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Elephant in a Cage
Why China has a Hard Time to Advance to the Group of Rich Countries?

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Abstract

This paper examines the structural and political-economic constraints that limit China's long-term prospects for convergence with advanced economies. Using the metaphor of an "elephant in a cage," the study highlights how market reforms unleashed growth but remain restricted by state control. The analysis traces China's economic trajectory from the Maoist command economy to decades of market-oriented reforms, while emphasizing persistent challenges such as excess savings, financial repression, capital market distortions, real estate instability, capital flight, and demographic decline. It argues that these constraints, combined with authoritarian governance, significantly hinder China's ability to achieve per capita income levels comparable to G7 nations. The paper concludes that while overall GDP parity with the United States may be attainable, genuine convergence in living standards will remain elusive without deeper institutional reforms and the establishment of rule of law.

Keywords: China's Economy, Convergence, Middle-Income Trap, Structural Reforms, Financial Repression.

Introduction

It is a well-known metaphor, frequently mentioned in scholarly analyses on China that the market economy can be conceived as a "bird in a cage". The suggestive image is said to have been coined by Chen Yun, one of the most influential colleagues of Deng Xiaoping, the father of market-orientated reforms in the PRC. Although not always in agreement with his high level protégé, Chen forged a strategic partnership with Deng and can be considered as the most important theoretician of early market reforms (he later fell out with his boss). In his thinking and propaganda, the bird was meant to represent market forces, which, once unleashed, can become extraordinarily dynamic and productive. Market forces came to be considered indispensable in lifting the Chinese economy to hitherto unimaginable heights and closing the at that time still huge gap in development between rich capitalist countries and poor China. But the other side of the metaphor is equally important. Chen never thought that the cage should ever be dismantled completely; it may become larger and larger, allowing more room for the bird to fly, but it should always define and restrict the parameters of its freedom. The primacy of political control and regulation must always be preserved to serve the objectives of the Chinese Communist party (CCP) which has remained building of socialism[1].

This eloquent Chinese metaphor about the bird in a cage was invented in 1982. It has also been used as a propaganda tool ever since. In the last 40+ years the Chinese economy has grown enormously and become the second largest in the world in terms of nominal GDP after that of the US. This unprecedented success in rapid economic growth was due to the market forces which were generated primarily by successive stop-go structural reforms. The market orientated reforms mobilized additional forces, first and foremost foreign investments and created new opportunities especially in exports. The fast-growing fiscal revenues also made it possible that the state – both at the central and subsovereign levels – undertook huge projects in improving physical infrastructure which, in turn, further enhanced the growth potential of the Chinese economy, especially in the private sector. Therefore, the metaphor was not just propaganda; it has proved its validity by reflecting reality.

It is important to mention that although the cage has been enlarged and reconstructed several times in the last 40+ years, it has remained a formidable and sturdy construct. Now, as the

[1]*Friedberg (2022) p.86.*

Chinese economy has become enormous in size, it is perhaps more apt to talk about an elephant instead of a bird. The large mammal is not to symbolize immobility, but it is certainly unable to fly, and even walk or run if the cage does not provide enough space. No matter how much the cage has been enlarged, it is still a cage. Moreover, at times the cage has been made smaller by new restrictions seriously undermining further growth potential. It is now a valid question whether the Chinese economy will overtake the US economy in size and efficiency in the next quarter of the 21st century. More importantly, it is an open question if the GDP per capita of China will reach the level of rich countries (e.g., the average of G7) in the 21st century at all.

The goal of the CCP is clear: closing the gap with the US in terms of economic and military might by 2049, the centenary of the establishment of the PRC. That implies sustained growth at a significantly higher rate than what can be attained in the major Western economies. If we look at relevant experience, higher rate of growth for a longer period is not impossible to achieve. Nevertheless, uncertainties remain. If the convergence is measured by per capita terms of nominal income, the stated objective is unrealistic. If measured by per capita in purchasing-power-parity (PPP) terms, it is still an extremely tall order. If measured by overall GDP in nominal terms, then it might be attainable, provided, the Chinese economy shows a constantly higher growth rate than that of the benchmark economy by at least 2 percentage points for the next 25 years[2].

This rough calculation is relevant because it is not weakened by any of the three most important mistakenly presupposed conditions. First, the growth rate will obviously fluctuate and there will be slump along the way. But we assume long-term trends calculated as averages here. Second, given the size of the Chinese economy, there will be no double-digit growth in the PRC ever in the future. But that is not necessary at all. Third, for obvious reasons not to be discussed here, the growth potential of the US is expected to be almost always higher than that of other G7 countries. Hence, for China, the best benchmark is the US economy. Consequently, convergence in overall size to the US economy, although far from being assured or guaranteed, is realistic and attainable.

Context in the Political History of Reforms

The history of Chinese politics, economy, and society under the rule of the CCP can be divided into three major periods. The first 30 years (1949-1979) can be described as the era of unfettered Maoism, when the PRC had gradually created a classical Stalinist command economy, complete with market suppression, autarchy, campaigns for directed accumulation based on forced savings. This period was characterized by abject poverty, intermittent famine, huge waste in human and physical resources which perpetuated historical backwardness[3].

