



# CHINA'S NEXT TRANSFORMATION

From humble beginnings, China has worked hard to bring about its meteoric transformation into an economic superpower. However the country now faces fresh challenges as its growth rate gradually slows, and is seeking novel ways to sustain its economic growth in the long run. **CHRISTINE LAGARDE**, Managing Director of the IMF, weighs in on the key steps China could take to rejuvenate its economy. Excerpts.

‘I have been coming to China now for some 20 years—and yet I never cease to be amazed to find it always changing, always rejuvenating, always striving to fulfill the “Chinese Dream”, as President Xi Jinping has put it. The IMF has been China’s partner in this quest. In fact, the Fund marks its 70th anniversary this year and it is worth recalling that China was one of our founding members. We have travelled far together.

It is hard to believe but, back in 1944, the IMF had only 35 member countries who struggled to rebuild a global economy torn apart by war. Today, we have 188 members, with countries now interconnected globally in myriad ways. In the process, the IMF has been transformed into a premier institution for international economic cooperation.

Of course, China has also been transformed: today it is the world’s largest trading nation; the world’s second-largest economy; and with a record in poverty reduction that is unparalleled in human history. The IMF, with our global experience and technical expertise, has supported China in this great endeavor. In turn, we have benefitted—and learned—from China’s achievements.

Today, China stands on the threshold of its next historic transformation—one that will propel it on a trajectory of even



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higher quality and more sustainable growth. And a trajectory of even greater global leadership. In that context, I would like to discuss three issues. First, the current state of the global economy and the implications for China. Second, the key policy steps in achieving China's next transformation. Third, China's global role in the 21st century—and what it means for the world.'

## The state of the global economy

'First, the global economy...Overall, global prospects are improving. The world economy is slowly turning the corner, although growth remains too weak and too unbalanced. In January, we projected global activity to strengthen from 3 percent in 2013 to about 3.7 percent in 2014—largely driven by improvements in the advanced economies.

Activity in emerging market and developing economies picked up slightly in the latter part of 2013, driven by stronger external demand from advanced economies. Although tighter external financial conditions will be a drag on domestic demand, emerging Asia will continue to be a bright spot, posting the highest growth rate of about 6.7 percent this year and next. China will continue to be a key driver of this momentum, albeit with lower but more sustainable growth rates.

Among the advanced economies, growth will be strongest in the United States, supported by robust private demand. Even so, it will be critical to continue to manage carefully the withdrawal of monetary support and to address medium-term fiscal uncertainty.

In the euro area, a modest recovery is taking hold—stronger in the core countries, but weaker in the South. Progress on banking union in recent days is encouraging and we look forward to further implementation—which is essential for a durable recovery.

In Japan, private investment and exports are seeing a boost from the monetary "arrow" of Abenomics. But for growth to be sustained, we need all "three arrows" to be fired—including a medium-term fiscal plan and structural reforms.

Overall, even as global prospects slowly strengthen, the specter of some old risks remain: incomplete financial sector reform, large debt burdens, increasing inequality and unacceptably high unemployment.

At the same time, we see some new

risks appearing. Let me mention two in particular. Number one, in the advanced economies—particularly in the euro area—the risk of prolonged low inflation is looming and needs to be appropriately addressed, including through unconventional monetary policies as needed.

Number two, in emerging market economies, there is a risk of heightened market volatility associated with the tapering of monetary policy in the advanced economies. Given that countries with larger domestic and external imbalances are likely to be more affected, strong macroeconomic policy responses on their part will be key—as will continued clear communication and cooperation among all parties concerned.

What does this mean for China? China has clearly emerged as a stabilizing force in the global economy. In fact, China accounted for more than a third of total global growth over the past

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five years—and for almost half of the emerging and developing economies' growth. Going forward, a strengthening global economy will help China's economy—and help maintain its leadership role in many areas of business, trade, and finance. But to sustain that role—and to enhance it—further important policy steps will be needed.'

## Key policies for China's future

'Which brings me to my second topic—China's next transformation. China's enormous economic progress is due to the courage of its leaders and people who were not afraid to undertake bold reforms, even if they were costly in the short term. China is again at a crossroads. While headline growth numbers remain impressive, this disguises some serious obstacles that need to be overcome.

In a recent address, President Xi Jinping put it this way: "Pausing and withdrawing are not a way out. Reforming and opening up only has a progressive tense, not a perfect tense." The challenge is clear: to make growth more inclusive, friendlier to the environment, and more sustainable. The reform blueprint announced at the Third Plenum is an impressively ambitious and comprehensive response to this challenge.

From that blueprint, I would emphasize three key steps: unleashing the potential of the services sector; building a modern, globally integrated financial sector; and strengthening inclusion and safeguarding the environment. Let me elaborate on each.'

## Transforming the services sector

'China's previous round of reforms transformed it into a manufacturing powerhouse. The next round of reforms must be aimed at increasing the role of the modern services sector. This will not only unlock the substantial growth potential in that sector, but also boost employment, consumption and living standards. As with the previous reforms, removing barriers blocking development of the private sector will be key.

