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RESEARCH REPORT

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China's Macroeconomic Outlook and Risk Assessment: Counterfactual Analysis, Policy Simulation, and Long-Term Governance — A Summary of Annual Report (2015–2016)

Abstract This summary report highlights the confluence of continued downward pressures and deflation scares in the face of looming uncertainty in China's key macroeconomic landscapes. Counterfactual analyses and policy simulations are conducted, in addition to benchmark forecasts, based on IAR-CMM model and taking into account both cyclical and secular factors. Economic deceleration is projected to continue in the short to medium term, with real GDP growth declining to 6.3% (5.5% using more reliable instead of official data) in 2016 and facing a significant risk of sliding further down in 2017. Five key factors contributing to the weak outlook, additional to frictions and impediments associated with economic transition/restructuring and lackluster domestic/external demands, are identified, including: lack of new growth/development engine, exhaustion of government-led driving force, the

[1] This article summarizes the main findings from a similarly titled annual report released in January 2016 by a research team at the Institute for Advanced Research (IAR), Shanghai University of Finance and Economics (SUFE), the other members of which include (in alphabetical order of last names) Jie Chen, Yuanyuan Chen, Zhe Li, Liguo Lin, Yuqin Wang, Howei Wu, Huabin Wu, Haichun Ye, Tao Zha, Lin Zhao, Min Zhang, Sisi Zhang, Yahong Zhou, and Mei Zhu.

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crowding-out of private sectors by state-owned enterprises (SOEs) with excess capacity\capital overhang, nonperforming government sectors and officials, and twist or misinterpretation of the "New Normal." A root cause of these problems, lying with sluggishness in China's transformation into a market based economy, has to do with overpowered government but underpowered market in resource allocation and government underperformance in enforcing integrity and transparency in the marketplace and in providing public goods and services. At the nexus between inclusive growth and institutional transformation are market oriented and rule of law governed structural reforms and harmonious development. As such, fundamental institutional reforms that *dialectically* balance demand and supply side factors and properly weigh short run stabilization against long run development should be elevated to the top of the agenda.

Keywords macroeconomic forecast, risk assessment, policy simulation, alternative scenarios, long-term governance
JEL Classification E01, E17, E27, E37, E47

Entering year 2016 China's macroeconomy sees continued downward pressures and (debt) deflation scares. In the mist of continuously weakening real economy activity, declining consumer confidence, sluggish investment growth, and stagnant exports and imports, is the wake of private sector bankruptcy waves and increasing tendency to relocate overseas. Spillovers from the downward trajectory in real sector to the financial sector are escalated, with convoluted risks heightened by elevated nonperforming bank loans. The accelerated paces of RMB internationalization and capital account liberalization, in the face of FED rate hikes, exert pressures on China's central bank for bigger yuan depreciation and contribute to record capital outflows. What darken the economic prospects most are the unpleasant realities that China has not obtained new engines to ensure sustained growth, that it has yet to develop into a new phase to achieve inclusive growth, and that it lacks institutional arrangements and rules of law to incentivize innovation-driven and efficiency-enhancing growth and development.

We have obtained the above assessments based on IAR-CMM model developed by Institute for Advanced Research at the Shanghai University of Finance and Economics, taking both cyclical and secular factors into

consideration. Our baseline forecasts indicate that real GDP growth is to continue slowing down in the short to medium term, dropping to 6.3%, or 5.5% based on more reliable instead of official data, in 2016, and facing a significant risk of declining further in 2017. The more reliable data are constructed by appropriately correcting the official statistics based on information embedded in total electricity consumption, national railway freight volume, and medium and long term loans, which, as widely believed, may provide more accurate measures of China's real economic activity. Counterfactual analyses under alternative scenarios concerning external conditions and other uncertain factors lend support to the robustness of our main conclusions.

In addition to providing the forecasts with the baseline and alternative scenarios, we have also conducted policy simulations under various scenarios to configure a menu of policy options that may help achieve the target growth rates that the Chinese government might have in mind. We show that this kind of stimulus packages should be used with caution in light of their side effects, especially from a long run perspective.

We have analyzed five key factors, additional to various frictions and impediments associated with China's economic transition and restructuring and lackluster internal and external demands, that have been contributing to the weak economic outlook, including: lack of new growth or development engine, exhaustion of government-led driving force, the crowding-out of private sectors by state-owned enterprises (SOEs) with excess capacity or capital overhang, nonperforming government sectors or officials, and twist or misinterpretation of the "New Normal." We have emphasized that a root cause of these problems, lying with sluggishness in China's transformation into a market based economy, has to do with the dominance of government and thus the subservience of market in resource allocation and government underperformance in enforcing integrity and transparency in the marketplace and in providing public goods and services.

At the nexus between inclusive growth and institutional transformation are market oriented and rule of law governed structural reforms and harmonious development. As such, fundamental institutional reforms that dialectically balance demand and supply side factors and properly weigh short run stabilization against long run development should be elevated to the top of the government's agenda.