The next period started immediately after the death of Mao (September 9, 1976) with the quick destruction of the retrograde forces of classical Maoism. (This moment is symbolized by the arrest of the so-called "Gang of Four" on October 6, 1976, less than a month after the death of the Great Leader.) The new quadriga, represented by Hua Guofeng (the new leader of the party handpicked by Mao), Marshall Ye Jianying, Deng Xiaoping, and Chen Yun, took power and started what first could be described as "opening"[4].

This is a hugely important point. Deng, who was in a kind of internal exile during the "Great Proletarian Cultural Revolution" which lasted a whole decade between 1966-1976 realized that opening the Chinese economy (both internally and externally) is a sine qua non condition of future, sustainable development. He understood that all countries which have achieved convergence with the Western world progressed by integrating themselves into the world market economy. Soviet attempts to create an alternative non-market type world economy failed because they kept ignoring consumer preferences and incentives for production units to improve much required efficiency did not exist[5]. Markers of efficiency even in a huge economic area must be imported from the outside world if the behavior of enterprises (better said: production units) is expected to follow and reflect a minimum degree of market rationality. Deng & Co. were intelligent enough to realize that without allowing market forces to play a major role in economic decisions abject poverty of China would never be overcome. That was understood as a matter of survival for both the CCP and the PRC.

The second period of Chinese political, economic, and societal development lasted approximately for 40 years (from 1979 most likely until 2019). This long phase can be labelled as the era of stop-go structural reforms. Why stop-go? Although halting and/or reversing reforms were not infrequent, these setbacks proved to be temporary and the reform drive toward more market orientation typically resumed after a relatively short pause. Significant events mark these sudden stops – most importantly the Tiananmen square massacre in 1989. It was followed by an "interlude" of 3 years when reforms stalled and there was even a threat of reversal. But it is also remarkable that these events did not impede the resumption of the reform drive after a short while (by Chinese standards). This almost permanent, albeit intermittent, progress toward market capitalism is also marked by hugely significant events. Among them the most outstanding is China`s accession to the WTO in the very first year of the new millennium (2001).

Within this 40-year-long reform epoch two sub-periods can be separated out. These are best marked and identified by changes in senior political leadership. The appointment of Zhao Ziyang as premier (1980) and Hu Yaobang as chairman of the CCP (1981) can be considered as a starting point of full-scale reforms. They were both protégés of Deng and implemented his ideas of economic reforms with great enthusiasm[6]. This first

[2]*According to IMF estimates, the size of the nominal GDP of the US and the PRC in 2024 will be USD 28.78 and 18.53 tr, respectively. Calculating with 2% growth per year (g/y) for the US and 4% for the PRC for the next 25 years, nominal GDP of the US economy will be USD 47.21 tn, that of the PRC 49.39 tr. Calculating with 3% g/y for the US and 5% g/y for the PRC in the same period, the results are 60.25 tn and 62.74 tn, respectively.*

[3]*See Coase-Wang (2012) Chapter 1.*

[4]*See Coase-Wang (2012) chapter 2.*

[5]*In a command economy there is no supply-side adjustment. See Bokros (2013) Subchapter 1.3.*

[6]*In fact, their appointment to these high positions was because the reforms they initiated on an experimental basis two-three years earlier had proved an extraordinary success. See Coase-Wang (2012) Chapter 3.*

phase of reforms lasted until 1989 when the repression of the students` freedom movement temporarily stopped the reform drive. The second sub-period might be supposed to have started after the "Tiananmen interlude" (1989-1992) and lasted for a quarter of a century. During this period the Chinese economy was finally transformed from a socialist command economy into a fundamentally capitalist market economy, albeit with "Chinese characteristics". In terms of political economy, it does not matter much that leaders of the CCP have kept talking about confusing and distorted concepts underpinned with ideological gymnastics and call the market reform even today an improvement of the socialist system. What we have in China today is not socialism, but market capitalism framed in an authoritarian political system. That was finally and by and large successfully established under two most significant leaders of the CCP right before and after the turn of the century: Jiang Zemin (1993-2003) and Hu Jintao (2003-2013). It was preserved almost intact by Xi Jinping in his first five years of being both president of the PRC and chairman of the CCP.

The end of this period is marked by three major events: Xi Jinping`s decision of becoming president for life and the start of the Covid-19 crisis with lockdown. In addition, it is equally important that after 20+ years of unfulfilled hopes for a real democracy, the CCP finally decided to destroy the rule of law and limited democracy which did exist in Hong Kong until the introduction of the so-called National Security Law. The law was approved by the National People`s Congress Standing Committee in Beijing in 2020 and incorporated into Hong Kong`s Basic Law. As a result, the political autonomy of Hong Kong SAR (Special Administrative Region) of the PRC has ceased to exist as a beacon of civil liberties and judicial independence in the whole Chinese civilizational sphere. Most significantly, it had a major negative impact on the hearts and minds of the people of Taiwan. Political repression not only halted but reversed structural reforms in the PRC itself. It may represent the start of a new period of long-term stagnation if not decline. From the viewpoint of political economy, its import is in the fact that reform reversal may seriously undermine the convergence of the Chinese economy to the level of the rich countries (G7) which is not impossible in theory. Since development is never preordained, advancement is never predestined, progress is never unilinear, China`s convergence is now the future`s mystery. We can only analyze the chances and probabilities, but never the certainty thereof.

