper but in my view it could be a combination of both options.

The decisions taken by the Third Plenum of the Communist Party's Central Committee in November 2013 serve as a starting point for the structure and considerations of this paper. Economic policy is now even more determined by the market economy and is intended to play a "*decisive*" role in the Chinese economy (Third Plenum chapter 1,2) compared to what was referred to as a "*basic*" role before November 2013. "Decisive" is certainly a stronger word than "basic". As already indicated, 2020 will be the major evaluation year for all of the 16 main objectives and the 60 sub-objectives that were decided on by the Third Plenum. It is certainly not very risky to forecast that each and every reform plan cannot be completed by 2020. The total number of the more or less concluded changes and the remaining time for the uncompleted reforms are particularly uncertain. So far, the level of transparency seen in these two important issues has not been encouraging. For instance, I could find a brief message that "*in the last two years, the central leading team has completed 181 major reform tasks and relevant central departments have fulfilled 261 reform goals...*" (Yang Xun 2016). However, despite very intensive attempts, I could not find any details about the progress he describes. Improvements with respect to transparency are indeed desirable, both for Chinese and foreign economists and (commercial) decision makers.

Briefly summarized, the overriding economic objectives of China's leaders are: a new development (growth) model focusing on more consumption (in relation to total GDP), more service-oriented production and more future-oriented investments with reasonable returns leading to more mid-/high-tech products and better productivity, and simultaneously a clearly improved environment with persistent GDP growth of at least 6.5 percent on average until the end of this decade, as mentioned above. 6.5 percent as the result of improved quality of growth would not be bad, 6.5 percent without structural progress would be less favorable. Without going into details in this chapter, 6.5 percent is the number I too use as a reference number in this context as it indicates the downsizing of economic growth sufficiently, despite all doubts about the statistical accuracy of GDP calculations (more about this and applicable business cycle analysis in chapter four and five).

It should thus be emphasized that a decent rate of GDP growth is still regarded as important by Chinese political leaders, among other things for the reduction of poverty. It is part of their legitimacy, but not the only one. The fifth generation has to achieve more: new or structurally modified contributions from the service sector to persistently good or reasonable economic growth, more sophisticated industrial products and production, more social security and a much better environment. The list also includes more competitive exports of goods and services.

The tools for achieving the primary objectives of the new economic policy have been expressed very clearly by the main political leaders. They are primarily innovation, IT and entrepreneurship plus the market economy mostly – but not always - in the first place. Social awareness and better social conditions – particularly for the non-metropolitan population - could also be regarded as a tool, in this case as a tool to increase households' propensity to consume more and to reduce precautionary savings. A notable portion of Schumpeterian forward spirit, and at the same time creative destruction, is reflected in the words and plans of Chinese political leaders since 2013 (see, for example, Li Keqiang 2016). One of the exciting open questions is the degree of creativity and practical determination the Chinese can achieve in the forthcoming years. New creativity certainly cannot emerge automatically and can be impeded by the substantial number of goal conflicts that

are inherent in the list of decisions from the Third Plenum (see chapter 3 of this paper). This reality deserves a lot of analytical attention.

But the Third Plenum is not the only plenum, even if it is the most significant one. Other guiding plena and their main issues should be mentioned, for example (Laband and Hengrui Liu 2014):

- the *Fourth Plenum* 2014: improvements of the legal system, more rule of law and transparency,
- the *Fifth Plenum* 2015: introduction of the next five-year plan, new two-child policy, future-oriented innovation, more consumption-oriented growth, medium to high GDP growth, better quality of life,
- the *Sixth Plenum* (to come): general ethics and culture,
- the *Seventh Plenum* (to come): discussion of the work report on the achievements in the past five years, final preparations for the incoming new political leaders.

## 2. Theory and research behind the new economic policy

Chinese officials frequently underline the importance of science and scientific background when it comes to the policy future of China (e.g. Third Plenum, chapter 1,2: “... *scientific development view as guidance...*”). For this reason, it may be interesting to find out to what extent the decisions of the Third Plenum from 2013 – a kind of strategic textbook – also have been based on theory and research. In my view, this is an angle that has not been dealt with in the economic literature so far.

Of central importance is the upgrading of the market economy, from a “basic” to a “decisive” role in the government’s reform policy. This strengthened priority influences many plans from the Third Plenum. At the same time, however, it should be kept in mind that the Chinese leaders still favor a mixed economic ideology, with much more market-oriented economy than before, but still with clearly recognizable elements of the traditional planned and socialist economic system (“*the objective of comprehensively deepening reform is perfecting and developing the system of Socialism with Chinese characteristics...*”, Third Plenum chapter 1,2). Let’s not forget: all reforms and changes should take place under the leadership of the CPC (Third Plenum, chapter 8, introduction).

In the past 35 years – i.e. after the revolutionary reform and opening-up message by Deng Xiaoping in 1978 - communiqués from the Third Plenum did not make particularly exciting reading since general economic policy showed more limited changes and reforms. The communiqué from the new party leadership after the Third Plenum in November 2013, however, gave quite a different impression, with many interesting ideas, strategies and new plans.