1 Macroeconomic Outlook and Major Risks

1.1 Steady Share of Consumption in GDP Growth but Falling Consumer Confidence

Cumulative growth in total retail sales of social consumer goods over the first 11 months of 2015 registered 10.6%, 1.4 percentage points below that in 2014, even though the Q3-over-Q3 yearly growth rate edged up compared to the first two quarters of the year. This was accompanied by faded consumer confidence, with the consumer confidence index, consumer satisfaction index, and consumer expectation index all dramatically declining in the second half of the year (see Figure 1). This is due in part to the recent economic downswing and stock market turbulence, during which trillions of yuan in consumer wealth evaporated. But, this reflects primarily some fundamental imperfections of the country's social-economic system, such as lack of public services, social security, and social safety net. Burgeoning overseas shopping and purchasing also drained resources from domestic demand, right in the face of lackadaisical foreign demand. All of these make consumption unlikely a major source of growth in the near to medium term.

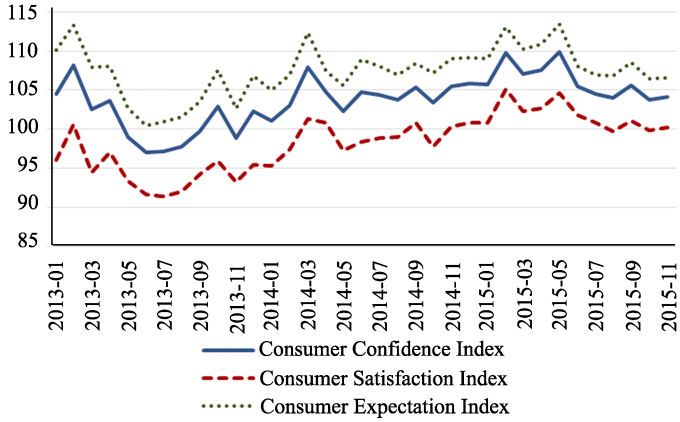

Figure 1 Consumer Confidence Index, Consumer Satisfaction Index, and Consumer Expectation Index

Source: National Bureau of Statistics of China.

1.2 Continuously Falling Investment Price and Plunging Investment Growth

While the negative growth in the producer price index already persisted for years, the year of 2015 also saw continuously falling prices for investment in fixed assets, positing greater deflation scares and an increased risk of debt-deflation spiral. Growth in national fixed asset investment decreased continuously, with cumulative growth over the year (January-November 2015) plunging to a record low of 10.2% (see Figure 2), and the reduction in yearly growth rate (compared with 2014) was across the board: largest in real estate development, dropping 10 percentage points to a mere 1.3%, followed by manufacturing, falling 5 percentage points to 8.4%, then by infrastructure construction. The declines in the first two categories are more secular than cyclical, and these trends are unlikely to revert in the foreseeable future. While it is conceivable that the government will rely on infrastructure investment to help achieve its growth target, this in our assessment is unlikely to play a decisive role in stabilizing the growth path, given the immense risks of unsustainability of local government debts.

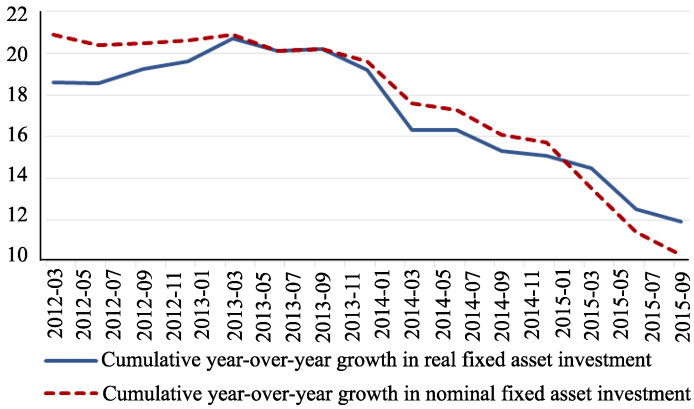

Figure 2 Real and Nominal Rates of Growth in National Fixed Asset Investment

Source: National Bureau of Statistics of China.

1.3 Declining Real Economy and Looming Bankruptcy Waves

Chinese industrial enterprises saw continued negative growth in profit during 2015, with the yearly rate of cumulative growth (January-November) for those above designated size registering a minus 1.9%, in contrast to the plus 5.3% for

the previous year (see Figure 3). The number of industrial enterprises suffering losses also grew briskly, 54,459 in the single month of November, with the November-over-November yearly growth rate reaching 17.4% (see Figure 4). Persistently high finance costs facing private enterprises set fire to the declining real economy, triggering massive waves of bankruptcies, which came back to haunt the banking sector, with convoluted systemic risks heightened by exalted