Constraints of Convergence

This essay is to highlight and assess the constraints of convergence as they unfold and make their negative impact on growth as well as on societal cohesion. Some of them might be addressed and slowly modified (e.g., excess savings) in a few decades, others (e.g., population decline and ageing) are more like factors of fate and cannot be significantly altered by government policy. The corollary is that the present historic combination of these economic and societal constraints constitutes an existential challenge to the autocratic political system and their removal might be impossible without giving up the absolute monopoly of the CCP. Although democracy is not an indispensable condition for sustainable economic growth, a strong and credible system of the rule of law might be, especially for countries trying and wishing to escape the middle-income trap. The authoritarian state seems to represent an insurmountable obstacle to final convergence. It is a cage made of Stalin`s steel, indeed[7].

Excess Savings

Saving is defined as income not used for consumption. In a closed economy, savings are identical to investments. In an open economy, domestic savings can be exported, and external savings can be imported. Hence, domestic savings (S) are not necessarily identical to domestic investments (I). S can be smaller or larger than I. This is the flow definition of S and I typically measured in a year[8].

The size of, and the change in, S have a huge impact on growth and financial equilibrium. More S allows more I. There is a wide agreement among economists that the more S a country has, the higher and more sustainable growth it can achieve without undermining external financial equilibrium. It is no surprise, therefore, that stimulating S is usually an important objective and instrument of growth-enhancing economic policy.

But too much of a good thing can turn out to be bad. China's savings rate[9] is exceptionally large, oscillating between 40 and 50% of GPD. Both the household and the enterprise sector have a high rate of S allowing an enormous amount of I, one of the most important factors leading to high level and sustainable growth. But there are two problems here. First, too much S cannot be invested in the domestic economy in an efficient way. No wonder, the so-called incremental capital-output ratio (ICOR) is constantly deteriorating in the Chinese economy. More and more I seem to be necessary for attaining the same level of growth. This suggests a huge amount of waste, especially in fixed capital investment.

Second, S of a particular economic agent does not mean that I is made by the same agent. As a result, S must be intermediated among various agents by a set of institutions, usually financial ones. That means some agents make a deposit, buys a bond, while others borrow. Excess S on one side can easily lead to excessive borrowing on the other side, leading to the accumulation of excessive debt.

China has been trying to emulate the Japanese & East-Asian model of growth, development, and convergence since its opening, but with a marked difference: it has never contemplated or undertaken the privatization of its huge army of state-owned enterprises (SOEs) at least in manufacturing industry and finance. Since the application of market forces was considered an important tool to build not capitalism but socialism which, in turn, was based on SOEs, enterprise reform meant invariably decentralization of decision making, corporatization, even the

[7]Stalin means steely in Russian. The late Soviet dictator has chosen his name to resemble and reflect his own image of his own character. But it is an apt expression for the regime he created for totalitarian rule.

[8]Both S and I can also be defined as an accumulated stock over years. The distinction is important because these interpretations play different roles in economic policy. The flow concept represents short-term, the stock concept long term variables having a different impact on the chances of sustainable growth in distinct time dimensions.

[9]Saving rate is defined as the proportion of S compared to a measure of income. At the macro level, the aggregate income is defined as the GDP. Savings can be compared to many different aggregates of income.

partial distribution of shares to employees, employee stock ownership plan (ESOP), but never real privatization[10]. Consequently, despite the enormous amount of investment poured into it, the large SOE-sector has never become a primary driver of high-level, sustainable economic growth. Other engines have proved to be much more significant: first, private agriculture after the abolition of the communes, second, rural industrialization led by the rise of township and village enterprises, third, the burgeoning entrepreneurialism of the urban youth and, finally, the establishment and progress of special economic zones (SEZs)[11].

Once the S is sky high and efficient I opportunities become scarce in the enterprise sector, there are two options for their application at the macro level. One is to finance a deliberately enlarged fiscal deficit (the Japanese solution in the last 20 years) and the accumulation of public debt to prevent the economy from falling into depression. The other is the acquisition of external assets (the preferred method in the Greater Chinese Prosperity Area) [6]. This latter has several channels: outward FDI and FPI, massive bank lending to abroad and rapid accumulation of foreign exchange reserves at the central bank. In 40 years, until 2019, the PRC used all these channels albeit in variable proportions. Given the magnitude of these outflows, it is obvious that they have served specific, well identifiable economic policy objectives. Outward FDI and FPI as well as lending was part of the expansion and efforts of securing foreign markets and investments in natural resources, while the accumulation of forex reserves was aiming at keeping the exchange rate of the renminbi yuan (CNY) artificially low to stimulate exports, preserve export competitiveness and create jobs[12]. The latter was frequently condemned as currency manipulation and became a point of contention between the US and the PRC[13] well before the commercial war initiated by President Trump of the USA.

This arrangement reflects the primary objective of economic policy in the PRC: exports keep constituting the most important engine of economic growth. When China started its opening, its exports were negligible; therefore, a high rate of export growth was not only possible, but also achievable. Now, as China is by far the largest exporter of manufactured goods, exports cannot grow at such a high rate any longer[14] because of the slower growth of absorption capacity of the rest of the world or the outright unwillingness of other countries to strengthen their unilateral dependence on China. No wonder, that since the Covid crisis economic growth in China has never exceeded 5% and it is highly unlikely that it can exceed that at any time in the future.

