THE CHINA PLUS ONE STRATEGY:

A SIGNAL OF THE NEXT STEP OF CHINA'S ECONOMIC DEVELOPMENT

By

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The 'China plus one strategy': A Signal of the Next Step of China's Economic Development

Abstract

China's economic growth over the past two decades has been a point of envy for developed and developing countries alike. China has been able to achieve this due to the policy focus of their government on trade liberalization and capturing foreign investment. This involvement by the government in aiding the national economy move up the technology ladder has been quite successful in stabilizing such rapid growth. However, recent government policies have instigated a new direction of the Chinese economy away from low-end manufacturing and more into high-end manufacturing and services, called the 'China plus one strategy'. This new direction initially showed no signs of problems for China's growth goals; however, the Financial Crisis was the final push causing a mass decline of low-end manufacturers in China. The resulting unemployment issue across urban and rural China has shown a significant weakness in the Chinese economy, namely that too many jobs are dependent on foreign consumer demand. Thus, China's future economic development will take on a new face of cultivating domestic consumption to support and stabilize jobs and strategic government initiatives like the 'China plus one strategy'.

Introduction

From the onset of the 21st century, China has experienced constant positive economic growth. The strength of the Chinese economy coupled with the authoritative hand of the government allowed China to maintain its economic momentum despite significant external pressures from the World Trade Organization (WTO) and the Financial Crisis of 2008. The government's hand in regulating and deregulating its domestic economy has given China a competitive advantage over other emerging economies, which has made China the most popular destination for Foreign Direct Investment (FDI). Additionally, China's labor supply and the lure of an untapped consumer market continue to attract businesses to set up shop in the country. However, the demand for Chinese labor over the past decade has put upward pressure on the minimum wage and the lack of infrastructure investment in western China has made low-end manufacturing companies pause in deciding to expand their operations in China. From this, a new business direction called the 'China plus one strategy' has taken root, where businesses are opting to invest in lower cost locations such as Vietnam while maintaining existing operations in China[1].

This movement of FDI out of China may seem like the natural progression of the business cycle, however a look at the Chinese government's involvement in their economy and their big-picture growth plan indicates that this movement out is partially orchestrated by the government. The government has been meticulous in attracting specific forms of FDI and directing that capital into particular sectors of the economy. Additionally, China is not bound by their external commitments (i.e. the WTO) to use non-tariff barriers to trade, and has utilized this opportunity to incentivize the growth of particular sectors of the economy while ignoring others. Thus, the Chinese government has the choice of how they want the national economy to look. Essentially, the government controls the local business environment and hence is promoting the movement of manufacturing companies out of China to leave resources available for higher-value manufacturing and services.

This all seems to signal that China's current economic plan or the 11th Five-Year Plan has been successful, however, there are indications to the contrary. China's currently faces a projected unemployment rate of rural-residents of over 9 percent, worsening income equality, and an inadequate welfare system[2]. Additionally, China's uncompetitive agriculture sector and desertification of arable land are diminishing employment in this sector that has traditionally been the base of employment in rural China. These factors combined with the movement of low-skill, labor intensive manufacturing jobs out of China creates real uncertainty whether the Chinese public will be able to cope with the new employment landscape and whether the existing social issues will be exacerbated and thus cause severe economic and political instability. Thus, as China nears the end of their economic plan for the years 2006 till 2010, the question is how will China's next plan, the 12th Five-Year Plan reflect its economic ambitions and societal concerns? Will there be a balance that was not seen in their existing plan? Or will they continue to sell the idea that blind economic focus will solve all problems? The objectives set in this next plan will be imperative for the future stability of China, and how well they execute their plan will depend on the Chinese government, external trade restrictions, and the economic recovery of China's major trading partners.

Section I: The 'China plus one strategy' and its Origin

China is regarded as the manufacturing capital of the world. Developed countries like the United States continually find that jobs are moving to China due to lower labor costs, lower taxation, and now a large supply of skilled labor. However, this is only one half of the story. China's manufacturing sector is experiencing this same trend where low-end manufacturing companies (i.e.: Toy and garment manufacturing) are moving to countries with cheaper wages. In 2005 the term 'China Plus One' was coined within the business community in China, to refer to the business plans many low-end manufacturers such as toy and textile firms adopted for their companies growth strategy into the 21st century[3]. These firms' costs were on the rise between 2000 and 2005 due to increases in the minimum wage and input costs, and with only projections for further increase these companies sought to expand their operations to other emerging economic with lower wages. But unlike many developed countries losing jobs to countries with lower labor costs, the Chinese government took this loss of jobs and investment in the country in stride. How could the government be so calm about this loss? It is because it was part of China's master plan for its modern economy. Consequently, much of China's development policies, formal trade relationships, and attitude towards economic development throughout the 1990s and early 2000s catalyzed the movement of low-end manufacturing out of China.

China's economic policies have largely been shaped by the reforms initiated by Deng Xiaoping in the 1970s. These reforms promoted market liberalization and a focus on attracting technology manufacturing into the country. During this time, Deng Xiaoping also envisioned China slowly moving up the technology ladder in their manufacturing capabilities to ultimately become the world's manufacturer of high-tech products and service provider[4]. To accomplish this, the Communist Party of China (CPC) uses their Five-Year economic plans to instill incremental changes to their economy to eventually support high-end manufacturing and services. A look at the most recent Five-Year plans, the 10th Five-Year Plan for 2000-2005 and the 11th Five-Year Plan for 2006 to 2010, demonstrate how the government over a ten year period has decreased its support for low-end manufacturers thus reducing the incentives for those companies to expand operations in China[5]. Thus, the loss of low-end manufacturers in China is very much a political decision rather than a perfect reaction to market forces.

The major impetus pushing low-end manufacturers out of China is rising labor costs. A major share of production costs for low-end manufacturers is labor; therefore moving to another country with lower wages (all other things equal) would be the rational and obvious choice for these firms. The CPC is well aware of this function of the business cycle, because it took advantage of it during the reform era to attract the manufacturing firms in question into their country in the first place. China brought in low-end manufacturers form Hong Kong, Taiwan, and South Korea to develop their domestic economy. Therefore, China's policies between 2005 and 2009 that increased the cost of labor were made with the knowledge that they would lose future manufacturing growth.