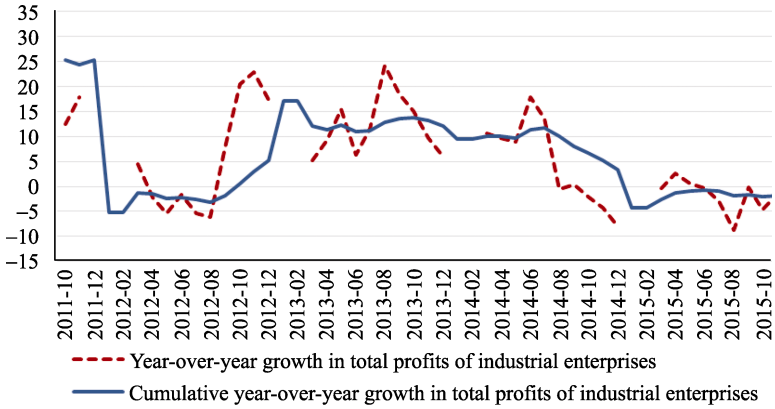

Figure 3 Yearly Profit Growth Rate of Industrial Enterprises

Source: National Bureau of Statistics of China.

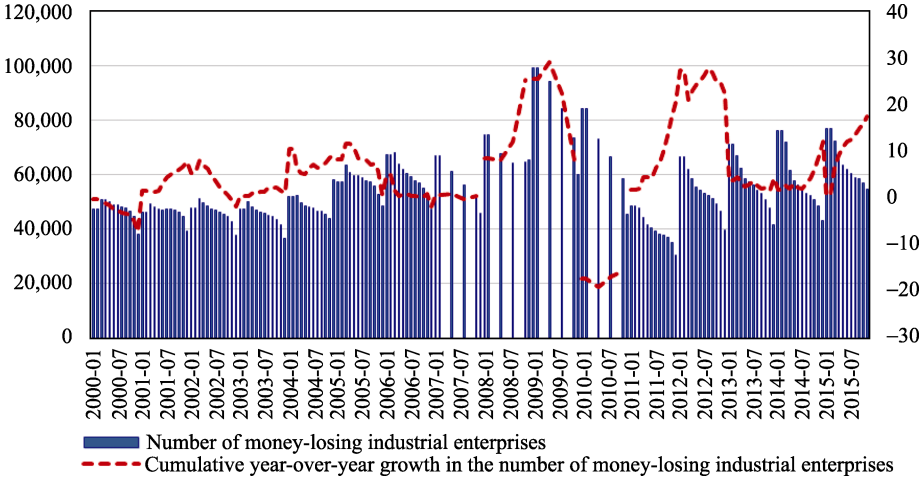

Figure 4 Number of Money-Losing Industrial Enterprises

Source: National Bureau of Statistics of China, in number of enterprises (left), in % (right).

nonperforming loans. The more advanced regions, with better developed private economy and relatively more favorable infrastructure and financial environment, such as Guangdong, Zhejiang, Jiangsu, Fujian and Shandong, did not fare any better. Pearl River Delta Manufacturing Collapse Investigation conducted by Daily Economic News reveals that furniture, textiles, electronics, ceramics, and several other labor-intensive industries were among the hardest-hits.

1.4 Greater Pressures on Foreign Trade Aimd a Diminishing Role of RMB Depreciation

Stagnant exports and imports characterized China's international trade for the entire year of 2015, with drastic widenings in passive trade surplus but in service trade deficit resultant in part from dramatically increased tourism service imports, posing greater pressures on balance of international payments. That year witnessed an 8% reduction in yearly growth rate of total export-import volume, amounting to USD 3958.64 billion, of which USD 2276.57 billion were exports and USD 1682.07 billion were imports, down 2.8% and 14.1% respectively from the previous year in their yearly growth rates (see Figure 5). This implies a trade surplus of USD 594.5 billion, USD 211.4 billion more than in 2014, reflecting mostly the drastically widening passive trade surplus, in the face of the widening service trade deficit which totaled USD 187.91 billion during the first 11 months

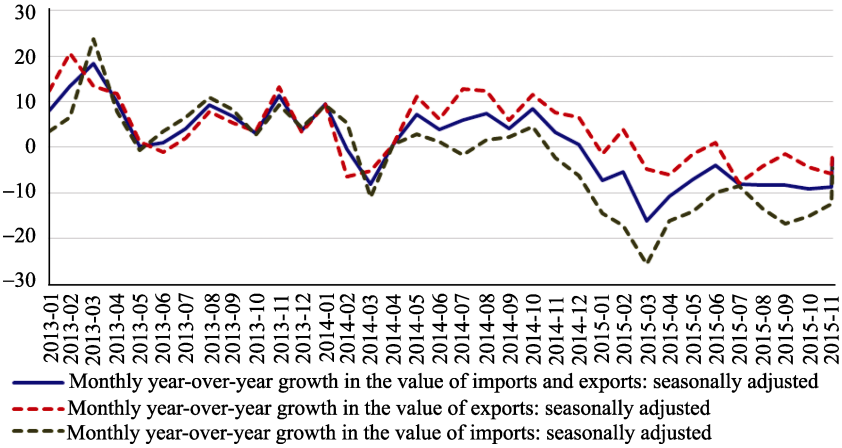

Figure 5 Growth in China's International Trade

Source: China's General Administration of Customs.