For example: China is currently among the top three countries in the

world in filing patent applications—more than 435,000 of them in 2011 alone. It also ranks first worldwide in terms of creative exports—that is, export products based on exclusive trademark registrations in China. The question is how to safeguard and nurture this success?

Productivity and innovation can only flourish with modern education, advanced health, and integrated financial systems. So the barriers to entry in these key areas need to be reduced—so that innovation can keep China at the leading edge of economic progress.

## A bigger, better financial sector

What about the financial sector? It too holds great potential to increase growth and improve welfare. China has taken commendable steps—including in recent days—to modernize its financial sector. Progress has been made in widening the exchange rate band, and People's Bank Governor Zhou has committed to complete the process of interest rate liberalization in two years. The market orientation of monetary policy implementation has also increased. Yet, there is still some way to go to establish the modern, robust, and globally integrated financial system that is essential to support China's next transformation.

For one thing, Chinese financial institutions would benefit from more competition and knowledge-transfer. This would help to better intermedicate the vast pool of domestic savings to the most productive uses. It would also prepare Chinese banks to play a bigger role globally. A gradual opening up of the capital account would facilitate this process, while helping to diversify domestic savings—and make the economy more resilient to shocks. It would also strengthen the potential role of the renminbi as a global currency.

Of course, opening up the financial sector must go hand-in-hand with a strengthening of macroeconomic policy frameworks and the constant upgrading of regulation and supervision. The crisis has taught us all this very important lesson.'

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### Safeguarding the environment

'I have talked about the services sector and the financial sector as important steps toward improving the quality of growth. The sustainability of growth is just as important. And for growth to be sustainable, it needs to be inclusive, its benefits need to be more widely shared, and it needs to be environmentally viable.

As with many countries around the world, China's economic success came at a price—increasing inequality and increasing environmental damage. The IMF's research shows that excessive inequality is bad for sustainable growth. Increasing opportunities in education, health care, and financial services can help greatly to address inequality. So too can reforms to increase competition. Social cohesion can also benefit from the right kinds of redistributive policies and a strong safety net.

Other recent work by the IMF also shows that there are significant economic gains to be made from increased participation of women in the labor market. In some parts of the world, per capita GDP could be as much as 27 percent higher if gender gaps in the labor market were

closed.

Fortunately, China has made important strides in leveling the playing field for women, especially in senior positions. It has also encouraged female entrepreneurship—a quarter of all business people in China are women. Even so, there are still many constraints. Addressing them will be good for Chinese women and men—and good for China.

In terms of the environment, the challenge is well known. Poor air quality, severe water shortage, and desertification are major health and economic hazards. They pose a serious risk to the next stage of China's development. Encouragingly, China has taken some important steps to improve its environmental footprint. An environmental protection tax is being considered and resources are being allocated to close down polluting factories.

And yet, more must be done to make growth greener. One issue that the IMF has been emphasizing for many countries is the better pricing of natural resources—and stricter enforcement of rules. This powerful combination can lead to a significant improvement in the quality of the environment.

I fully appreciate the breadth and depth of these reforms—in the services, financial, and environmental areas—and the courage and commitment needed to see them through. They will not be easy to implement but, if done well, they will indeed support China's next transformation. As the wise Chinese proverb says: "Do not fear going forward slowly; fear only to stand still".'

### China's leadership in the 21<sup>st</sup> Century

'This brings me to my third and final topic...I have just discussed China's economic leadership at the global level. China has also affirmed its global leadership in many other areas. In technology, for example: China is now home to the world's largest network of high-speed railways. In just six short years, China has gone from importing this technology to exporting it.

China is a leader in science—from sea to sky. China's manned ocean research vehicle boasts the greatest depth range of any in the world. China's lunar lander has already docked on the moon, and the Shenzhou-10 spacecraft is now in orbit.

China is also a leading partner for development in many low-income countries, including in Africa. In addition, China is playing an increasing role in major international fora—the G20, APEC—and in strategic dialogue at the highest levels.

As China moves forward, there is potential for an even greater global role. I mentioned earlier, for example, that with appropriate financial reforms, the renminbi could over time achieve the status of an international reserve currency—and occupy a position on a par with China's economic size.

China can also play an even greater role in international institutions. At the IMF, China will become our third largest member once the 2010 governance reforms become effective—an objective on which we continue to push hard. China is already an important contributor to the IMF's financial resources and operations.

In addition, China is providing leadership at all levels of the IMF. I am extremely grateful to Min Zhu for bringing his wisdom and experience to our Management team, and to the young Chinese economists we recruit every year—in 2013 alone, Chinese nationals accounted for a third of our new intake of talent.

Through the IMF, China can play a leading role in international cooperation—the "new multilateralism"—which I believe is crucial to the success of every nation in the 21st century...By taking the steps to achieve its next transformation, China will not only help itself, it will also help the world. Indeed, China's success is critical to the success of the global economy.

The steps to be taken are clear. China has risen to the challenge before. I am confident that it will do so again. As Lao Tzu wisely said: "Do the difficult things while they are easy and do the great things while they are small. A journey of a thousand miles must begin with a single step." ■

Keynote speech by Christine Lagarde, Managing Director of the International Monetary Fund, at the China Development Forum in Beijing on March 24, 2014.