At the end of the 10th Five-Year Plan, the CPC passed labor law reforms that required firms to pay their workers on time[6]. This act addressed a long-standing issue in China concerning the level of back pay that was owed to migrant workers by low-end manufacturing firms. These firms cut costs by withholding the monthly pay for migrant workers for months and very often till they left the firm a year later. This benefited the manufacturing companies, because they had more disposable monthly income to invest in the company's future and more importantly they would end up paying less in wages[7]. This is because of the idea of the time value of money or simply the impact of inflation. This concept finds that one-dollar today, or in this case one *yuan* today is worth more than one *yuan* in the future. Therefore, if you earned 500 *yuan* in September, but your employer pays you three months later, you should receive more than 500 *yuan* to earn the same worth. However, manufacturers would just pay the nominal amount of wages instead of the adjusted real amount of employees' wages. Thus, how much the company paid in wages at the end was not adjusted for the time value of money meaning the company ended paying less than the worker would have gotten if received on a monthly basis. In passing this law the government also created a state account where employers were required to put the funds for monthly wages that would then be disbursed by the account managers. This held manufacturers to the law without much leeway to cheat, which was a significant change in the business practice and thus the costs incurred by these firms for labor. Although, this system has not been fully implemented it was first put into effect in the most developed economic zones with the greatest proportion of migrant workers such as Shenzhen. Thus, there were noticeable impacts on companies cost structures.

The 10th Five-Year Plan and the 11th Five-Year Plan set the national economic agenda to focus on the growing income inequality in the country[8]. Traditionally, countries that have developed policies to combat this same problem use income redistributive measures such as providing greater welfare support to lower income individuals. Western European countries as well as the United States use welfare as a method to increase the disposable income of low-income citizens thus reducing the income gap within the population. However, China depended on wage increases and labor rights protection to curb this issue, which puts the burden on companies rather than the government.

Both these Five-Year plans impacted the minimum wage directly and indirectly. The 10th Five-Year Plan established an official minimum wage in 2004, while during the 11th Five-Year Plan the government appreciated the *yuan*[9]. The government in their effort to curb the growing dissent between urban and rural residents due to income inequality required city and provincial governments to reassess the wages paid to rural migrant workers. This mandate by the CPC, caused cities like Shanghai and Shenzhen, where many low-end manufacturers are located, to increase their minimum wage for rural migrant workers up to the urban resident minimum wage. In 2008 Shanghai the minimum wage increased by 14.3 percent and in Shenzhen it was an increase of 17.6 percent[10][11]. Shanghai and Shenzhen were the most extreme cases of wage increase, but there was a general trend of increasing wages across major economic areas of China after the CPC called for it. If one considers an average toy-manufacturing firm in China, 20 to 25 percent of their cost is in labor. Thus, if wages increase by 17.6 percent like in Shenzhen that increases their overall production costs by 4.4 percent. Beyond this immediate impact on costs, this policy by the CPC to use wage increases rather than taxes for example to deal with income inequality signaled to these firms that the government would not protect the interests of low-end manufacturing firms as it did in the past where policies actively sought to keep labor cost low.

Now, one might look at this information and conclude that the political aspect of this decision was more between social stability and economic growth rather than a decision between higher-end manufacturing and low-end manufacturing. However, one has to ask why the government did not chose an alternative to wage increases and/or why did the government not offset the increasing cost of labor with other incentives for firms? The CPC has always taken a very active role within their domestic economy even when they were opening up the market. Since the economic reforms of the late 1970s, China has dismantled many of their State Owned Enterprises (SOEs) however many still exist in industries of 'national importance'. Some of these so-called industries of 'national importance' are the auto manufacturing industry and hardware manufacturing industry. China over the years has increased their subsidization of these SOEs despite the increasing costs to the government and their economic inefficiency. Thus, China's political imperatives in protecting industries from complete foreign control outweighed the economic efficiency argument. Today, that practice is no different, in fact government funded fixed capital investment for SOEs in 2009 was over 95 percent of total government spending when it was only around 70 percent of the total spending in the early 2000s [12]. This increase in spending was accompanied by increasing unprofitability of these same firms. So, it is irrational to expect the CPC to put money into subsidizing costs for low-end manufacturers if they decided to protect the industry. However, the government made no attempt to offset production costs of low-end manufacturers. For one, this is seen by the fact that tax-incentives have not been extended for these firms. Additionally, the government in the past has employed alternative methods of redistributing income rather than wage increases. For example in 1998 the CPC introduced a housing cash subsidy program and began constructing low-cost housing in cities, this in effect increased the income of its citizens because it reduced costs[13]. The CPC could also adopt a welfare policy. Since rural workers are of the lower income bracket, the CPC could have qualified them for a certain level of government assistance. This also would effectively increase their disposable income relative to higher income citizens closing the gap slightly. However, the CPC did not engage in this option either to reduce the pressure to increase wages. Understanding that the CPC had alternatives to how they handled this situation reveals that the government was purposeful in their policy choice.

Additionally, throughout this time period (2005-2009) the CPC also allowed their currency to appreciate by removing the peg to the U.S. dollar. In 2005 the CPC tied the RMB to a basket to a basket of currencies and controls the value of the RMB through a managed float currency system. The government allowed the currency to reach market appreciation point of 8.11 RMB to the USD in 2005 and now is managed within a 0.05% band[14]. The government accomplishes this by mediating their monetary policies to maintain the value of the RMB within the designated range. For example, if the demand for RMB was increasing causing the worth of the RMB to exceed the band set by the CPC, the government would print more money and put it into the market thus impacting supply and driving down the worth of the RMB to a desired level. Additionally, since the RMB is still connected to the value of the dollar, the CPC has been active in mediating the depreciation of the value of the USD. The Chinese government purchases the USD companies earn from exportation to remove the amount of dollars in the international currency market. This effectively prevents the USD from depreciating to the point that it would appreciate the RMB beyond the upper bound set for the currency. Therefore, the CPC takes monetary precaution to maintain their currency. This revaluation of the RMB was in part initiated by demands by outside forces such as China's major trading partner the U.S. However, China's domestic goal of preventing the economy from overheating in order to maintain healthy levels of growth into the future is more likely the real reason the CPC revalued the currency. Allowing the currency to appreciate offset the rate of inflation in the country, which helped prevent excessive levels of economic growth to occur in China thus protecting China's goal for sustainable development[15]. But again the companies that were hurt were the low-end manufacturers.