of the year. Our estimates indicate China's exports and imports are fairly inelastic with regards to exchange rate variations, with the elasticities being –0.36 and –0.48, respectively. This implies that RMB depreciation will have a limited impact on China's international trade. In contrast, income elasticities of China's exports and imports are found to be much greater, estimated at 4.4 and 1.2, respectively. This implies that global economic recovery may help China's exports rebound more than does yuan depreciation.

1.5 A Spiral of RMB Depreciation and Capital Flight

China's long time international payments surplus eventually came to an end. Fifteen years after Q3 2000, its balance of international payments for the first time registered USD –22.58 billion in Q1 2015. The quick reversal in Q2 was followed by an even bigger deficit, reaching USD –88.8 billion in Q3. As discussed above, rapidly increasing service trade deficit was a main contributor, offsetting much of its goods trade surplus. In addition, accelerated RMB internationalization and capital account liberalization, in the face of weakened domestic economy and US FED rate hikes, exerted great pressures for bigger RMB depreciation and contributed to record capital outflows (see Figure 6). The spiral of RMB depreciation and capital flight is a kind of vicious cycle and poses one of the greatest risks threatening China's financial and foreign exchange stability.

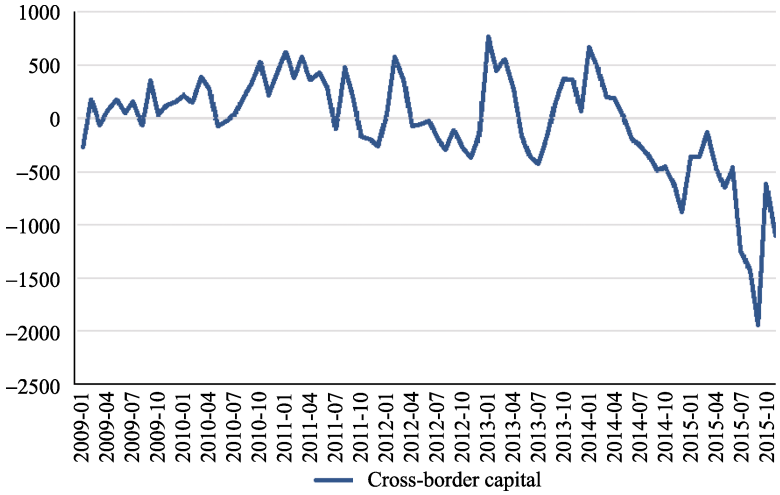

Figure 6 Cross-Border Capital Flows

Source: China's State Administration of Foreign Exchange, in hundred million dollars.

1.6 An Impending Debt-Deflation Spiral

The aforementioned persistent negative PPI growth and continuously fallen investment price are accompanied by further declined GDP deflator whose growth rate trickled down to –0.5% in Q3 2015 (see Figure 7). The impending deflation scares in the production and investment sectors lifted real rates of interest faced by enterprises in the face of rising costs of labor and other factor inputs. This further squeezed corporate profits and exerted greater pressures on corporate debt burdens. The severity of the problem was evidenced by the continuously declining industry profitability and increasing numbers of enterprises running deficits, going bankrupt, or tending to relocate overseas. The higher real costs of capital and tightened borrowing constraints exacerbated the real economy, reducing investment, production, and income, let alone firms' incentives for hiring or to create new jobs. One major threat to China's macroeconomy the year saw is such a debt-deflation spiral starting to take shape.

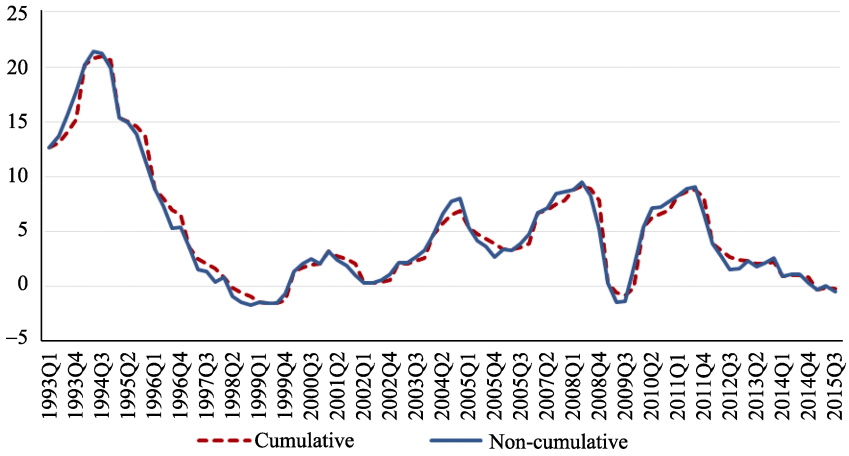

Figure 7 Yearly Growth Rate of the GDP Deflator

Source: Institute for Advanced Research, Shanghai University of Finance and Economics, in %.