The best way out of this export saturation would be less S and more consumption at home. That would certainly require higher salaries and wages (which should be compensated for by commensurate increase in productivity), much better social services (especially health and childcare, higher pensions and more social support. In sum, China needs to make significant steps to improve the living standard of its own population. That would require a new reform drive, the acceptance of some erosion in export competitiveness, lower profitability for several enterprises, increasing losses at the SOEs, more efficient procedures for bankruptcy and liquidation (corporate restructuring) and, finally, higher taxes to contain the burgeoning fiscal deficits. That is a sea change which is impossible to achieve without strong political support. But the point is that these reforms cannot be substituted by provisional and random monetary and fiscal stimuli which is frequently discussed and sometimes used by the political leadership.

Financial Repression

The problem, however, is not only the excessively large amount of S but its application, too. If S is collected by ineffective mechanisms and invested in dubious projects, the growth potential of the economy is seriously hampered. The collection, redistribution, and transformation of S into I is carried out by the system of financial intermediation. The two most important institutions here are the banks on the one hand, and the capital market on the other. Both set of institutions suffer from structural weaknesses and serious government-inflicted distortions in China. Consequently, the transformation of S into I is increasingly inefficient, which applies a further brake on high level and sustainable growth.

The backbone of the Chinese financial system is consisting of the commercial banks, primarily by the state-owned banks (SOBs). The two-tier banking system was created after 1979 when the PBoC assumed the role of the central bank and four specialized state lending and deposit taking institutions were established[15]. Today they represent the four largest banks of the world in terms of total assets. But they have very limited autonomy and little responsibility in credit allocation and risk management. After 40+ years of their establishment they still behave primarily as the transmission belt of government policy including lending to designated enterprises. They keep financing seriously inefficient and sometimes openly loss making SOEs and charge them with well below market interest rates. No wonder that they repeatedly accumulate a large amount of non-performing loans (NPLs) and then regularly bailed out and recapitalized by the government. They serve as a constant source of financing for the SOEs which also receive large fiscal subsidies. Providing financial and fiscal

[12]Today the PRC has forex reserves of USD 3200+ billion. Interestingly, the amount of forex reserves has shown a steady decline from 2014 when the stock peaked above USD 4 trillion. The reduction of the stock of foreign exchange reserves is the direct result of less intervention of the People`s Bank of China (PBoC), a softer approach in currency manipulation and, increasingly, more capital flight. We come back to this topic in Subchapter 5.

[13]The best description of this so-called "lethal embrace" between the US and the PRC economies can be found in Wolf (2008). The fact that the US provides an almost unlimited export market to Chinese manufactured goods and at the same time makes possible the deployment of huge Chinese forex reserves in the American capital markets offers obvious advantages to the development of the PRC. At the same time the fact that the US can afford huge deficits both in its fiscal and current accounts – living well beyond its means – is hugely advantageous to the US government and population. The question is whether this arrangement is sustainable or not in the long run. Bipartisan attempts by US establishment to thwart the rise of China and the misguided tariff policy of the second Trump administration puts this issue to a sharp light.

[14]The Earth is a closed economy. Unless China starts exporting to the Venus and the Mars, it is stuck with the "small" market provided by the global economy on Earth. Even if we disregard protectionist forces mobilized by many countries against cheap Chinese exports, the absorption capacity of the global economy is simply finite.

[15]The SOBs in both global and Chinese ranking are the following: Industrial and Commercial Bank of China (ICBC), total assets: CNY 40 tn (USD 5.6 tn); China Construction Bank (CCB), total assets: CNY 36 tn (USD 5 tn); Agricultural Bank of China (ABC) total assets 35 tn (USD 4.9 tn); Bank of China (BoC), total assets: CNY 29.5 tn (USD 4.1 tn). With the Bank of Communications (BoCoM) – which is "only" the 15th largest in global ranking – they constitute the hard core of the financial intermediary system in the PRC. See www.statrys.com

subsidies to SOEs, which are not allowed to improve efficiency by laying off employees to the required extent or cannot go openly bankrupt (no transparent mechanism for bankruptcy and liquidation exist), the SOBs take over a significant portion of SOE losses which is then socialized by frequent bailouts. While using the SOBs as channels of income redistribution may be an astute mechanism to maintaining political stability, it is certainly not an efficient economic arrangement. Redistributing income from profitable firms to loss making ones impedes economic growth[16].

The SOBs are not required to absorb all the losses, however. Their autonomy on charging interest rates according to their own risk assessment is hampered not only on the asset side of their balance sheets. The PBoC regulates passive interest rates not only by monetary policy but also by administrative restrictions. The SOBs do not compete for deposits among themselves. Moreover, they enjoy a monopoly in more than half of the rural population centers. Since the CNY is not fully convertible, individuals have limited choice of financial savings instruments. The inflow of cheap funds into SOBs and then to inefficient SOEs is guaranteed by the lack of alternatives for financial investments and the limited convertibility of the CNY. This mechanism transfers a big part of the losses of the SOEs to the population at large. Instead of concentrating losses where it is created, the government redistributes the losses on a very large group of people by chipping away the real value of their hard-earned S. Again, it may be a clever political mechanism, but it is reducing growth potential.

Capital Market Distortions

Another outlet to deploy household and enterprise S is the capital markets[17]. The CCP leaders have understood that there is no such thing as efficient product market if it is not supported and underpinned by free movement of factors, i.e., markets for capital and labor. They also realized, albeit with much hesitation, that the new title holders of shares in corporatized enterprises need a channel for the eventual disposal of their shares. Once bonds were issued and SOEs corporatized, and their shares sold or distributed to managers and employees, the need for secondary trading of these securities came to the fore[18].