Finally, China's economic plans did not invest enough in new areas for low-end manufacturers to expand to. Most low-end manufacturers situated themselves along the coastal region of China, in particular the Pearl River Delta. However, over time more suppliers established themselves in the same region causing the costs to operate in the old, established economic zones to increase. The costs to operate a manufacturing plant in Shenzhen increased by 10 annually percent since 2000[16]. Therefore, manufacturers needed new economic zones in China that would have lower overall costs of operations. But a look at how investment money was allocated between regions, we see that there was only a modest increase in funding for new development zones, while over 80 percent of funding went to the established economic areas that were unsuitable for low-end manufacturers.

In these new development areas, the government also did not invest enough to make it competitive with other emerging countries attracting manufacturing firms. When China first developed their Special Economic Zones (SEZs) in the 1980s companies like low-end manufacturers were attracted to invest in the country, because of the upfront investment the government put into developing the necessary infrastructure for manufacturing plants such as an electricity grid and roads, the tax-breaks of being located within a SEZ, and the location by a major port reduced their transportation costs for exports[17]. These were new incentives at the time, but are now basic requirements for any country wanting to attract manufacturing firms. Additionally, this strategy of using SEZs or similar economic incentive programs is now common practice amongst other developing countries. So China's new economic zones have to not only offer incentives, but also be more enticing than their competitors. This is feasible for China, because compared to the main developing countries they are competing with for foreign investment in the region (i.e. Vietnam, Sri Lanka, and Bangladesh) China has more government money at their disposal to provide the most competitive incentives for manufacturing companies to offset the disincentive of higher wages. This is particularly the case in China as demonstrated by the fact that since the 1990s firms have favored China over other developing nations such as India even though they faced higher wage costs[18]. However, China's newer economic zone along the Beibu Gulf only offers 2 years of tax exemption, followed by 3 years of half tax with no offer for extension. Compare this to Vietnam who offers 2 years of complete tax exemption and 4 years of half tax with the option for extension for foreign manufacturers moving into their economic zones along their coast. Thus, China did not create new areas for low-end manufacturers to expand to that were competitive with other emerging economies.

Individually, each of these policy choices was to reach specific goals in their short-term economic plans: reducing income inequality and fostering sustainable development. However, all of these actions impacted low-end manufacturers by increasing labor costs. More importantly, these three policies were enacted within a fairly short time frame and basically overlapped each other compounding the cost problem for low-end manufacturers. The manner the CPC runs the national economy lends doubt that the effect of these three policies aligning with each other was an accident. Rather it shows the coordinated effort by the CPC to reduce the growth in low-end manufacturing to move on to their next phase of the plan of high-end manufacturing and services. Thus, prompting the 'China plus one strategy'.

The second major aspect to the onset of this strategy is China's commitments to international organizations such as the World Trade Organization (WTO) and the Association of Southeast Asian Nations (ASEAN). Both agreements support China's higher-end manufacturing and service industries beyond any other sector of their economy. China's agreement with the WTO achieves this end by protecting the domestic firms in higher-end manufacturing and services while significantly reducing support for low-end manufacturers. The agreement with ASEAN on the other hand, helped expand foreign demand for Chinese products in higher-end manufacturing to push development away from low-end manufacturing.

China joined the WTO in December of 2001. For all countries seeking to be a WTO member, countries must meet the requirements of the organization. In general, the leaders of the WTO assess whether a country is able and committed to liberalizing their domestic economy to allow foreign competition. This entails loosening import quotas, reducing tariffs on imports, allowing foreign firms to operate within the country, and most basically allow foreign products to be sold in their domestic market[19]. Although, all countries joining the organization have to liberalize their trade policies by committing to a tariff reduction schedule and reducing subsidization to a WTO prescribed level, countries are allowed to enact other protections (non-tariff barriers) on their domestic economy. China took full advantage of this and was strategic in how they used their options.

One protection not constrained by the WTO is how companies are restricted once operating in China. For example, the WTO would sanction China if they just do not allow foreign firms to set up in the country, but the WTO does not monitor China's requirements of foreign firms once they are in China[20]. Thus, China included a clause in their WTO agreement that foreign firms in the technology manufacturing and service sectors have to operate as a joint venture (with certain exceptions). A joint venture is a partnership between a Chinese company and a foreign company in the same industry. This essentially forced a level of technology, knowledge, and skill transfer between the experienced foreign firm and the adolescent domestic firm. The final outcome of this strategy was the development of new, competitive domestic firms in these industries to further drive the growth of these sectors. China did not support the low-end manufacturing sector to the same degree. There were no additional clauses beyond the tariff reduction schedule and tax exemption on imported parts to support low-end manufacturing. This clearly was not enough for this sector because within a few years of WTO accession, these companies are expanding out of China.

China's agreement with ASEAN also supported the high-end manufacturing sector by fostering greater demand for those products, but it also has increased the cost efficiency for higher-end manufacturing firms in China[21]. ASEAN or the Alliance of Southeast Asian Nations comprises of 10 Southeast Asian countries: Indonesia, Singapore, Malaysia, Philippines, Thailand, Laos, Cambodia, Brunei, Vietnam, and Myanmar. The organization was established in 1967 as a loose network for the region to have international bargaining power. But since then, ASEAN has become a major economic interest for large economies including the U.S., European Union (EU), Japan, and most recently China. This is a result of the Asian Free Trade Agreement (AFTA) between member states that required each state to reduce their tariff levels for goods from member states. ASEAN developed a comprehensive list of goods with varying tariff reduction schedules to ultimately reach a fully functioning Free Trade Area (FTA) that would provide a sustainable trading base between member nations[22]. In 2000, China entered into a FTA with ASEAN that placed the same tariff reduction goals for the various classifications of goods between China and ASEAN nations. The deal's final goal is to achieve a 0 percent tariff zone between China and ASEAN by the end of 2010 (for core members, 2015 for new members).

The rules of the FTA have generally been adhered to by the nations in the agreement. Tariff levels have been decreasing steadily since 2000[23]. This gradual decline of tariffs has been accompanied with a gradual increase in trade between the countries. It is estimated that since 2003 the average increase trade volume between China and ASEAN has increased by 18.2 percent[24]. Overall, the impact of this agreement is beneficial to China because it has helped expand the market for Chinese goods thus contributing to China's high growth rate. However, a look at the mix of goods being traded between the two parties indicates that the gains from trade are unevenly distributed between industries in China.