1.7 Heightened Systemic Risks in the Banking System

Transmissions of the downward pressures in the real economy to the banking sector were escalated in 2015, with convoluted risks heightened by elevated nonperforming loans and plunged growth in bank profits. China central bank

benchmark interest rate was lowered five times during the year in an attempt to maintain the target growth rate. Amid such lax monetary policy net interest rate spread, a traditional source of commercial bank profits, narrowed considerably. By Q3 2015, net interest margin of commercial banks was merely 2.53%, 0.15 percentage points below that in 2014, and lowest since 2010; and, yearly cumulative net profit growth saw an even bigger, 10.5 percentage-point, reduction from the level in 2014, to a historical low of 2.21%; in the meantime, the share of nonperforming loans as a fraction of total loans rose to 1.59%, up 0.09 percentage points on a quarter to quarter basis and 0.43 percentage points year on year (see Figure 8), with the increases being the largest for industries suffering from severe excess capacity or capital overhang (e.g., manufacturing, mining, wholesale, retail). This not only trimmed traditional banking profits, but also induced banks to engage in risky off-balance-sheet activities, which fostered the development of an opaque shadow banking system, created gridlock and systemic risks, generated network externalities, increased the complexity of the financial architecture, and facilitated and nourished stock and real estate bubbles.

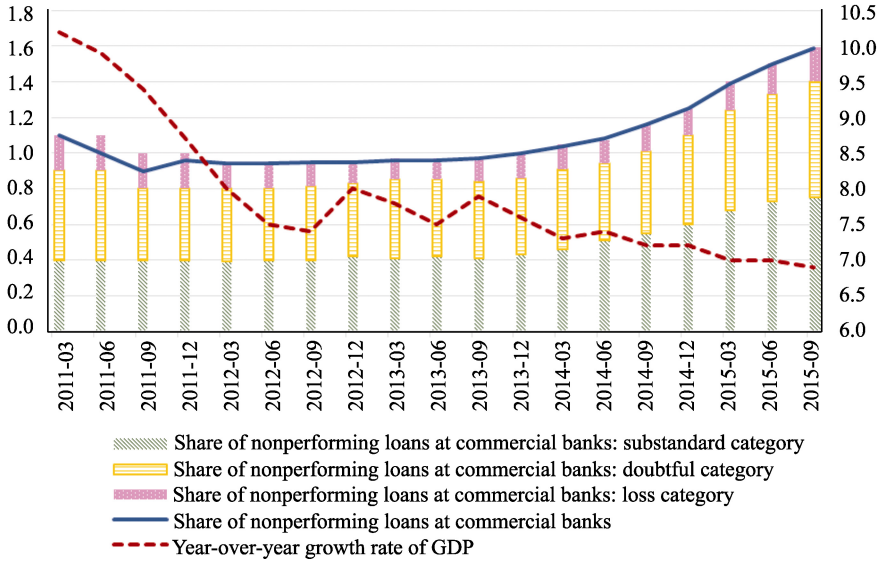

Figure 8 Yearly GDP Growth Rate and Share of Commercial Bank Nonperforming Loans

Source: National Bureau of Statistics, China Banking Regulatory Commission, in %.

1.8 Immense Risks of Local Government Debt

Fears that China's debt mountain might turn into an avalanche hit the headlines in 2015. The December 2015 study by China's National People's Congress (CNPC) found a remaining balance of local government debt of RMB 15.4 trillion at the end of 2014, which, when added with local government contingent liabilities, amounted to RMB 24 trillion, taking up 37.7% of GDP, while estimated national debt totaled 79.7% of GDP. With the RMB 16 trillion cap on total outstanding local government debt for 2015 approved by the CNPC on August 29 of that year, local governments' total liabilities are estimated to be 1.88 times of their budget revenues (see Figure 9). As local government deficit widened approaching the end of 2015 and entering the year of 2016, debt finance need continued surging, posing immense risks on the sustainability of local government debt and debt restructuring.

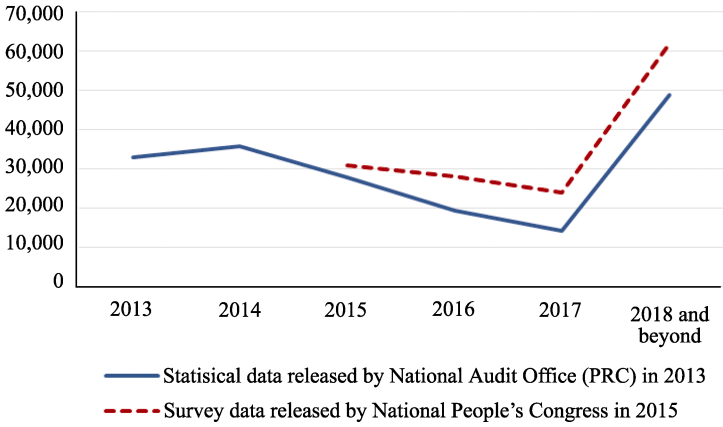

Figure 9 Local Government Debt Matured by Year

Source: National People's Congress, National Audit Office, Wind, in hundred million yuan.