The significance of the introduction of capital markets in a formerly socialist country cannot be overestimated. It is by far the most important inflection point between socialism and capitalism[19]. Once the trading of ownership shares became not only tolerable but even supported by the ruling party, the economy has been transformed to a largely capitalist one. But the size and quality of the capital markets do matter. In this respect the history of Chinese capital markets has always been, and remained, quite murky. Consequently, enthusiasm was transformed into widespread disillusionment very rapidly. Local governments in China started to "privatize" loss making SOEs because they had gradually run out of fiscal resources to support them. The appearance of "stock cooperatives" in Shandong province between 1992 and 1994 officially labelled as enterprise restructuring can be considered a "stealth" privatization[20]. But when employees are obliged to pay for the shares of enterprises with negative net asset value it is tantamount to outright cheating. No wonder, employees wanted to get rid of their shares rather quickly. In the absence of any meaningful requirements for providing reliable and trustworthy information, especially on the value of assets (net asset value of enterprises), with few rules for listing and trading, etc. stock trading was more like a lottery rather than a serious business. It is no surprise, therefore, that the history of capital markets in China is full of cheating, insider trading, and high volatility[21]. This has been a "wild East" model of capitalism very similar to what happened in Russia and many other former socialist countries rather than a best practice approach to good governance prevailing in modern Western market economies. In addition, a good part of the volatility is generated by sudden, unpredictable, and ineffective government interventions[22]. Market distortions were caused by random fiscal subsidies, regulatory privileges, and monopolistic arrangements. The lack of proper regulatory environment makes the capital market a mockery of itself. Many individual investors lost their savings because of these market distortions. No surprise that the trust and confidence of the public in the capital markets is extremely low. Under these circumstances the capital markets cannot fulfill their primary functions of price discovery and reallocation of capital either. It does not contribute significantly to economic growth, either.

[16]Financial repression is sometimes portrayed as a positive instrument to contribute to higher level of capital accumulation and, hence, higher rate of economic growth. See e.g., Kroeber (2016) p.12. Nothing can be further from the truth. While financial repression may be celebrated as the triumph of government interventionism over free market fundamentalism, the fact is that financial repression leads to inefficient overinvestment and the prolongation of the life of inefficient enterprises. Neither is a reliable a source of sustainable economic growth.

[17]The first exchange for secondary trading of corporate bonds and shares was initiated in Shenyang in 1986. The second was established in the special economic zone of Shenzhen in 1988. The Shanghai Stock Exchange was (re)opened in 1990. Interestingly, this process was completely coincidental with similar development in Hungary.

[18]Similar developments were observable in the fast reforming Central and Eastern European (CEE) countries at this time after the quick disintegration of the socialist system. Bond issuance and privatization almost always and immediately produced a need for secondary trading. See Bokros (2013) Subchapter 2.7.

[19]Bokros (2013) pp.44-45.

[20]Coase-Wang (2012) p.131.

[21]"This lag between practice and regulation was quite common throughout the Chinese economic reform. The phenomenon is aptly referred to in China as 'get on the bus first, buy the ticket later.' It may seem irresponsible or even negligent on the part of government regulators to let a new practice go ahead without first putting in place proper regulatory rules. But without the practice being tried first on the ground, how could the regulator know what and how to regulate?" Coase-Wang (2012) p.112.

This is patently wrong. Capital markets have hundreds of years of history in the West and Western countries have an immense treasure trove of experience with regulatory theory and practice which could have been tapped by the Chinese authorities and market participants. The history of rejuvenation of capital markets in CEE shows that those countries which had prepared a sophisticated regulatory and supervisory system before secondary trading was allowed en masse had created a vivid and flourishing stock market which was praised even by the public. Those countries, like the Czech Republic or Russia, followed the Chinese "wild East" model discredited and largely destroyed the trust of the public in their own capital markets very quickly. See Jezek (1997) and Mlcoch (2001).

[22]A good example of that is the aggressive monetary stimulus measures introduced by the PBoC in September, 2024. Injecting USD 100 bn into the stock market by supporting share buybacks by companies and helping investment funds, brokers, and insurance companies to buy stocks seems like a desperate measure to revitalize the largely moribund capital markets. By the end of September 2024, the blue-chip CSI 300 index covering both Shanghai- and Shenzhen-listed companies soared by 8.5% only to fall by 7% a week later. In addition to being ineffective, excessive volatility induced by botched government intervention makes a mockery of the capital markets, seriously distorts investment behavior and, finally, has nothing to do with the mandate and remit of a prudent central bank.

Real Estate Bubble

A third option to use household S at a massive scale is investments in housing. In theory, from the viewpoint of the ultimate goal of economic growth improving the living standard of the people, it is the most important in contemporary China. There are several reasons for that. First, the housing stock of the PRC used to be very small, its quality extremely low. As earnings have gradually grown in the last decades, people obviously were yearning for better living conditions. Second, despite the overwhelming success of rural industrialization at the beginning of transition, most of the new development of modern and more sophisticated manufacturing has taken place in the cities. Industrialization and urbanization always go hand in hand. Despite the rigidities of the residence registration (hukou) system, which makes it impossible for people to get access to social services in places other than their original domicile, tens of millions of people who migrated to the old and new cities were in need of proper accommodation. The demand for flats grew enormously; it was important to meet that demand for both economic and political reasons.