China initially exported to ASEAN low-end merchandise like textiles and watches, to mid-line products like machinery, optical instruments, and chemicals. The FTA generated growth for all Chinese exports, however the greatest export growth was in machinery, which accounts for over 50 percent of total exports[25]. This demand for Chinese goods has fueled the development of new SEZs in China, such as the Beibu Gulf that is focused on mid-line manufacturing for the growing ASEAN demand for electronic goods and machinery[26].

Now, a look at ASEAN's exports to China shows that ASEAN imports are also supporting China's technology manufacturers while breeding competition for China's low-end manufacturers in textile. Of the 40 percent increase in exports from ASEAN, one-third of it comprises of electrical and electronic products used as inputs for China's technology manufacturing firms[27]. This helps China's technology products be more competitive, because the inputs are becoming cheaper as the tariff level decreases. Additionally, half of the ASEAN nations export textiles and garments internationally. These merchandise are seeing an increasing share of trade to China from 5.8 to 8.3 percent in 10 years[28]. These nations (Vietnam, Cambodia, Philippines, Brunei, and Indonesia) are less developed than China, which means they offer firms lower wages and consumers cheaper clothes. This growing level of ASEAN imports to China is creating competition for domestic textile manufacturers thus making production in China less economically viable.

So, what ultimately caused the 'China plus one strategy' to take hold amongst low-end manufacturers in China now? It was the combination of politics and economic forces. Low-end manufacturing companies are always the first to relocate to cheaper locations. It is the nature of their industry, because wages are a significantly greater portion of their operating costs than other industries. So, as other developing countries with lower wages become viable options for relocation, market forces push these companies in their direction. However, an understanding of how China has structured its economy it is clear that global market forces are not the end all and say all. The CPC has enough capital and authoritative efficiency at their disposal to modify the impact of market forces on their domestic economy. Therefore, this change in China's comparative advantage in low-end manufacturing is also the choice of the Chinese government.

Section II: Initial Impacts on the Chinese Economy

Given that this changing direction of China's economy is partially orchestrated by the government it is curious to see the impact of the strategy on China's growth. Was it in China's best interest to lose their advantage in low-end manufacturing now just a few year after joining the WTO? The initial impacts of the 'China plus one strategy' all suggest that the country was ready for the change since its economy was not negatively influenced as measured by their goals within the Five-Year Plan.

The most general assessment of the health of the economy is its GDP growth. If, China's growth declined during the time period low-end manufacturers began to expand outside of China it would be a clear indication that the domestic economy was not ready to lose growth in this sector. Between 2003 (the trend began before 2005 but was only named in 2005) and 2007 China's GDP experienced continuous positive growth above the target annual rate of 7.5 percent (*Look at Table I)*. Moreover, looking at the incremental growth there is also a positive trend. These figures indicate that

China had sufficiently developed other sectors of the economy to be the drivers of growth rather than just low-end manufacturing.

Table I: China annual Gross Domestic Product in constant prices

Year	Annual GDP Percent Change	Incremental Percent Change
1990	3.832	
1991	9.2	5.368
1992	14.199	4.999
1993	14.004	-0.195
1994	13.097	-0.907
1995	10.929	-2.168
1996	9.997	-0.932
1997	9.299	-0.698
1998	7.798	-1.501
1999	7.6	-0.198
2000	8.408	0.808
2001	8.308	-0.1
2002	9.104	0.796
2003	10.003	0.899
2004	10.105	0.102
2005	10.403	0.298
2006	11.606	1.203
2007	13.016	1.41
2008	9.554	-3.462
2009	8.735	-0.819

Another concern about losing low-end manufacturing growth is the impact on job creation. Low-end manufacturing is the most effective sector in creating jobs. Since it is a labor-intensive industry, an increase in output by 1 percent of GDP creates approximately 1 million new jobs. Compare this with the service sector an increase by 1 percent of GDP creates only about 8 hundred thousand new jobs[29]. This is of particular concern because China's working age population increases by 7 to 8 million people each year[30]. Thus, to evaluate whether China was ready for this change is if unemployment did not increase dramatically during this period. The only national unemployment rate published by the CPC is the urban registered unemployment rate. China's official urban registered unemployment between 2003 and 2007 remained between 4.2 and 4.5 percent. This movement within 4 to 5 percent indicates a very stable urban unemployment rate since it is within established estimates for natural unemployment. However, this unemployment calculation is not relevant to this discussion, because it only looks at the population with a permanent residency card in an urban city. This ignores China's migrant labor force and rural population, which is the segment of the population most responsive to a change in growth in low-end manufacturing since they are the population who are mainly employed in this sector. Therefore, the unemployment statistics we are interested in is the rural unemployment and migrant labor unemployment.

Although, there are no official statistics for these groups regarding unemployment/employment we can look at indirect indicators to make an educated conclusion of the state of employment for these groups. For the migrant worker population two indicators that can be correlated to employment opportunity are migrant labor population growth and labor shortage in industrial production areas. The first indicator seeks to measure the demand for migrant labor, and thus job opportunity in urban areas. Given that labor mobility is positively related to demand for labor, then an increase in the migrant labor force implies an increase in demand for migrant workers and vice versa. Between 2003 and 2007 the migrant labor force grew from about 114 million to about 150 million people[31]. If one considers population growth amongst rural residents, this increase in the migrant population may just account for an increase in the labor force population. China's average population growth rate in about 0.6 percent, thus we expect a natural increase in the migrant population due to population growth of about 900,000 people annually[32]. Since the growth of migrant laborers is greater than the population growth the immediate conclusion drawn from this example is that there were at least stable demand for migrant laborers and therefore no unemployment issue for this group. But there are seriously faults to this conclusion, because the growth of this population is not purely a function of supply and demand. The population may have increased due to diminishing employment opportunity in rural areas, rather than actual job opportunities in urban areas. Therefore this population increase may be due to a push effect rather than a pull effect. Thus, we have to look at reported job vacancies in developed areas to assess whether there is in fact a pull factor.