1.9 Labor Market Frictions and Rising Unemployment Risk

Increases in corporate debt burden in the face of declining profit margin reduce firms' capabilities and incentives for hiring or posting jobs in the transitional and restructuring Chinese economy. To get a quantitative feel about their impacts on unemployment and output, we estimated matching efficiency in Chinese labor

market in the context of DMP search-matching theory with Chinese household and firm level data. Our estimate implies that a 5% (10%) reduction in job vacancy posted by firms will result in unemployment rate rising 0.42 (0.87) percentage points, and, by Okun's law, GDP declining 0.84 (1.74) percentage points. However, our estimate is likely to understate true matching efficiency, as the job formation data that we used in coming up with the estimate only count successful matches through labor service agencies. When we weigh our estimate and the estimate based on the US data, we find that a 5% (10%) reduction in job vacancy posted by firms will result in unemployment rate rising 0.15 (0.32) percentage points, and, by Okun's law, GDP declining 0.30 (0.64) percentage points.

1.10 Weak External Outlook and Global Recovery Uncertainty

Recoveries of the world major economies from the global recession have been sluggish and at uncertain paces. The emerging market economies, except India, have also encountered difficulties in sustaining their economic growth, and they are faced with tremendous risks of capital outflow, geopolitical conflict, economic restructuring, and falling prices of staple commodities. In light of the weak external outlook and global recovery uncertainty, China is likely to continue seeing weak export growth in 2016.

2 Near to Medium Term Forecasts and Policy Simulations

Our semi-structural forecasts, counterfactual analyses, and policy simulations are based on quarterly IAR-CMM model. Table 1 displays baseline growth projections for major macroeconomic indicators for Q4 2015, and for each quarter of 2016, along with the realizations of these variables in the first three quarters of 2015.

Four major assumptions about external environment underlying the baseline forecast are summarized below.

(1) Global recovery assumptions for major developed economies are taken from IMF October 2015. Rates of economic growth in 2015 and 2016 are projected to be 2.6% and 2.8% for the US, 1.5% and 1.6% for the Eurozone, and 0.6% and 1.0% for Japan;

(2) International bulk commodity prices are expected to rebound gradually,

with tame oil prices and about steady global trade;

(3) Two 25 base point federal funds rate hikes in 2016;

(4) The exchange rate of RMB against USD is expected to depreciate to 7.0 in 2016.

There are also nine baseline assumptions concerning internal environment.

(1) Falling consumer confidence and lackluster consumption demand in the face of gradually upgrading consumption structure through the end of 2016;

(2) Stagnant exports and imports and their limited roles in boosting economic growth;

(3) Dwindling profit margin and looming bankruptcy waves delivering a major blow to the already plunging investment growth;

(4) Heightened systemic risks in the banking system with the size of nonperforming loans reaching the level of 2008;

(5) A RMB 16 trillion cap on total outstanding local government debt;

(6) Decelerating real estate development investment in 2016, considering the slowdown in commercial housing sales since 2015, without factoring in other external impacts;

(7) Upswinging restructuring frictions in the labor market;

(8) Monetary policy is expected to remain accommodative in year 2016, with one 25 base point reduction in the benchmark interest rate coupled with four to six 25 or 50 base point reductions in the required reserve ratio (RRR);

(9) Fiscal policy is expected to be stimulative, with government budget deficits growing to RMB 2.1 trillion by the end of 2016.

The take-home message from the baseline forecast, as can be seen from the first two rows of the table, is that growth deceleration will continue in the near to medium term, with annual real GDP growth rate declining to 6.3% (5.5% using more reliable instead of official data) in 2016 and facing a significant risk of sliding further down in 2017.

In light of the uncertainty on the economic outlook, we have considered alternative scenarios to explore the implications for the outlook of alternative forecast assumptions. We report here two sets of alternative scenarios that reflect alternative assumptions on the paths of the federal funds rate and the RMB/USD exchange rate. The optimistic scenario, which assumes more gradual funds rate hikes and stronger recovery of the US economy contributing to a 10% increase in China's exports, results in annual real GDP growth rate of 6.4% (5.6% using

Table 1 Near to Medium Term Baseline Forecast of Yearly Growth Rate[2]