Most of the new housing construction taking place in China in the last 30+ years has been initiated and promoted by subsovereign governments. They were eager to provide land for new construction. Selling land to developers has become one of the most important sources of revenue for local governments[23]. They established so-called Local Government Financing Vehicles (LGFVs) which became the main conduit for selling land and raising debt in the capital markets. The most important characteristic feature of this arrangement is that housing construction has been fueled by an extraordinary amount of bond issuance. LGFVs and private developers were happy to tap the enormous amount of S of the domestic household sector. Moreover, the LGFVs debt instruments offered much higher yield than the banks (sometimes as high as 6%) while their return of equity (ROE) remained hardly more than 1%. So long as additional land has been available for sale, the model worked (like a Ponzi scheme for a while). But this is a very fragile and even dangerous arrangement for a variety of reasons. Excessive S resulted in an excessive accumulation of debt in the books of financial intermediaries and developer firms. When the final demand for housing stopped growing or even declined (like during the Covid crisis years, 2020-2022) then it was not only difficult to start new construction by issuing new debt, but even the refinancing of the already accumulated debt became difficult if not impossible. No wonder, therefore, that the largest bankruptcy of any real estate developer company in the world happened in China when Evergrande collapsed in 2021 under the mountain of USD 340 bn of debt. (Country Garden, the second largest developer, defaulted on roughly USD 200 bn of outstanding debt.) More than 50 of the largest developers went bankrupt during the horrible years of 2021-22[24].

That destroyed an enormous amount of wealth and value owned ultimately by the Chinese people. This value destruction has, in turn, seriously undermined the trust and confidence of the people in the real estate sector in general and in speculative housing investments in particular. International bondholders also suffered enormous losses, recovering less than 1% of their bond investments. The destruction of accumulated household S as well as international investor confidence is yet another brake on growth.

Capital Flight

In countries where entrepreneurs and ordinary people struggle to find adequate return on the growing amount of their financial S and they do not trust either the financial intermediary system or the government at large or both, private economic agents try everything in their power to export their S themselves. That creates large capital outflows. If there are no adequate and legally acceptable mechanisms to export S, illegal methods come to the fore. That is what I call capital flight[25].

Since capital flight by definition is illegal, it is extremely difficult to measure. We must analyze very carefully the structure of the balance of payments (BoP) in order to assess its magnitude. Exporting S results in the accumulation of foreign assets, most of it financial. The yearly outflow of domestic S might be captured by the inexplicable items in the capital account (CapA) of the BoP. The change in foreign assets, especially financial ones, may offer some clue about the magnitude, structure, and significance of capital flight.

The starting point to the analysis should be the current account (CA) position of the balance of payments (BoP), because this is identical to the difference between domestic I and S. From 1990 the CA of the BoP in China has almost always shown a surplus (except in 1993). From 1994 through 2004 the surplus was relatively small; it fluctuated between 0.2 and 3.8 of GDP. After WTO-accession in 2001 it started to grow and reached almost 10% of GDP in 2007. Since then, it has come down significantly and stabilized at the level of 1% or 2.5% from 2011 onwards. This trend did not budge during the covid crisis in 2020-2022, either[26].

CA surpluses have their counterparty items either in the CapA or in the further increase of forex reserves held at central banks. This latter has also skyrocketed in the case of the PBoC in the last quarter of a century. Nevertheless, this item needs to be excluded from the assessment of capital flight because it represents

[23]From the viewpoint of prudent fiscal management that is clearly an inadequate arrangement. One-off revenue stemming from the sale of assets must not be used as a constant source for current outlays. Permanent outlays need to be financed by permanent revenues. Nevertheless, selling land for housing construction is a general practice frequently used by subsovereign governments the world over.

[24]The Chinese government felt obliged to intervene in the property crisis by instructing state-owned developers to buy up land from bankrupt private ones, subsidizing local governments to repurchase land to do the same. An exhaustive and deep analysis of the renewed role of the state in the housing sector can be found in an FT article written by Campbell, Ding, Hale and Ko (FT 2025)

[25]There is considerable confusion in literature about capital flight. Many economists simply consider it largely identical to capital outflows. That is a mistake. In an open economy operating with a fully convertible domestic currency capital inflows as well as outflows are normal and largely beneficial phenomena occurring constantly.

[26]It is important to note that a 1% or 2.5% surplus today may be much larger in absolute terms than a surplus of 6-8% 25 years ago because the size of the Chinese GDP has almost quadrupled in a quarter of a century. When exporting domestic S to the outside world, the absolute size does matter a lot because the absorption capacity of the global market for Chinese surpluses is finite or at least it does not grow at the pace of the Chinese economy. That means that the profitable investment of Chinese domestic S in abroad is not an easy endeavor. Both official capital export (like within the framework of the Belt and Road Initiative) or private sector exports (via banks, capital markets, real estate purchases, etc. may result in tremendous amount of waste and value destruction. There is no escape from the efficiency problem in the application of domestic S either within or without.

official application of domestic S in abroad. Most of the capital flight can be detected among the items of the CapA: foreign direct investment (FDI), foreign portfolio investment (FPI) and lending (L) either by banks (both bank-to-banks or bank-to-enterprises, or among enterprises, called intercorporate lending).