Today, Chinese academics are active all over the world. They are becoming more and more familiar with research in the U.S., Australia, the UK, Germany, Sweden and many other countries. This means, of course, that many good and trusted results from economic research overseas can be taken back home to China for discussions, tests and even applications (Freeman and Wei Huang 2015). An opening up is taking place these days for both Western research and academics, even if the Chinese do not appreciate advice from foreign experts when these people have no clue about the Chinese system and how it works.

In the table below, Fischer and Fromlet (2015) try to find theoretical or research-oriented links to different chapters of the communiqué from the Third Plenum. The angle analyzed here focuses on future improvements in the quality of economic growth with higher value-added production and better environmental conditions - improvements which China’s political leaders are working for and

which they regularly refer to in their speeches (e.g. Li Keqiang 2016). Chinese political leaders and other commentators have commented frequently during the past year or so that the quality of economic growth should be considered as more important than the quantitative GDP changes.

However, success is still very limited in this latter respect. This is probably due to two reasons. First, most Western financial economists still know very little about the Chinese economic system. Second, Chinese authorities still have not increased (statistical) transparency sufficiently. Since global financial markets usually react “online” or on the spot when significant information has been published, it remains easier to quickly interpret the numerical GDP results instead of conducting a difficult, deeper qualitative analysis of GDP changes. Improved quality of GDP statistics would help.

The table below reveals the links between economic theory/research and the objectives of the Third Plenum, including the “decisive role” of the market economy. The importance of a more market-oriented economy as an important sustainable GDP-growth contributor has proven well-founded in China since the end of 2013. This becomes, for example, evident from China’s strong ambition to be recognized as a market economy by the EU (Langhammer, chinaresearch.se 2016) – whatever one may think about the timing (which may be a good topic for another paper). By the way, China’s priority for the market economy actually strengthens in times when parts of the market-economy system are increasingly questioned (e.g. Akerlof and Shiller 2015).

Almost twenty years ago, Abel/Bernanke (1998) wrote in their textbook that *“no one understands completely why economies grow, and no one has a magic formula for inducing economic growth ... Nevertheless, economists have gained useful insights about the growth process”* (p 182). This is exactly the point, and can be applied to today’s China as well. In my understanding, there is no doubt that China’s political leaders know what is needed to bring or keep the country on a decent and sustainable growth track. The main (analytical) questions are rather how the existing economic conflicts of goals can be tackled, how certain economic strategies can be aligned with unmovable political principles, and how China can avoid financial turmoil or other major negative events originating in long-lasting economic and structural imbalances.

It is worth mentioning that the Chinese in their methodological reform approach also apply interdisciplinary links like economics and social or institutional issues. It appears that Chinese political leaders are aware of the link between the confidence of households in the future and their willingness to save less and to consume more. The politically highly preferred policy objective of a manifestly increased consumption ratio assumes – as already pointed out – visible reductions of what is still a high household savings ratio. Furthermore, there is also another interdisciplinary connection in this context since declining or increasing confidence is linked to psychology (reactions).

Surprisingly perhaps, important Chinese decision makers since the end of 2015 also clearly demonstrate their support for what they – and Western economists – call the supply side of the economy. By supply-side policy the Chinese probably do not mean exactly what former President Reagan and, for example, his advisor Arthur Laffer (Laffer Center 2016), and in Europe Herbert Giersch (1993) from academia meant. My impression is that the Chinese mainly see it as the availability and improved quality of products by innovation and technical development, whereas American supply-side policy in the early 1980s was more about improvements of incentives and fundamental conditions for households and corporate America. But similarities certainly exist as well, particularly when it comes to the more long-term oriented time horizon of supply-side policy in contrast to the more short-term stimulating demand-side policy (The Economist 2016), and finally to achieve an appropriate mix of demand side and supply side policy as seen in a number of countries since 20 -25 years ago. China may eventually think in the latter terms as well.

Theoretical concepts in the objectives set by the Third Plenum in November 2013 (Fischer/Fromlet)