Looking at news articles published between 2003 and 2007 from China's main news agencies (China Daily and Xinhua Net), there are indications that there was a labor shortage in industrial areas. In 2005 Shenzhen, the Pearl River Delta, and Fuzhou province all reported a shortage of low-skilled workers. Shenzhen notified that they had a need for 400,000 more workers, while Fuzhou needed 50,000 in 2005[33]. Combine with these reports of labor shortages in manufacturing there has been consistent service sector growth over the past ten years of about 10.8 percent each year[34]. Thus, the job vacancies in manufacturing areas suggest that there were employment opportunities for this group and therefore no unemployment problem as a result of the 'China plus one strategy'.

However, there is an argument to be made that these job vacancies require skills that rural residents do not have since there are fewer low-end manufacturing jobs due to this business trend. So as more rural residents leave their hometowns for jobs in the cities, they are not finding jobs because they are under skilled. This would be a problem from an employment perspective only if there was no job opportunity in rural areas. If there is job opportunities in rural areas, then this under skilled population have alternative employment prospects. To measure whether there are employment opportunities in rural areas we have to look at two indicators, the rural labor surplus and rural output growth. A study on the rural labor surplus (unemployed) found that the surplus has decreased at about 6.32 percent annually[35]. This decrease is not enough to conclude anything, because as more rural resident leave the area as migrants it automatically reduces the surplus rate thus not indicating job growth. However, if we combine the unemployment rate with output growth we can see whether a decrease in unemployment is due to job growth.

Between 2005 and 2007 agricultural output from China's rural provinces (Sichuan, Guanxi, Yunan) grew by 5 percent[36]. This indicates that there is growing work options in rural China. This conclusion is supported by CPC policy changes in the early 2000s. The CPC stimulated the agricultural sector by abolishing the agriculture tax in 2006. This tax, taxed farmers proportionately to how much land they owned regardless of how good the harvest was. This tax incurred farmers excessive costs, depressing the income from farming, and deterring demand for farming itself[37]. Thus the removal of this tax provided an alternative livelihood for rural residents overall and specifically for the sub-population of migrant workers. This suggests that the CPC agriculture policy did in fact pull labor back into that industry, thus fostering an alternative for some rural residents and migrant workers.

Additionally, China invested in new SEZs in southwest China. In 2000 the Chinese government committed 240 billion RMB over ten years in Chongqing located in the middle of China and opened the Beibu Gulf SEZ in 2006 in Guangxi province[38]. These new industrial areas in rural provinces created job opportunities for rural residents and migrant laborers within some rural provinces. Overall, these indicators suggest that unemployment did not grow significantly amongst rural residents and migrant workers due to a decrease in growth of low-end manufacturers in China. There is excess demand for labor in urban areas of China, and there is growing focus by the CPC on stimulating rural jobs during the time low-end manufacturers started this strategy.

All these indicators conclude that China's economy was not negatively impacted initially by the change in low-end manufacturing growth. In addition, these indicators may also suggest that China's economy needed this change to support the growth seen in these alternative industries thus positively impacting China's goal for economic diversity and regional growth. China's development since the late 1970s has mainly focused on the east coast of the country. This general area had the comparative advantage over Western and rural China, because it had access to cheaper transportation through ports, lower infrastructure costs, and a network of vertically supporting industries (i.e. parts suppliers for electronic manufacturers). Therefore, this area naturally attracted FDI, while the interior region did not. Additionally, labor mobility supported the growth of this region of China while discouraging growth and investment in their hometowns. Now, that the 'China plus one strategy' has taken hold there is a less future employment opportunities for low-skill migrant workers. This future prospect prompted the government's 'Go West' initiative in the 11th Five-Year Plan, to invest in the economic development of Western China[39]. One effect of the 'Go West' policy is the creation of the Beibu Gulf Economic Zone in 2006. This new economic zone is situated in Guanxi province and employs over 12 million workers from the region[40]. Therefore, we see that this movement of low-end manufacturing out of China and therefore the jobs for many rural residents has pushed investment in a part of the country that naturally cannot attract FDI away from the coast.

Additionally, the growth of the service sector we have observed in China between 2000 and 2007 depends on labor. Although, the service sector tends to require much less low-skill labor than low-end manufacturing the government goals for the service sector will require a large portion of the labor force. In order to grow the service sector to contribute more than 50 percent to the national economy by 2020, which is the CPC's long-term goal, requires access to over 1 million workers each year[41]. Therefore, by reducing the growth of the low-end manufacturing sector provides excess labor for the service sector and it reduces the demand on labor thus mediating upward pressure on wages. Thus, we see this negative relationship between low-end manufacturing sector growth and the service sector, where the reduction of one helps grow the other.

The final conclusion from this analysis is that the 'China plus one strategy' came at an appropriate time in China's development plan. The decrease in manufacturing growth was coupled with job growth in other sectors to offset the unemployment issue that the strategy threatened. The CPC's policies for agriculture growth and the development of Western China helped employ rural and migrant workers who otherwise would not have had employment options due to this trend. Additionally, this relaxation of demand now and into the future for Chinese labor in manufacturing aids the service sector by providing more available labor and reducing the upward pressure on the minimum wage in China. Overall, China orchestrated this new phase of their economic composition quite effectively with well-rounded economic policies. However, the government did not consider potential external forces that could derail the success this plan. Therefore, when the Financial Crisis of 2008 reached China, low-end manufacturers were hit the hardest and the 'China plus one strategy' quickly became the 'Leave China' strategy for low-end manufacturers.

Section III: The Unforeseen Global Recession of 2008

China since the 1970s has become a greater player in the global economy. It has embraced this role by focusing domestic policies to increase FDI into the country and more recently increasing Chinese FDI in other developing countries like Sudan, Kazakhstan, and Indonesia[42]. Additionally, China's accession to the WTO formally connected China with the 148 countries in the organization in 2001 (153 in 2008). China has largely used this position in the world economy as a platform to further its domestic goals, and has used domestic policies to ensure the effect of international trade has a net benefit for China. The best example of this is when China entered the WTO required most IT firms to enter the country as joint ventures thus supporting domestic firm creation in the process of economic liberalization. China's stellar performance throughout the process of world economic integration seemed to instill the view that China could set their own economic agenda independent of international pressures.

To some extent this was a rational belief for the CPC to adopt. The country has an abundance of resources in the form of labor and capital that virtually no other country has at their disposal. This allows China to maintain a low level of production costs for firms through indirect subsidies. Thus, China could supply firms with the resources necessary to want to invest in China and continue to grow the nation. But China forgot about the demand side of global integration.