Data reflecting these items published by the Chinese authorities are shaky and unreliable but given the fact that the total sum of the BoP is zero, it can be estimated from here. According to some Western analyses, capital flight has reached several hundreds of billions of dollars in the last couple of years, especially during and after the complete lockdown implemented by Chinese authorities between 2020 and 2022[27].

Sudden increases in capital outflows in China seem to be closely correlated to market expectations of CNY devaluation[28]. Since the CNY is not fully convertible, and capital controls apply at various levels and at different degree, the PBoC – in concert with SAFE - has managed to maintain a dominant role in determining or at least heavily influencing the exchange rate of the domestic currency in both onshore and offshore markets. At the same time the CNY has already achieved a relatively advanced degree of partial convertibility which makes it possible for domestic holders of hard currency to find some legal ways to export their S in hard currency thereby protecting it against devaluation.

But capital flight cannot be explained exclusively by expectations for currency depreciation. If the growing middle class (which is said to be larger today than the whole population of the US) has little confidence in the domestic currency and, more importantly, in the institutions behind them, there is a persistent inclination and temptation to acquire foreign assets, especially real estate, first and foremost in the US, Canada, Australia and New Zealand, but increasingly in other parts of the world, predominantly in the EU. In any case, it is not very far-fetched to label capital flight as an Achilles' heel of the Chinese economy[29].

Demographic Decline and Emigration

It is not only capital that flows out of the PRC but also people. In addition to population decline, there is also emigration. In combustive combination it is an exceptionally serious challenge to growth and development. In 2022 China's population peaked at 1.425 bn and has started to shrink by roughly 800k per year[30]. The gross negligence and brutal mismanagement of the Covid-crisis accelerated the process of population decline further. According to UN estimates, the total number of people living in the PRC may not be larger than 600 million in 2100. Even if the loss of population will be much less drastic, nobody can deny that China is facing a dramatic demographic crisis, indeed[31].

Specific economic problems stemming from this speedy decline are many. First, unlike Japan and South Korea, China may become old before it becomes rich. That puts an especially huge strain on the pension and health care systems, which are already far from adequate in China. Second, working age population is shrinking even faster. It means that economic growth in the future must rely exclusively on productivity improvements. For that to happen, large and growing I is insufficient; the country also needs innovation, research, development and, first and foremost, free entrepreneurial spirit, not hampered by excessive and unpredictable, administrative government interventions. The cage should be dismantled or at least reconstructed to accommodate a much bigger elephant. It is obvious that deep structural reforms are urgently needed to address these challenges of historic proportions.

From my perspective, what is even more remarkable is emigration from China. Almost half a million citizens of the PRC leave the country every year and the outflows are said to have accelerated since Xi Jinping came to power, especially, from the start of his third tenure in 2022. Curiously, the largest group of immigrants, crossing the infamous Darién Gap in Panama is also the Chinese. Hundreds of thousands of people from China make every effort to reach illegally the US, a country designated as "archenemy" of China. The problem is further exacerbated by the fact that most of the emigrant are relatively younger and better educated than the average citizen of the PRC. Does it remind us to something we have already seen many times in history? The Berlin Wall was built to stem the massive outflow of people from the "East German socialist paradise". Nevertheless, East German convergence with West Germany was achieved only after reunification and it took more than one generation to reach that in terms of comparable living standards. (Some say it is still far from being fully achieved.) At the same time no country with massive emigration has achieved full convergence with the most advanced economies (G7) in modern history[32].

Transition with Convergence

It was useful to briefly highlight some of the most important impediments to sustainable economic growth because they seem to be quite unique in China in the history of transition from socialism to capitalism. No country in CEE has ever struggled with excess S; on the contrary, the problem used to be insufficient S. Financial repression has never happened and countries overcame capital market distortions rather quickly. Real estate bubbles did form along the way but never in the excessive proportions observed in China recently. All currencies in CEE are fully convertible, including war-torn Ukraine; exporting domestic S is completely free, investment opportunities are abundantly available. Capital flight is a huge problem in Russia and a significant one in Central Asia, but not in CEE. The only factor which

[27]*According to data reported by the State Administration of Foreign Exchange (SAFE), the Chinese authority for giving permission to transactions involving foreign exchange, the amount of corporate and household capital leaving China in 2023 was USD 68.7 bn on a net basis. Whenever there is a significant net outflow or a sudden change in the outflowing amount, a good part of it can be considered as representing capital flight. Another part of capital flight can be detected in the trade account of the CA camouflaged by underpriced exports and overpriced imports.*

[28]*See Robin Brooks (2024)*

[29]*Robin Brooks considers the US-China trade disputes and the introduction of large tariffs in the US as the most important reason behind currency devaluation and, hence, the most important trigger to a new wave of capital flight. In my view, the underlying problem is much wider and more fundamental. Capital flight is an unavoidable characteristic feature of every authoritarian system.*

[30]*In the same year India overtook China as the most populous country in the world*

[31]*What matters from the viewpoint of economic growth is not so much the size of the population but the speed of change. Very rapid growth (like the one in Sub-Saharan Africa) is as much a challenge as a steep decline.*

[32]*In the last century some small countries have pulled off this feat: Finland, Ireland, South Korea, Taiwan, Singapore. In no case was emigration a marked phenomenon. Some of them, on the contrary, enjoyed the fruits of massive immigration, like Ireland, which has strengthened further this historic advancement.*

seems to be commonly significant is demographic decline and massive emigration. And that is the most difficult to tackle by public policy.