<i>Theoretical framework</i>	<i>Chapter</i>	<i>Direct quote from decision (communiqué) text of the Third Plenum</i>
<b>Neoclassical framework</b>	I,2	"market has a decisive role"
	I,3	"efficiency optimization"
	II,8	"support the healthy development of the non-public"
	III, 10	"move forward with pricing reform in water, oil, natural gas, electricity, traffic, telecommunications and other such areas, set competitive market prices free"
	IV, 14	"maintaining the general economic balance"
	V, 18	"perfect the tax revenue system ... perfect local taxation"
<b>New Growth Theory</b>	III, 13	"deepen science and technology reform"
	III, 13	"develop technology markets ... improve funding conditions for science and technology-type small and mid-size enterprises"
	III, 13	"reform selection and management systems for academics"
	XII, 42	"foster quality workers and skilled talents"
	XII, 43	"complete structures and mechanisms to stimulate employment and entrepreneurialism"
<b>Institutional economics</b>	I, 2	"institutional innovation"
	II, 5	"perfect property right protection systems"
	III, 10	"raise transparency"
	III, 13	"strengthen intellectual property rights"
	VI, 21	"endow peasants with more property rights"
	VI, 23	"accelerate household registration system reform"
	VIII, 29	"let the popular masses feel fairness and justice in every judicial case"
	IX, 33	"move forward with open trials and prosecutions"
X, 36	"strengthen anti-corruption structure"	
<b>Institutional economics, focus: Finance and financial markets</b>	III, 12	"perfect financial market systems"
	III, 12	"implement financial supervision ... establish deposit insurance systems"
	III, 12	"move forward with stock distribution ... promote many channels for equity distribution ... develop and standardize bond markets ... enrich financial market levels" (also institutional)
	III, 12	"perfect mechanisms for the formation of the Renminbi exchange marketization, accelerate with moving interest rate marketization forward" (also institutional)
	IV, 14	"correct the tendency of evaluating officials' achievements merely by the speed of economic growth"
	V, 17	"establish standardized and rational debt management and risk warning mechanisms for central and global governments"
<b>Socioeconomics</b>	I, 2	"social fairness"
	VI, 23	"bring peasants who settled in cities into urban housing and social security systems"
	XII, 45	"establish fairer and more sustainable social security systems"; "research the formation of policies that gradually raise the retirement age ... accelerate the establishment of social service systems to care for the elderly and the development of services industries for the elderly"
	XII, 46	"deepen medical and hygiene structure reform"
	XII, 46	"start ... a policy where it is permitted to have two children if either a husband or a wife is an only child" (in 2015 already reformed further)
<b>Environmental economics</b>	IV, 15	"strengthen public service ... environmental protection"
	V, 18	"bring high-energy consumption and high-pollution products and a part of high-end consumption into the scope of tax collection"

More traces from Western economic research can be found in the medium- and long-term planning of the Chinese top politicians. Innovation (à la Schumpeter) is a frequently used term. So is the New Growth Theory, in line with the research of Paul Romer, Phillipe Aghion, Peter Howitt and others, focusing on human capital, technology, entrepreneurship, etc. Institutions have contributed a lot to economic research and literature in the past decades – see, for instance, Douglass North, Elinor Ostrom and Oliver Williamson - and have also gained momentum in the eyes of the Chinese architects of the new economic policy. The same can be said about other interdisciplinary research sectors as mentioned above, such as economics on the one hand and sociology, health, politics and the environment on the other.

*Considering all this, one may come to the conclusion that a great deal of the economic and social chapters from the Third Plenum in 2013 could also have been written by Western experts.*

The details from the chapters of the New Plenum's summary look a bit like an applied textbook on contributions to sustainable good economic growth in our part of the world. But how many of these - mostly good - ideas can be verified?

### 3. Conflict of goals

It has been concluded before in this paper that most of the plans from the Third Plenum are logical and urgently needed. Unfortunately, the reform program will not be enforced 100 percent. This can be said already today. Too many conflicts of goals hinder the optimization of all the relevant chapters and subchapters – indeed, this is a phenomenon that has been well known for many much needed changes even several years before the decisions of the Third Plenum were taken in 2013 (Fromlet 2011).

All in all, the following seven *domestically*-based assumptions have to be made in order to conclude that China's economic and social reforms can be (reasonably) successful – even if more has to be done and accomplished after the evaluation year of 2020:

- ✕ political and social stability over time,
- ✕ sustained general good consensus on the reforms within the leadership of the CPC,
- ✕ macroeconomic stability,
- ✕ financial stability,
- ✕ decent GDP growth in the medium and longer term,
- ✕ acceptable development of private household income (wealth) and the environment,
- ✕ reasonable optimization and compromises regarding the conflicts of goals.

The first six assumptions are probably well-known to most analysts dealing with China. The seventh assumption in the list above, however, is apparently scarcely discussed: the considerable number of conflicts of goals that are incorporated into the 60 sub-objectives set up by the Third Plenum. Some of the conflicts of goals are summed up below:

- ✕ market economy versus certain principles or the primacy of the CPC,
- ✕ transparency versus the CPC's prerogative of interpretation,
- ✕ restructuring of corporate China versus a fairer distribution of regional growth,
- ✕ urbanization versus rural development,
- ✕ economic growth versus the environment (at least in the shorter term),

- ⌘ keeping unemployment down (social fairness) versus the environment,
- ⌘ deregulation of the capital balance versus the risk of unpleasant speculation,
- ⌘ market prices versus social considerations (working poor and unemployed),
- ⌘ social security and more personal confidence versus fiscal restrictions on all government levels,
- ⌘ complete implementation of the Party's educational policies versus decisive role for the market economy.

It should be repeated in this context that five new members of the most powerful political institution – the Politburo's Standing Committee – will have to be selected in 2017 (if we assume that the total number of members will continue to be seven; only President Xi Jinping and Prime Minister Li Keqiang will - most probably - receive another five-year term). It seems possible that the fifth political generation after World War II will become more transparent after 2017 - and may give an indication of where reform policy will be heading in reality until the big evaluation year of 2020.

There is no way of giving the assumptions and conflicts of goals any numerical probability. In this case we really can speak of the classical Knightian uncertainty – uncertainty that cannot be measured at all (Knight 1921, 2006). But the fact that the probability of a certain event or trend cannot be measured does not mean that the probability necessarily must be defined as low. This is one of the major risks in China which corporate and purely financially oriented analysts have to live with, including when it comes to forecasting the eventual results of China's new economic policy. It is still surprising to watch how little the world knows about China – and wants to know about China.