China's economic growth in the modern era is driven by exports. Companies invest in China, make goods and services, and then export it to be consumed by foreigners. In 2006, China's trade surplus was worth 177.5 billion USD, which was an increase of 77.5 percent from the previous year[43]. Foreign consumption of export also impacts the investment function of GDP growth, which is the greatest portion of their GDP. As foreign consumption of Chinese produced goods increases, there will be increased pressure for firms in China to produce more causing the CPC and foreigners to further their investment in China's economy. Thus, foreign consumption impacts over half of the economic growth of China. China up till 2008 basically assumed that foreign demand was stable since the government was working to keep prices low. But then the Financial Crisis and the resulting global recession exposed the true volatility of foreign consumption on China's domestic economy.

The 2008 Financial Crisis originated in the U.S. Major relaxation of credit regulations both for the consumer and commercial markets caused the overvaluation of assets. The climbing values of assets made it impossible for individuals and firms to pay back their debt causing individual and firm level bankruptcies. This then became a global crisis because of two factors; one much of international trade depends on the U.S. ability to buy, and two when AIG and Lehman Brothers became financially insolvent the business that they worked for lost their assets and therefore became financially unstable. So, major economies around the world such as the U.S. and EU nations had a spike in unemployment and decrease demand for goods and services. In the U.S. alone unemployment increased from 4.6 percent in 2007 to 9.3 in 2009, causing a contraction of domestic consumption of imports by 33.7 percent between 2008 and 2009[44]. The reduction of domestic consumption for Chinese imports was also reflected in these years with a decrease of 12.24 percent between 2008 and 2009 in the U.S[45].

China's economy reacted to this, because it is the manufacturing hub of the world. The U.S. alone purchases over 30 percent of all Chinese exports[46]. Thus, the crisis caused a decline in demand for Chinese products causing a decrease in export revenue. Additionally, as firms operating in China were unable to sell their goods, companies had to cut their operational costs in order to survive the recession. Consequently, many Chinese workers were laid-off. It is estimated that over 20 million migrant workers lost their jobs in the cities between 2008 and 2009[47]. However, laying-off workers were not enough to save low-end manufacturing operations in China, firms reacted to the recession by completely shutdown their operations in China to concentrate on their new operational sites in cheaper locations.

In 2008, 49 percent of all toy-manufacturing companies collapsed in China[48]. The global recession impacted low-end manufacturers more than other industries, because these firms operate on very low profit margins. Low-end manufacturing goods face a highly elastic demand curve, which means that firms can earn more revenue by keeping the price low. However, by operating with a narrow profit margin it makes low-end manufacturers highly responsive to changes in costs and demand for their products. Up to the Financial Crisis, low-end manufacturers had faced increasing cost of wages of about 20 percent and increasing input cost of raw material by also about 20 percent[49]. This trend of increasing costs very much prompted the 'China plus one strategy', but with the decrease of demand for these goods above the increase in costs businesses could not profitably operate in China. This exit of low-end manufacturers completely from China sent the unemployment rate soaring. Zhou Tianyong from the Central Party School in Beijing estimated that unemployment in 2008 was around 12 percent and could rise to 14 percent in 2009 due the retraction of firms in China and the slowed down growth of the entire economy[50].

China was not ready for this dramatic increase in unemployment, and the derailment of their economic progress. Thus, the government reacted like most other governments with a stimulus package. China passed a 4 trillion RMB stimulus package to prevent further deterioration of the domestic economy[51]. The stimulus package is earmarked for different projects, but it was clear that the CPC recognized the need to protect the low-end manufacturing sector. China increased subsidies for a wide spectrum of low-end manufacturers such as textile companies and bicycle manufacturing firms. China, despite their WTO commitments to reduce their protectionist measures, funneled 10 billion RMB of the stimulus to increase their export-tax rebate by 55 percent for textile manufactures alone[52]. This subsidy essentially increases the profit of each unit they export, thus allowing firms that are still in China to maintain their overall profitability regardless of the lower demand for exports. This effort was clearly aimed to prevent further flight of low-end manufacturers in China. But why would China protect this sector, when it essentially tried to push it out in the preceding years?

This is because the 'China plus one strategy' allowed China to have the best of both worlds. They were able to maintain low-end manufacturing while growing higher value sectors. The strategy did not reduce the number of manufacturers, nor did it reduce the number of jobs in manufacturing. The strategy just reduced future growth of the industry thus reducing the number of new jobs that would be created in the sector and the overall contribution of low-end manufacturing to their GDP growth. China did not want to, nor can they sustain a complete exit of this sector of their economy. The impact on unemployment by the current number of firms that have exited is an increase of at least 10 million people above the annual increase of 7 to 8 million people in 2009. China does not have the capacity to grow over 11 percent annually and the fact that other sectors cannot create jobs as efficiently as low-end manufacturers requires the reemergence of low-end manufacturing in China. China needs a basic level of low-end manufacturers in China to employ their large population, thus China's future economic plan will have to incorporate policies that protect this industry from international competitive pressures.

This, global recession revealed the need in China for low-end manufacturing and therefore the country's place in the development cycle. The global recession pushed China back in their development plan. Money that would otherwise have been used for higher-end manufacturing and service sector creation has been diverted into retaining some competitive edge in low-end manufacturing. Thus, this crisis unhinged China's economic plan and the effectiveness of their domestic policies regarding economic growth. This impact on the Chinese economy is alarming for the CPC, because it has exposed a significant fault line in their national economy that went unnoticed. The government has long believed that China's economic stability lay in being an export-led economy with a trade surplus. However, with this crisis China's level of dependence on export consumption has become a liability. Thus, China's future economic plan will see a stark shift in policy to overcome the shortfall of the current economic structure.

Section IV: The Crisis Impact on the 'China plus one strategy'

The global recession showed how interconnected the world's economies are, and China being no exception. Once consumer demand in the major developed economies of the world declined, the immediate effect was felt in China. Demand for Chinese exports decreased causing their export volume to decrease by over 20 percent by 2009[53]. This obviously impacts the revenues from trade that contributes to their annual economic growth, but more importantly Chinese jobs depend on foreign demand. Therefore, we see the direst impact of the recession on the average citizens of China due to job loss. This reaction to the global recession has highlighted the need for policy reform in China. The government must evaluate the areas of greatest vulnerability and correct the situation if they want to avoid this scenario from reoccurring in the future.