Transition has now a history of 35 years in CEE[33]. Some countries have made significant progress in convergence (most remarkably the Baltic states) others have fallen behind (the most recent example is Hungary)[34]. It is also important to mention that the development of individual countries has always been cyclical with different trajectories: some countries started with comprehensive reforms then stalled or even reversed them (Hungary); others postponed reforms almost for a decade but then caught up very quickly and even overtook some of the early reformers (e.g., Slovakia). Interestingly, the perspective of EU-accession has almost always been a pull factor for reforms but after accession some countries have fallen behind again (Bulgaria). Although the prospect of EU-membership has significantly contributed to a rejuvenated reform drive in several CEE countries, its attractive force has lost intensity to a considerable extent by now.

In case of the PRC, of course, there is no such pull factor. China has neither desire nor opportunity to become part of a larger political and economic unit. China is not a country but an empire; some would say that it is a civilization onto itself [35]. Not only size but also history and culture do matter; and Chinese history and culture cannot be more different from that of the small CEE-periphery. Moreover, in historical terms and unlike in China, the communist interlude has been too short and shallow in the CEE-region for its legacy to become a decisive factor for future development. (Relapse into authoritarianism characterized with dirigiste economic policies and excessive state interventionism in the economy might be much more important and similar with Chinese development. The best example of that is, again, Hungary.)[36]

Since the PRC has become a capitalist market economy, the remaining part of transition can be identified as answers to its "Chinese characteristics". Of course, China needs another major reform drive, but it is now already within capitalism. To get rid of the clearly identifiable impediments to convergence, precisely these unique characteristics are the ones which need to be eliminated or modified. The most important areas of structural reforms are the following:

- Privatization of most SOEs[37]. Instead of enlarging them by huge fiscal and financial subsidies, which deprives them of incentives to improve efficiency and constitute a huge waste of taxpayer money, most of the SOEs should be sold to primarily strategic investors who can provide better corporate governance, new technology, quality R&D, higher salaries, etc.
- SOEs which cannot be privatized as going concern must be dismembered, sold separately as smaller ventures, or liquidated and their assets sold. For this to happen three conditions are to be met: (i) much-improved bankruptcy and liquidation legislation and regulation, (ii) reliable and predictable judiciary practice, (iii) retraining programs for laid-off people.
- Financial sector reforms must include the privatization of the large SOBs, making them responsible for credit policy and risk management, carving out NPLs and their workout by private asset management firms; securing autonomy for the PBoC in monetary policy and practice, better prudential regulation & supervision for banks, insurance companies, capital markets.
- Comprehensive reforms in the areas of health care and pension systems should aim at improving quality, ensure much more equal access and cost control. Corporate and individual contribution to social insurance need to be increased, obligations strictly enforced. The resident registration (hukou) system should be gradually eased and then abolished altogether.
- Subsovereign finance and administration reform must offer real autonomy and responsibility to provincial, district, city, and village councils even if the ultimate control of personnel selection is retained by the CCP. The modified tax system should offer permanent, reliable, and predictable financial resources to subsovereign entities with clearly defined tasks.

This is obviously not an exhaustive list of what needs to be done in China to speed up development and make convergence possible in the long run. Nevertheless, it is important to identify the key areas of reforms and see the most fundamental common denominator behind them. If the PRC wants to achieve convergence or at least ensure that it can get much closer to the G7 countries in terms of economic efficiency, income level and living standards for its own people then it is indispensable for the whole state to be based on the rule of the law (Rechtsstaat). This system implies, first and foremost, the reform of the state: instead of an omnipotent, omnipresent, and omniscient creature the Chinese state should be transformed into a much more limited and at the same time better operating entity which respects the legally defined autonomy of economic agents, enterprises, banks, and private citizens, etc.

Instead of destroying the reliability of the formerly much respected and respectable judiciary system in Hong Kong SAR completely, its autonomy needs to be fully restored not only in the special administrative region but copied and strengthened in mainland China, too. Checks and balances are important not only within the state to prevent it from making inefficient, arbitrary decisions, but also outside the perimeters of public administration to protect the autonomy of all economic agents. This is a very tall order, and some will say it is outright impossible to achieve in a dictatorship. History will give us an answer in the next quarter of the 21st century. But one thing seems to be sure: although it is far from sufficient, the rule of the law seems to

[33]Transition in the CEE-countries is considered to have started in 1989 and it is symbolized by the fall of the Berlin Wall. In the Soviet sphere, the dissolution of the Soviet Union in December 1991, can be regarded as the starting point of real transition. Of course, there is significant time discrepancy among individual countries, too. See Bokros (2013)

[34]See Bokros (2014) and (2021)

[35]See Wood (2020)

[36]See Bokros (2021)

[37]Kroeber states that one of the lessons from the experience of transition in CEE is that privatization is not the critical step. "The indispensable feature of a market economy is not privatization but competition." Kroeber (2016) p.102. But the experience of CEE countries both before and after transition clearly shows that only fake competition is possible among SOEs. Privatization, therefore, is a necessary condition for real competition, too.

be an absolutely necessary condition to convergence. China will not be an exception.

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