What we do know, however, is that China faces an enormous restructuring process (Pettis 2013; Langhammer, China Daily Europe, 2016). According to Pettis (2013, p 4), "*China has no choice but to rebalance and restructure its economy*". This is absolutely correct.

## 4. Modified and new analytical design

Most forecasters of the Chinese economy, as has already been pointed out, have so far usually prepared their country analysis by looking at quantitative GDP developments, some other macroeconomic numbers and – maybe – the assumption of political stability. There were, of course, some economists with good country skills and the capacity to come to reasonable structural conclusions as well, based on a deeper qualitative understanding of China rather than some quick attempts to interpret recent statistics. Often, however, forecasts on the Chinese economy were until now rather technical by applying the underlying growth trend and stable risk conditions.

Today, this analytical practice is still common, albeit somewhat less pronounced according to my current own reading and impression. However, evidence for the conclusion that the country analysis of China is still too easygoing in many places around the world can be found. For example, when the Chinese National Bureau of Statistics published the outcome of GDP growth in 2015 (already on January 19, 2016), there was a lot of focus on that 6.9-percent number, also in Western analysis (e.g. Worstall 2016). But practically nobody cared about the insufficiently reported GDP aggregates. Furthermore, most Chinese and Western economists did not pay attention to what the more involved and initiated Chinese politicians, economists and journalists had been correctly emphasizing for quite some time, i.e. that the quality of growth since the Third Plenum has become more important than the pure GDP figures (Fischer and Fromlet 2015).



Thus, it appears that most analysts outside China still exhibit analytical shortcomings. It is probably true that many, but certainly not all, chief and senior economists still have not understood how complicated the analysis of the Chinese economy really is. Consequently, China analysis is often not conducted by genuine, educated China experts but by inexperienced economists (which is not wrong per se if the less experienced and/or younger economists are allowed to work on China during a longer period of time and not just under “trainee” or substitute conditions). What I want to stress here is the fact that China analysis cannot be treated as a residual part in an organization’s research department.

This is at least the hypothesis I want to launch here according to many personal observations, but without having conducted any deeper quantitative research on this issue. This could, by the way, form a good topic for an assignment, a thesis or a similar project, for instance with the objective of finding out more about the background of people from the financial sector dealing with research on China. China analysis must be conducted seriously with the necessary resources.

Looking at the details of the decisions of the Third Plenum, a lot of areas of the Chinese society and economy are now - or will become later - subject to change and/or modernization. This implies that methods and areas of China analysis will also have to be modified, emphasized more strongly, supplemented or re-thought.

Consequently, there is an urgent and obvious need to improve the understanding of the Chinese economy and its (hopefully) coming structural changes. The following examples relate to the new or revised reality, based on what was called “decisions by the Third Plenum” or what might have an impact on the interpretation of these decisions.

### **Statistical quality**

Country analysts know the rule of the game: the better the statistical input into the econometric models, the safer the results of the tests or calculations. Since the quality of many Chinese macroeconomic statistical time series is uncertain or even poor, it is hard to know which statistical numbers can effectively be used for a country analysis of China and which indicators should be avoided. There are observers who say that the quality of Chinese statistics has been improving (Xinhua 2016, January 21 and March 1) - but what do we really know about this? Opinions on this issue differ (e.g. Linnaeus University 2016). Critical voices, for example, point at the measurement problems for the GDP deflator (Wildau 2015) and, consequently, for real GDP as a whole. This skeptical angle may indeed be justified since China also has difficulties to prepare the Consumer Price Index (CPI) for the whole nation for weighting reasons as regards the eight different categories of prices and the right distribution of rural and urban inflation in percent. Furthermore, the GDP deflator is a much broader aggregate than the CPI and for this reason more difficult to calculate.

Obviously, China is still negatively affected by its persistent transparency shortcomings (Fischer and Fromlet 2015). The risk is that statistical improvements at some point - when they finally happen more markedly - will not be acknowledged on time. Certainly, better transparency is an objective of the Third Plenum. But when can we be sure that real improvements on a broader scale have indeed been achieved? How will we know for sure? One solution could be that the IMF, the World Bank and the OECD become more ambitious in this statistical China respect and invest more resources themselves in such statistical evaluation projects – with the objective that these experienced organizations eventually will come to well-based opinions on China’s statistical standards.

Hopefully, some improvement of statistical standards may arise from China’s recent subscription to the IMF’s SDDS system (Special Data Dissemination Standards, leading to regular publication of

economic and financial statistics; IMF 2015). This is a voluntary step, aimed in the first place at receiving more domestic and international recognition, but also at presenting the way the Chinese economic and financial statistical system works in reality. It tells analysts which different economic time series the NBS publishes on a regular basis. Improvements in this Chinese website are certainly desirable. The use of the SDDS standards, however, brings already today China analysts a little bit further along in their big statistical puzzle (SDDS 2015, China/People's Republic).