To understand the severity of the situation one must look at the Chinese media coverage of the issue from 2008 to 2009. The media reported that since 2008 about a third of small to mid-sized firms in China have gone bankrupt and larger enterprises have also needed to restructure to cope with the global decrease in demand for goods and services. Additionally, national news agencies reported that the government asked migrant workers not to return to the cities when they went home for their two-week Spring Festival vacation in February 2009[54]. The action taken by the government to relieve unemployment in the urban areas is quit telling of the severity of the situation. There was a rise in urban registered unemployment in the third quarter of 2009 to 6.2 percent. The government's request of migrant workers combined with the increase in urban registered unemployment all point to the conclusion that urban areas were losing more jobs than creating them. Additionally, the fact that the urban registered employment, which is a small and particular group of the population, increased indicates the lack of government control of the situation. China admittedly and publicly failed at their goal of keeping urban registered unemployment below 4.5 percent (according to the 11th Five-Year Plan). But what really stung the government was the fact that their policies made their economy vulnerable to the forces that created the mass unemployment in their country.

On a micro level, the CPC's policies targeting low-end manufacturers beginning in the early 2000s took away certain cost supports which made these companies become highly responsive to market forces. This result on the face level was not bad. In fact, free market proponents would say these were the right steps taken by the Chinese government, because it is inefficient and costly to subsidize firms in any way. This is a logical conclusion by free market thinkers; however, this school of thought does not consider the instability that comes with freeing up the market. China, has taken this concern into their economic planning, thus one can observe that rapid liberalization in one sector that caused unemployment was accompanied with job creation in another sector. This balance of job loss and job creation was ensured by the CPC, by entering and securing new markets for Chinese products. Therefore, there was an element of certainty during the short-term period of transition. Now, looking at low-end manufacturing in China it seems that they employed a very similar strategy, but without securing new markets to support the transition from low-end to high-end manufacturing growth.

When China entered the WTO, they agreed to massive liberalization of the agriculture sector. China reduced tariffs on agricultural imports by 17 percent and allowed more foreign imports into the market[55]. These changes caused 11 million farmers to lose their jobs. However, this job loss was supported by an annual GDP growth of over 10 percent in that same year and job creation in manufacturing. This did not perfectly offset the loss, but it gradually absorbed unemployed farmers as they were retrained to be functional in the new economy. This balancing act was possible and sustainable because other aspects of the WTO agreement such as the 'most favored nation status' for China ensured growth in China's industries by opening up more foreign markets. This assurance was valued at creating an additional 1 percent of GDP growth above the established GDP growth rate of 7.5 percent[56]. Thus, the WTO accession assured high overall growth in manufacturing and services to cope with the immediate decline of agriculture. This entire plan was well orchestrated, and even though the agriculture sector went through severe changes the plan was only put into action with essentially a contract that other sectors of China's economy would grow. This level of security was not present when the CPC enacted policies to move up the technology ladder away from low-end manufacturing.

The CPC approached the task of reducing the presence of low-end manufacturers rather severely. The CPC enacted policies that pretty much overlapped each other multiplying the burden of cost on low-end manufacturers. The policies worked perfectly up till 2008, because global demand was fairly steady for low-end manufactured products and those companies in China could at least maintain what operations they had profitably. But the CPC did not actively seek to secure new markets for those products, which left the industry very vulnerable. It seems to have been a careless decision on the part of the government, because historically the CPC since the 1970s have taken very measured steps toward their ultimate development goal. In some ways it was a reasonable assumption by the CPC that there would be sustained demand for those goods, since the Financial Crisis largely was unforeseen. Yet, not ensuring a certain level of demand for their production during the time that they were trying to transition their economy was a major fault in CPC governing, which resulted in the exit of a majority of low-end manufacturers in China and a desperate policy response of increasing subsidies to the firms that were left. The final result is it forced China to take a step backward on their path to progress.

On a macro-level, it was the government's long standing policy of being an export-led, trade surplus economy that left their country susceptible to economic forces outside their border. China has long developed its economic policies along the concept that their national security and economic health depended on having a trade surplus. This ideology is a legacy from the Opium War ending in 1842[57]. The result of this conflict was China being coerced to allowing exports into their country, by Western nations. This flood of imports caused domestic consumption to divert towards buying imports rather than local goods. This tilted the balance, and China operated under a trade deficit that ate up their entire foreign reserve, bankrupting the nation and crippling their domestic economy. Thus, the lesson China took away from this was that their economic health hinged on being an export led economy and limiting imports into the country. For the most part this plan has served China well. Functioning on a trade surplus means that there are more revenues coming into China than leaving China. This has prompted China to reinvest in their country and procure a large foreign reserve that can be used to maintain monetary stability. However, China's trade surplus as of 2006 accounted for about 50 percent of annual growth, which reveals why it is such a vulnerability for China as well[58].

This figure indicates that 50 percent of China's year on end growth is dependent on foreigners. Foreigners have to consume Chinese products for China to grow at such extraordinary rates. This fact also implies that much of China's jobs are dependent on foreign consumption as well. Thus, this policy of focusing on trade surplus as a means of retaining domestic security has evolved into a liability. China has only so much control over the foreign consumer markets. They can make sure that their products are the most attractive due to lower prices, but they cannot directly control economic factors that impact aggregate consumption. The Financial Crisis is a case in point. When firms in the U.S. lost their assets it resulted in layoffs. When household mortgages went underwater it resulted in many bankruptcies. The final result was a dip in consumer's disposable income, or a lower level of income available to spend on goods and services. China cannot effectively influence the employment situation, or the credit crisis in the U.S. although it directly impacts China. Thus, China's policy to be an exporting nation was not a full proof method of protecting their economy from foreign forces. Instead of facing the fall of domestic producers due to an increase of foreign imports, they are facing the fall of domestic producers due to a decrease in foreign demand.

