

Introduction to China's New Normal Economy

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Over the past 37 years, China's economic reform has been successful, making it become a major economic power. It has been the second largest economy measured by GDP, the largest exporter and holder of foreign exchange reserves, and one of the biggest host countries, as well as home countries, of foreign direct investment. China's rapid economic growth has largely depended on abundant use of natural resources, low-cost investment and labour with support of high saving rates, a large amount migrant workers, and exploitation and usage of coal and other resources. Government policies have played an important role in promoting infrastructure construction, manufacturing production and international trade. However, a number of challenges have arisen along with the achievement in economic development, including high debt to GDP caused by the investment-driven growth model, demographic challenges of a low fertility rate and rapid population aging, inequality in income distribution, environmental degradation and constraints in resources and energy, and wide-spread corruption and rent-seeking activities. Over the past five years, China's economic growth rate has fallen from the historic double-digit rate to the current level of 6-7 percent. Without solving these problems it is difficult to achieve "stable and sustainable" growth, which requires balancing the

relationship between economic development, social development and environmental protection.

It is widely agreed that China is at a remarkable point in time during its economic transformation. In response to the above issues, the Chinese government has attempted to rebalance its economy to achieve a “new normal” of less rapid but more sustainable economic growth. This special issue aims to raise discussions concerning the ways in which further reform of the Chinese economy can be conducted in the context of challenges and opportunities of the new normal. The issue comprises five papers that exhibit special insights of interests.

In the five papers, we firstly attempt to discuss the following questions. How can an economy grow with a balance of social stability and environmental sustainability? Should the Chinese government continue its dominating role in setting up industrial policies to drive growth, or should China reduce the power of the government and have market and the private sector to play a more of a role in driving growth? This question is vital for the existing reform and has been debated over years, particularly between two prominent Chinese economists, Professor Justin Yifu Lin and Professor Weiyang Zhang recently, both from Peking University. Following their latest, first face-to-face debate in public on industrial policy in November 2016, the two economists again put forward their positions and debate each other in their papers published in this special issue.

The first paper is written by Justin Yifu Lin. Modern economic growth relies on technological innovation and industrial upgrading. The growth of a middle-income country will be trapped when it loses its competitiveness in manufacturing production and fails to catch up with developed countries through technological innovation and industrial upgrading. Lin argues that the existing theories of development economics are not able to provide developing economies with a catch-up guidance. Based on his famous “*new structural economics*”, he points out that

avoiding the middle-income trap can only happen if the government plays an appropriate facilitating role in a market economy. Industrial policies, including subsidies, tax breaks, financial and non-financial incentives, and protections, are important in prioritising the usage of limited resources to facilitate industrial upgrading and technological innovation during the structural transformation. Smart industrial economies require that governments in developing countries are able to identify which industries the country has latent comparative advantages in and which infrastructure and institutions need to be improved / provided. Lin has classified industrial policies according to five types of industries in developing countries to help governments develop the industries with latent comparative advantages. The national competitiveness of these industries will be the foundation for sustainable growth.

In the second paper, Weiying Zhang provides an opposing view to Lin's. He agrees that growth relies on the efficiency of resource allocation and innovation but he does not agree with Lin's idea that government or smart industrial policies would facilitate innovation. He believes that a market economy is the only system that can maintain sustainable economic growth and entrepreneurs are the "*king of economic growth*". China's rapid growth over the last three decades came from improvement of efficiency of resource allocation, which has been achieved primarily by the *arbitrage* activities of entrepreneurs. Nowadays, the gap between China and developed countries has decreased and the latecomer advantages are being depleted, so the room of arbitrage is shrinking. China's further economic growth shall rely on entrepreneurial *innovation*. In his paper, Zhang details the difference between arbitrage (including productive arbitrage and non-productive arbitrage) and innovation (including subversive innovation and improvement innovation), and how these two functions of entrepreneurs successively alternate in promoting economic development. Arbitrage activities help entrepreneurs discover and utilise opportunities for profits in market disequilibrium and entrepreneurs innovate to make money when the market reaches equilibrium. For Zhang, all government regulations, anti-

monopoly law, industrial policies, state-owned enterprises, and macroeconomic policies obstruct innovation, and they shall be removed. The emergence of entrepreneurial innovation requires liberty, the rule of law, and the effective protection of private property. Therefore, to avoid the middle-income trap, China needs to deepen the reform of its economic system, political system, legal system and other aspects as well in order to eliminate institutional obstacles to innovation.

The third paper is written by Yi Qu, Yingqi Wei, Tao Jiang, and Nan Zheng. Previous studies on firm performance have been mainly based on a resource-based view and industrial organisation approach, within which the institutional environment is treated as background. This paper links firm innovativeness, government institutions, foreign direct investment (FDI) and firm profitability in one framework. The authors' argue that firm performance is not only positively associated with innovation but also the level of innovativeness. Firms with original innovation performed better than those without. Not only do government institutions, i.e. national innovation system (NIS), measured by R&D services, contract and property protection, and access to information, create a positive effect on firm performance, but also they moderate the effect of FDI spillovers. The paper shows the important role of original innovation and improvement in institutions in firm performance. It also concurs with the notion that government should take action to provide better R&D services and strengthen the enforcement of laws and regulations. To some extent, this paper provides evidence to support Zhang's argument for innovation in support of the protection of property rights, as well as Lin's argument for the importance of the government in providing a better institutional environment.

In the fourth paper, Duan Liu, Shengyong Li, Hongbo He and Shujie Yao also examine the competitiveness and performance of the firm from the perspective of capital structure. Financial constraints are faced by many firms, especially small and medium enterprises during

the economic recession. On the one hand, financial constraints curb a firm's ability to compete and leave the rival firm without the constraints to be able to adopt predatory market strategies. On the other hand, financial constraints can be used as a factor to determine how credibly aggressive the firm can behave. In this paper, the authors examine the precise channels of the impact from financial constraints to firm performance, highlighting the effect of pricing behaviour in their theoretical model. They provide empirical evidence that the financial constraints of firms in China's manufacturing industry hamper competitive performances in product market across business cycles. This negative effect is more pronounced in economic recessions than in economic expansions. In an economic recession, a firm is more likely to be financially constrained and tends to raise its product price, which in turn hampers its competitive performance in product market.

The fifth paper is written by Wenjin Long, Simon Appleton, and Lina Song. Their research focuses on studying the relationship between social networks and wages of rural-urban migrant workers. China's migrants have offered great labour resources to the Chinese economy but have difficulties in access to an institutional assistant from the government at their destinations. Therefore, social networks become vital important for migrants to find employment in urban areas. However, the effect of such job search mechanism on subsequent wages has not been examined in the literature. To address this gap, this paper compares the wage effect of migrants using contacts to find employment and the wage effect of using network contacts to find jobs. They find that those using networks tended to be older and less educated, or have been migrants for longer. Married workers and those from villages with a high migration ratio were more likely to use network contacts, while those without a local *hukou* (residential registration) status were less likely. Controlling for selectivity, they find a negative wage effect of using networks implying a higher cost of using networks to access to urban employment for migrants. This

finding implies that, from an aspect of labour policy, the Chinese government ought to promote more a contractual approach to assisting rural migrants to find jobs.

These five papers in this special issue provide different arguments with their empirical evidence for debate on how economic development in China shall be directed in the future. We hope that they will provide readers with new insights and raise a broader discussion on China's future growth in the coming decades.