### **Strength/weakness of economic (GDP) growth**

China's national accounting system has quite a number of qualitative weaknesses which can explain why many international analysts still have their doubts about the real growth performance of China. First, GDP calculations concentrate on the production side, both annually and quarterly. *Annual GDP statistics* exist also for the expenditure side with the aggregates we are used to, such as private and public consumption, investment, changes in inventories and net exports, but only the nominal results are published. Second, *quarterly GDP statistics* are still exclusively calculated from the production side (primary, secondary, tertiary sector) with only volume terms being published. Third, the sums of the four quarterly GDP results are taken to get to the preliminary estimates for the entire year (SDDS 2015), usually without notable revisions later on. This is certainly not in line with good statistical information to decision makers in both China and abroad. Fourth, GDP results are usually very – or rather too - close to the top politicians' previous objectives. Fifth, official comments on quarterly GDP-growth rates and methodological improvements remain insufficient and do not really contribute to improved skills and more transparency for professional analysts.

A special tool that could be used in the interpretation of the current growth momentum has recently been presented by three researchers from central banks (Fernald, Hsu and Spiegel 2015). They have composed an activity index which includes energy consumption, cargo volumes, commodity consumption and retail sales. This index is similar to the so-called "Li Keqiang index" (The Economist 2010), named after the current prime minister who a couple of years ago as a provincial governor said that he believed more in aggregated micro indicators such as electricity consumption, bank lending and cargo volumes than in GDP calculations (an opinion which seems to be outdated these days as well since the constructed combined Li Keqiang index covers industry nowadays too heavily, as compared to Fernald et al. who at least include parts of the service sector, i.e. retail trade).

The future use of Chinese economic statistics is very much about credibility. Fluctuating GDP-growth numbers and more pedagogical official comments – also on other economic indicators - could indeed increase trust in China's statistical standards, particularly when improvements really are taking place. More illuminating press releases from the statistical office NBS could be a good start, including more visible statistical moves forward for the politically strongly favored service sector.

### **Psychology / behavioral finance**

Psychological understanding must be regarded as crucial for analysts of the Chinese economy (Fromlet 2012) and the new economic policy. This can be related to, for example, the envisaged increasing role of private consumption, mass entrepreneurship and, of course, financial markets (behavioral finance). In particular the two Chinese stock exchanges are quite often influenced by psychological reactions, a phenomenon that may become visible in the real estate market in the future as well. The planned deregulation of the country's capital balance (free cross-border capital movements) will also, at some point in the future, require substantial psychological observation. The same can be said about the future reductions of the state-owned enterprises and the reactions of their (fired) staff. Other examples from the new economic policy could be given with the

involvement of psychology. Sources for this kind of analytical input will require a lot of reading and discussions with experienced academics and practitioners.

### **Social developments**

Some socially interesting indications with possible impact on the economy have already been given above in the psychological examples. As an outstanding example, the future creation of new jobs will be extremely important. The worsening distribution of income has both a social and an economic connection and should gradually be reversed. This will certainly be difficult. Social dimensions can also be found when it comes to the official plans for more urbanization and the management of the still challenging and so far insufficiently reformed hukou system (household registration). The future development of the environment and the expectations of better healthcare can also influence the social mood of the Chinese people and, consequently, the economy. This is a frequently forgotten angle. Here too updated information can be received by intensive and regular reading of news in Chinese and Western newspapers plus talks with professionally well-informed people.

### **Institutions**

Institutions do matter when it comes to GDP growth, particularly in emerging economies. This is nothing new. It might be a good idea to apply this conclusion to China as well, preferably in a broader sense in line with Douglass North who also includes habits and traditions in his definition of institutions (Fischer and Fromlet 2015). Chinese institutions are lagging behind substantially compared to those in more mature countries (Linnaeus University 2016). This can be considered an impediment to economic growth and, consequently, potential growth. On the other hand, one may say that deep and comprehensive institutional reforms would mean reasonable contributions to future economic and potential GDP growth. Such an outlook should be encouraging. Institutionally improved conditions may also contribute to avoid accidents such as bursting bubbles on asset markets and other policy failures - and for this reason alone make a lot of sense.

### **Politics**

China's economy cannot be predicted without considering the political outlook. This can be said both for short-term and long-term forecasts. Politics may play a role both when it comes to the already mentioned composition of the new Standing Committee of the Politburo, now having seven members of which five will probably be replaced in 2017 (but the total number changes occasionally). President Xi Jinping and Prime Minister Li Keqiang, however, will (most probably) keep their seats in China's most powerful forum. Will the presumably five new Standing Committee members be (strong) supporters of Xi's and Li's economic reform policy? Will we see the emergence of an intellectually united fifth generation of political leaders after World War II? There are also economically very crucial political answers that will be given during the important 19<sup>th</sup> Party Congress in fall 2017. Analysts should remember that the Standing Committee is responsible for all of the most important political and economic decisions. The previous "automatic" assumption of unchanged political conditions for economic forecasts has become obsolete. Politics matter for the economic country analysis. But this does not need to imply that political problems will show up any time soon.

### **Commenced and concluded reforms**

Recently *initiated* economic reforms are often presented in Chinese newspapers, also on the internet. In this respect, information from China is not bad. China Daily and People's Daily can be mentioned as regular sources. I also like Western China reports, among them publications of BOFIT in Finland and MERICS in Germany. However, the reform analysis becomes more complicated when analysts wish to follow the *results* of reforms that have been already commenced or concluded. It is not easy to understand why China's administration still has not managed to publish a reasonable and regular

summary of its reform achievements. At least I have not yet seen any official publication with such a link. Making this happen would be a win-win situation, both for China and the world outside China.