	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2015	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2016
GDP	7.0	7.0	6.9	6.8	6.9	6.45	6.15	6.25	6.35	6.3
GDP (adjusted)[3]	6.3	6.3	6.1	6.0	6.2	5.65	5.36	5.46	5.57	5.5
Consumption	10.6	10.2	10.7	11.2	10.7	10.7	10.4	10.7	11.1	10.8
Investment	13.5	10.4	8.6	8.8	8.8	8.5	8.1	9.1	9.5	9.5
Export	4.5	–2.9	–6.2	–4.9	–2.8	–0.8	2.2	2.0	1.8	1.36
Import	–17.8	–13.8	–14.5	–10.6	–14.1	–6.3	–3.8	–5.2	–4.1	–4.8
CPI	1.2	1.4	1.7	1.5	1.4	1.4	1.3	1.2	1.2	1.3
PPI	–4.6	–4.7	–5.7	–5.9	–5.2	–4.0	–3.6	–2.7	–1.5	–3.0
GDP Deflator	–0.33	0.09	–0.5	–0.6	–0.3	–0.1	0.1	0.0	0.0	0.0
M2	11.6	11.8	13.1	13.1	13.1	12.8	13.1	13.3	13.3	13.3

more reliable instead of official data) in 2016. The pessimistic scenario, which assumes a 20% depreciation of RMB against USD, results in annual real GDP growth rate of 6.15% (5.36% using more reliable instead of official data) in 2016. These two sets of alternative forecasts are reported in the first two rows of Table 2. Note that the middle column of the table shows the baseline forecast that is already reported in Table 1, which is replicated here in order to provide a reference to which the alternative forecasts can be compared.

In addition to providing the baseline and alternative forecasts, and given that the Chinese government seems to have in mind certain growth target for year 2016, it is also fitting that some explorations are undertaken to configure a menu of monetary and fiscal policy options that may help achieve the target growth rate. Consider a target growth rate of 6.5%, or 5.7% in terms of adjusted data, for year 2016. The following combinations of monetary and fiscal policy options for the year may help achieve this growth target under the three alternative scenarios (see Table 2):

[2] The statistics reported in the table are based on real measure for GDP but nominal measures for the other variables. Yearly growth rate is cumulative for investment but noncumulative for the other variables.

[3] Adjusted GDP data are constructed by appropriately correcting the official statistics based on information embedded in total electricity consumption, national railway freight volume, and medium and long term loans, which, as widely believed, may provide more accurate measures of China's real economic activity.

Table 2 Alternative Forecasts, Counterfactual and Policy Simulations (for year 2016)

	Optimistic	Baseline	Pessimistic
Yearly growth rate	6.4%	6.3%	6.15%
Yearly growth rate (adjusted)	5.6%	5.5%	5.36%
Target growth rate	6.5%	6.5%	6.5%
Target growth rate (adjusted)	5.7%	5.7%	5.7%
Monetary policy easing	25 BP reduction in RRR	50 BP reduction in RRR	50 BP reduction in RRR; 25 BP reduction in the benchmark interest rate
Fiscal expenditure（trillion yuan）	19.06	19.35	19.64
Fiscal expenditure growth rate	11.1%	12.8%	14.5%
Fiscal deficit（trillion yuan）	1.88	2.17	2.46
Fiscal deficit growth rate	16.2%	33.9%	51.6%

Source: IAR, SUFE.

(1) Under the optimistic scenario: A 25 base point reduction in the required reserve ratio and fiscal expenditure of RMB 19.06 trillion, an 11.1% increase from the 2015 budget;

(2) Under the baseline scenario: A 50 base point reduction in the required reserve ratio and fiscal expenditure of RMB 19.35 trillion, a 12.8% increase from the 2015 budget;

(3) Under the pessimistic scenario: A 50 base point reduction in the required reserve ratio coupled with a 25 base point reduction in the benchmark interest rate, along with fiscal expenditure of RMB 19.64 trillion, a 14.5% increase from the 2015 budget.

However, one should not take our counterfactual analyses and policy simulations as suggesting that we advise the government to adopt these monetary and fiscal stimuluses, or to pursue its target growth in the first place. Clearly, we do not. Rather, we urge that this kind of stimulus packages should be used with caution in light of their side effects, especially from a long run perspective.

3 Deciphering China's Economic Slowdown from Longer Term Perspectives

China's economic slowdown is both cyclical and secular. In considering the longer run prospects of China, as rapid workforce expansion and a massive shift of labor from the agricultural into more productive sectors have run their courses,

and its population aged 15–59 has started shrinking about 700,000 per year and dependence ratio rising steadily since 2010, the potential rate of growth has declined moderately. The switch of growth into a lower gear is also natural in the face of the restructuring Chinese economy, which has been shifting away from export- and investment-driven models towards consumption- and services-led growth, and as the law of diminishing returns has already set in.

In addition to such frictions and impediments associated with its economic transition and restructuring and the various cyclical factors discussed above, such as the lackluster internal and external demands, five major factors have contributed to China's economic slowdown, including: (1) lack of new engines to ensure sustained growth or development; (2) exhaustion of government-led driving force; (3) the crowding-out of private sectors by SOEs with excess capacity or capital overhang; (4) nonperforming government sectors or officials; (5) twist or misinterpretation of the "New Normal".