#### **From micro to macro and vice versa**

The ongoing development in China increases the need - much more than in the past - for establishing helpful links between microeconomic developments/observations and their correlation to macroeconomics (or vice versa). These links may exist between free(er) pricing rules and inflation, new products and the nation's international competitiveness (exports), new companies and China's productivity, institutional improvements and economic growth potential, just to give a few examples for the micro/macro relationship. The reversed correlation, i.e. macro links to micro, can, for instance, be found between official innovation policy and individual corporate investments and between general environmental laws and their effects on single products and investments.

## **5. New analytical applications by the corporate sector**

So far a lot has been written in various publications about future official economic and social policy steps that should be taken or have recently been initiated, but not so much – as indicated in the previous chapter - about the necessary changes that already are taking place. Certain advances have been made in the past two years. But how much has really happened effectively? Some obvious or probable developments are mentioned below.

It seems, for example, credible that the role of the service sector has been strengthened more recently. This is a cornerstone in the new economic policy. The exact degree of this improvement is not known but the tertiary sector's share of total production may now in reality be slightly more than 50 percent of GDP compared to roughly 40 percent for manufacturing (applying calculations by the NBS). Some further marketization of the financial sector and improvements in financial supervision can also be observed since 2014. The yuan has become a more international currency. Institutional shortcomings like corruption seem to be counteracted more strongly these days than in the past. The residential registration system (hukou) is about to be modernized, although probably not fast and broadly enough. Urbanization as a main driver of economic growth is going on, and let's not forget the planned new Belt and Road Project with investment magnitudes that could become very high if everything goes to plan. Focus on innovation, (mass-) entrepreneurship, e-commerce and other IT developments, pollution and the "new normal" with lower potential – but qualitatively better - GDP growth has been intensified by the Chinese decision makers and has also led to concrete measures. An interesting detail is the introduction of a bonus and penalty system for pollution in an increasing number of cities in order to meet the compulsory government reduction targets of the current five-year plan (Guo Kai 2016). Further plans for pricing reforms should also be mentioned.

Thus, Chinese political decision makers are certainly not passive. Improvements have taken place recently and will happen in the future. However, insufficient reform steps may also be noted. Modern corporate analysis has to consider the promising parts of reform policy but also the major difficulties that China presumably will be confronted with in the forthcoming years or decade, the private and public (local) debt problem included.

This mixed - but not really unfavorable and to a non-negligible extent quite favorable - outlook for the Chinese reform policy should be the general **main scenario** in my view, even if the various risks, goal conflicts and possible delays definitely should not be neglected (see chapter 3 and 4 of this paper). This remaining uncertainty is also the reason why I am so strongly pleading for analysts to

persistently remain updated on developments and trends in China. Temporary and limited studies of the Chinese development will not give an applicable understanding of the Chinese economy in the global and corporate world of today.

It is generally known that main scenarios do not always come true. Most experts and companies dealing with China do not use a potentially coming major failure of the Chinese reform policy as their main scenario for the next five to ten years – based on the already mentioned Knightian uncertainty while hoping for a relatively benign development. Things may turn out well after all. In the following reflections and conclusions, devastating failures of China's new economic policy are not *assumed* by the author of this paper. However, there are obvious limits to many of the strongly pushed and necessary changes. Remember that assumptions are not forecasts.

Usually - but not always - financial markets have a different time perspective on China than non-financial corporations. The latter tend to be more concretely interested in the medium and long-term perspective than financial markets are. In most cases, financial markets only look more closely at long-term trends when risks seem to be increasing or when individual companies are analyzed. Non-financial corporations with interests in China, however, are usually more frequently interested in long-term perspectives on a more regular basis, for instance when they develop new market strategies, plan investments (including geographically), develop new or modified products, consider an adequate composition or number of their staff, etc.

There is reason to assume that China's process of restructuring the economy this time around will be much more time-consuming than generally suggested (Zhang 2015). Below, some of the most urgent questions from a corporate perspective are discussed a little bit further, some of them with really difficult answers and uncertainty à la Knight (summed up without ranking and without certain criteria such as importance or difficulties to meet the objective).

⌘ *Which corporate areas may be influenced by China's new economic policy?*

This depends on two factors: the geographical location of the headquarters (home country) and the volume of activities. If we concentrate the answer on a foreign and probably not very small company, the following areas or departments of the company may feel or will/may be affected by the results of the new economic policy (if business with China is not too limited): strategy, sales (marketing), purchasing, product development, production, finance, human capital formation, etc., i.e. major parts of the company in the case of quite extensive business with China. China's composition of imports from the Western world may change quite a bit compared to the past two or three decades, the demand patterns of young people included. Foreign companies may even be forced to develop new or clearly modified business models for China, in certain cases also considering reforms of the Chinese tax system. It should be added that many Chinese companies, too, will have to change their business models, either to expand in the future or in order to survive.

⌘ *Are there any Chinese economic statistics that can give companies some analytical guidance?*

We cannot be sure that the time series really are applicable. Doubts exist with regards to quality concerning the GDP from both the production and the expenditure side, as well as regional growth statistics, unemployment, inflation (CPI and GDP deflator), lending by the shadow banks, non-performing loans of the banks, local debt (Fromlet 2013), etc. A major problem – and this should be stressed once again - will be finding out when single economic and financial statistical time series finally have achieved notable qualitative improvements (Chung Chang et al 2015). Clear and recognizable improvements in other areas of Chinese statistics could be helpful in this context. GDP changes, for example, still serve as a very prominent economic indicator both in China and abroad, despite the qualitative shortcomings that have been recognized by analysts all over the globe. This

phenomenon could be observed again, for example, directly after the publication of the GDP results for the fourth quarter of 2015 and 2015 in its entirety. Again, financial markets strongly focused on the numbers (see, e.g., Shaffer 2016), to some extent because of the lack of alternative comprehensive business cycle indicators.

A tool to aid in the interpretation of the current growth momentum has recently been presented by three researchers from several central banks as introduced on page 10 (Fernald et al. 2016). Their composite index may give some clarification on the status of the business cycle.

Furthermore, some “proxy” indicators should not be forgotten when discussing possible guidance regarding the temperature of the Chinese economy. Changes in the monetary and credit policy of the People’s Bank of China – including slight ones that either ease or tighten – can express official interpretations of current growth in the economy. The same can be said for the central budget deficit, particularly officially “permitted” deficit increases compared to the previous year. A visible and more than temporary weakening of the currency, the yuan, may signal that political decision makers have become concerned about exports and their contribution to economic growth.

✧ *How trustworthy is quantitative analysis – or should analysts only rely on qualitative judgments?*

The latter option should be preferred also in the foreseeable future, at least until the day we have more concrete knowledge of considerable improvements in the quality of economic and financial statistics. Econometric models must be supplied with reliable data. The traditional guiding rule - that the results of econometric modeling can never be better than the quality of the statistical input - is still very much valid. This fact remains an unpleasant impediment to interesting economic research on China that may provide policy guidelines, and should be changed for the better as quickly as possible, despite the methodological difficulties in covering such a giant country statistically.

✧ *Does interdisciplinary analysis lead to better conclusions and forecasts – and what does it mean?*

Interdisciplinary analysis means - as pointed out in chapter two and four – that a number of non-economic areas in society may have an impact on the economic development of a country, both in the shorter and in the longer term. Politics, for example, may influence the economy also on the corporate (micro) level, as may social and environmental issues. This is exactly why the Chinese economy has become even more complex to analyze in these times of new economic policy.

✧ *Which are the most important structural changes from the new economic policy to follow up continuously in an international or Chinese corporate perspective?*

A number of examples can be given. China’s new growth model focuses on an increasing role for private consumption which includes the service sector as well. The tertiary sector is prioritized by Chinese political leaders, and this also contains services that are produced and bought by the commercial sector. This means that, for example, financial services, education, IT solutions, healthcare, elderly care, public transport and travel belong to the more future-oriented areas in the service sector, backed up by the more general plans of the Third Plenum. The far-reaching, continuous urbanization process should also give new and/or extended business opportunities for (foreign) companies dealing with technical solutions, various services, efficiency (production processes) and the environment. Some guidance may come - at least for the next couple of years - from the investment areas of (other) foreign companies, the geographical places that these companies prefer for their new investments and the products/product areas they make the new investments for.

✧ *What can Chinese companies tell us about investments that are based on the new economic policy?*

The objectives of the political leadership are well known since the Third Plenum. It will be very

interesting to learn (somewhat) more about the main motives for future investments by domestic companies as well; for example whether they are based on innovation, new technology, new products, upgrading in the value-added chain and more focus on the service sector. Future volumes of investments by SoEs will also be informative since political leaders want to reduce this sector which is often a burden on the Chinese economy. New credits to SoEs may serve as an illuminating indicator as well. Knowing more about all this, however, necessitates a lot of active networking and research.

✧ *What does the new economic policy mean in a regional context?*

Regional developments will to some extent look different when compared to the past. Provinces with heavy basic industries such as Shanxi, Liaoning and parts of Henan will be confronted with increasing difficulties because of the planned downsizing of unprofitable SoEs. Metropolitan cities and regions like Shanghai, Beijing, Guangzhou and Hangzhou will continue to lead the development in the future. Other cities, regions or provinces with promising plans and projects for the future will catch up. New regional trends and developments will show up as a result of the ongoing new economic policy and changing or strengthening conditions for future business activities. The new so-called Silk Road Economic Belt and the 21<sup>st</sup> Century Maritime Silk Road project (the Belt and Road initiative) can also provide new regional - and maybe even supranational - stimuli if all the Chinese plans really are carried out (Wang Yiwei 2016). All in all, future (expected) regional conditions should be part of many business decisions now, or as soon as the plans and/or the results from the new economic policy become more concrete and visible. China is also hoping for more Western startups in various regions.