A root cause of these problems, lying with sluggishness in China's transformation into a market based economy and development into a phase of inclusive growth, has to do with the dominance of government and hence the subservience of market in resource allocation and government underperformance in enforcing integrity and transparency in the marketplace and in providing public goods and services. At the nexus between economic growth and institutional transformation are market oriented and rule of law governed structural reforms and harmonious development. As such, rule of law based, fundamental institutional reforms that dialectically balance demand and supply side factors, properly weigh short run stabilization against long run growth and development, and effectively incentivize efficiency-enhancing and innovation-driven modes should be elevated to the top of the government's agenda.

4 Reform and Governance: A Long March to Continue

Since beginning to reform its economy in the late 1970s, China has experienced a gradual transformation from a closed central planning economy to an open-door market economy, which has set it on a catch-up growth trajectory that has made it the world second largest economy nowadays.

However, this path to a free market economy has not been a smooth journey and, in many parts, does not appear to be the result of a well-conceived or well-designed process, with compliance to the development logic and

governance logic at the same time. Rather, it has been characterized by constant tensions between two countervailing forces, the free market and the government's proclivity to do whatever it takes to maintain "stability and order," and recurrent resistances from entrenched interest groups. This results in China's economy remaining underdeveloped and inefficient in dramatic ways, with considerable distortions and misallocations of resources throughout the system. Nevertheless, the "old two," factor-intensive growth models, that is, investment-driven growth centered on heavy industry and infrastructure, and export-led growth facilitated by globalization and strong external demand, in the face of favorable demographic factors, have allowed China to enjoy thirty-plus years of rapid growth, notwithstanding substantial environmental and resource costs as well as rising inequality.

But, today, the "old two" engines that drove China's economic boom for the past thirty five years have come to a halt, and the country is at a major crossroads on its long journey to economic development. To be better positioned to withstand the transition to the next phase of its development journey, it is imperative for China to develop and implement a scientifically coherent reform strategy, with compliance to not only the development logic but also the governance logic. This is based in the idea of a limited government promoting free enterprise with fair competition embracing policies that would transform China into a modern market economy and regulatory state with a high standard of living.

The government has a long way to go on the path to such a market economy. A key step is to rebalance the sources of economic growth and development by restructuring the overall macroeconomy in a way that shifts from the "old two" to the "new two" engines centered on domestic consumption and services, which would help spurring innovation and ultimately creating a knowledge economy. As discussed above, slower growth in the near to medium term is a natural by-product of Chinese rebalancing. But by rebalancing the economy towards more slowly growing yet environmentally more friendly consumption and services-led activities, China is set to begin a decisive transition to a more sustainable and healthier growth path. This would help China avoid the dreaded middle-income trap.

However, China's restructuring/rebalancing and regulatory reforms have been more challenging than expected. The main reason is that many policy measures implemented have not been well-thought, well-designed, directed towards the

laws and regulations, or well communicated with the populace or among the government officials themselves, with unpredictable backtracking and sidestepping that involve on-and-off heavy-handed government interventions, resulting in serious distortions, confusions, and volatilities in the economy. Recent examples of poorly executed (although perhaps well-intentioned) policy reforms are government interventions in the stock and foreign exchange markets, especially the promulgation and halt of Circuit Breaker policy in early 2016. Such a one step forward, two steps sideways approach to reforms has increased the risks that arise during the transition to a new phase of economic development. Without systematic legal and institutional reforms aimed at allowing markets to have free rein and, thus, leaving prices to be set in accordance with relative scarcities and social preferences, China's unbalanced economy can hardly be corrected. In other words, better governance or rule of law is a key to the success of regulatory reforms and restructuring/rebalancing.

This is no easy task. To ensure that China stays in right course, its government should continue promoting private or mixed ownership enterprises and entrepreneurships while undertaking state-owned-enterprise reforms, and developing and nourishing a healthy and transparent marketplace that is rooted with good faith and fair and orderly competition. This requires transforming the government from a "grabbing hand" to a "helping hand," from a market participant to a market regulator and public goods and services provider, and from a patron of special interest groups to a guard of public interests. It calls for the need to rebalance power between central and local authorities, between the state and the party, and between the government and the populace. This may be achieved by legalizing the governance boundaries between government and market, and between government and society, that will incentivize bureaucrats and administrators to put the rule of law and due process ahead of politics and special interests.

It is equally imperative that China stays on track in fostering innovation, reducing inequality, maintaining social justice and fairness while enhancing social safety net, combating corruption, improving ecological environment, further opening its economy, building cultural industries and international soft power, and managing foreign relations.

All of these are crucial elements in China's transformation into a modern free market economy and regulatory state.

While still a long march, China is decisive to continue along this unmistakable trend.

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