✧ *To what extent are other countries influenced by economic developments in China?*

From trade theory we know about the so-called gravity model (Tinbergen 1962) which demonstrates that a country – in relative terms - tends to have more trade with neighboring countries than with more distant countries. In the case of China, however, things are different because of the enormous size of the country and its economy. Developments in China can, for example, affect Japan, other countries in Asia, Australia, Europe and the Americas – or all of them simultaneously. In the summer of 2015 and in the beginning of 2016, the nervous signals from the two stock exchanges in China had negative effects all over the globe. Weakening Chinese GDP-growth conditions at the same time also provided lower GDP-growth projections for major economies in the Western world, not to forget the psychological uncertainty that may have affected investment plans in many countries – and still does. It is, however, hard to be more precise about these effects.

Econometric models that calculate the impact of major Chinese slowdowns or upturns on specific countries are mostly based on bilateral trade relations. This may be acceptable in many cases, but not always. Rapidly decreasing GDP-growth expectations for China in particular can also provoke negative psychological reactions elsewhere. This may gradually affect the financial and real economy outside China's border. A couple of years after China's stimulation policy in 2009, in the aftermath of the subprime crisis, it was exactly the other way around. China's rapid growth then for a while contributed considerably to increase growth optimism in the world by giving the global economy more than 50 percent of its total additional GDP growth, nowadays around one third or one fourth.

China matters for the world economy – and will do so even more in the future, for better and for worse.

✧ *Is China also important to foreign companies without direct business with this large market?*

China's new strategy for the promotion and production of more value-added products may also create new markets for Chinese companies in our part of the world. This could mean harsher competition for many Western companies also at home, probably backed up by further strong

increases of Chinese FDI overseas, in order to increasingly establish Chinese firms as an integrated part of the world economy by skills- and technology-raising outbound mergers and acquisitions.

✕ *Finally, how should all the incoming reports and statistics from China be handled?*

This is indeed a key question. Not all news from China is misleading. Analysts must develop skills and a feeling for what may be appropriate and what may be wrong to use. This is possible if developments in China are read and interpreted on a regular basis. It is the only way to find out when conditions or trends in China are changing. It also makes sense to check official comments or reports. By doing this continuously, it will be easier to understand messages from China and to read between the lines.

Barro (2015) expects to see future GDP per capita at around 3-4 percent compared to the officially envisaged or implied 6.5 percent – a growth rate which he regards as enough for moving on nicely if sustained over several decades. According to Barro, political risks may emerge from unfulfilled economic dreams. Barro summarizes: *“Reducing the unrealistically optimistic growth expectations ... would reduce the risk of this (political, own remark) tension and lower the temptation to manipulate the national accounts data”*. These words may be too cautious or too pessimistic, but they signal all the same that China still is in control of its own destiny.

So far so good. However, time is tight for necessary changes.

## 6. Conclusions

Certain results and conclusions in this paper seem to be quite safe, others remain uncertain in the foreseeable future. Particularly uncertain are the answers to the questions about which single reforms will be manageable and to what extent they will or can be carried out. It does appear certain, however, that China’s new economic policy will have an impact on many corporate decisions, both within and outside China. To what extent, of course, depends on the future success of the ongoing economic reform policy and its specific advances. Both the financial and the non-financial sector will be affected.

China’s political leaders want to raise the quality of economic growth by achieving more-value added products in industry and a considerable relative increase of the service sector in total production - created by education, research, innovation, new (green) technology, IT and mass entrepreneurship. All this is based on the forward-looking decisions of the Third Plenum in November 2013, a kind of manifesto for China’s new economic policy which is relatively well based on Western economic research. It is important to be aware of the fact that many of these reforms will have an impact on countries and corporations all over the globe. For this reason, many foreign and domestic Chinese companies will have to revise their business models for the Chinese market, adapting to urbanization, demography, more competitive products, new preferences of consumers and many other challenges.

New commercial opportunities and challenges will become increasingly logical and transparent in line with the realization of the new economic policy and the “Made in China 2025” upgrading strategy (The Economist 2015). Gradually weakening markets in China, however, should also be recognized on time. More academic field research may be a promising supplement in these respects.



China's new economic policy will lead to many major and minor changes. Temporary and unsteady analysis of the economy becomes more and more inadequate. China has to be analyzed continuously and not only on special occasions when a new global forecast or sales plan has to be prepared for the company itself or for its customers. Quantitative (statistical) macroeconomic analysis has, however, many shortcomings and should thus not be relied on too heavily. Instead, more emphasis should be placed on the qualitative improvements of economic growth (which is not easy) and also on the possible risks that may show up in the forthcoming years.

Traditional brief macroeconomic analysis – the “automatic” assumption of unchanged political conditions included – can therefore not be applied anymore to a country that will likely change to a great extent in the next decade in order to be able to maintain or achieve what Chinese top politicians call “a moderately prosperous society in all respects”(Xinhua 2015, November 3) – and to escape from or avoid the middle-income trap. More interdisciplinary research that includes politics, institutions, sociology, psychology, the environment, health, etc., is certainly needed. China has to be analyzed from different angles, much more rigorously than many economists have done in the past.

*In conclusion, changing economic conditions should imply modernized analytical approaches for the world's second largest economy. This is the main message of this paper which at the same time argues for the need for better statistical quality and transparency from China's official authorities.*

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