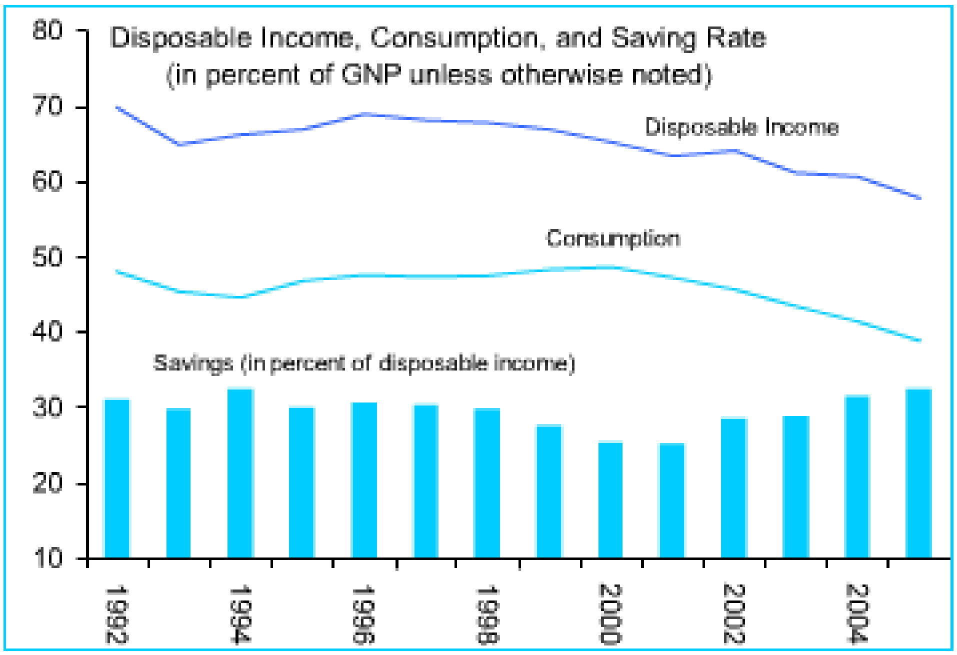
Both these issues that China is facing on the micro and macro levels are important for the CPC to address quickly. The problems that arise from depending so heavily on foreign consumption will be chronic for low end manufacturing (and eventually goods and services higher on the technology spectrum) as international trade moves through the boom and bust cycle. This creates a very volatile situation for China's domestic economy and social fabric since the segment of the population that will always be hardest hit are the low-income wage-based workers (versus salary-based labor). Additionally, China's major foreign markets, namely the U.S. and the EU are experiencing slow recoveries from the recession. In the U.S. for example unemployment is still at 9.7 percent two years after the crisis, and is projected to remain in the 9 percent range through 2011[59]. China, therefore, must address these issues for the sake of both short-term growth and future sustainability in their upcoming Five-Year economic plan.

Section V: China's New Direction and the 12th Five-Year Plan (2011-2015)

The 11th Five-Year Plan is in its last year and was quite successful in meeting its major goals and minimizing the severity of the global recession. However, the events of the past two years have exposed fault lines in the Chinese economy that the upcoming 12th Five-Year Plan will have to address. The major issue is how to structure their future growth so that the success of domestic policies (i.e. the movement of low-end manufacturers out of China) and domestic jobs are not so dependent on foreign demand. This will require the CPC to look at other drivers of growth that can replace foreign consumption, and focus their investment and policies to cultivate this adapted form of growth. The main area that has been identified by scholars and accepted by the CPC as the way to reduce the role of foreign consumption in China's growth is to increase domestic consumption[60].

Scholars argue that increasing domestic consumption in China would provide a new and stable consumer market for the goods and services produced in China. Since the Chinese consumer market is quite undeveloped at the moment, there is potential to expand sales of goods and services within China itself. However, the fact that domestic consumerism is low in this day and age indicates why this solution is not an easy one. China's domestic savings rate in 2008 was 49 percent, which means that about half of their disposable income is used for consumption[61]. Even as China's per capita income has increased by 10 to 15 percent over the past decade, consumption has only risen proportionately, leaving China as the nation amongst large economies with the lowest contribution by domestic consumption to the their national economy[62]. Additionally, since 2005 consumption share of GDP has made a slight decline to less than 40 percent of GDP[63] (see *Graph I)*. The slight decline of domestic consumption and adherence to high savings indicate that there are obstacles to releasing Chinese disposable income to be used for consumption purposes.

Graph I: China's Declining Consumption Rate



However, if the Chinese consumer market can be tapped to drive domestic growth it will help China foster healthier economic growth. On the micro level it is simply a new market for manufacturers to sell to, and therefore will be able to receive revenues from new consumers while the old consumers recover. Additionally, manufacturers in China will have greater incentive to maintain operations in China if they sell a greater portion of their products in China rather than just as exports. This is because the companies will face lower transportation and foreign tax costs for those good consumed in China. This may offset the cost benefits of operations outside of China, if there is enough demand within China for their products. So domestic consumption can help keep low-end manufacturers in China, when China eventually reduces the subsidies due to their WTO agreement and to international pressure. By cultivating domestic consumption the 'China plus one strategy' can function like it did before the Financial Crisis, because it will maintain a certain level of low-end manufacturing in China to employ the excess low-skilled workers from primary industries.

This solution is even better for the macro economy, because it will give China back control of their economic growth and development. Given that Chinese consumption growth can increase by more than foreign consumption growth, this would result in an increasing proportion of goods being consumed by Chinese nationals rather than foreigners. In result, Chinese citizens will propel an increasing proportion of the economy via consumption while the proportion of China's growth dependent on foreign consumption decreases. This does not mean China has to become a trade deficit nation. It only means that the relative contribution between the trade surplus and domestic consumption contracts, so that part of China's growth remains in their own hands. Countries like Singapore and India both are trade surplus countries, but have higher consumption rates than China. It is a completely attainable reconstruct of China's economy, but China's next Five-Year Plan will have to focus on opening up the domestic consumer market far more than it has in the past. The main area that has been identified as an obstacle to higher consumption in China is the high savings rate.

The mainstream argument of how the CPC can harness the potential of the domestic consumer market is to develop policies that address the pressure on the individual to save for retirement and medical expenses. China has historically had a high savings rate, but this is correlated to the high cost of healthcare and retirement in China[64]. This high individual cost exists because there are inadequate health and retirement plans in China. Basically, there is no real social security plan for the nation. The government has a basic health and pension program for former SOE employees and urban residents that is funded by government revenues collected within the urban jurisdiction. Rural residents' land rights and the value of that asset has long been considered their social security. These policies are not enough because it does not cover a large enough segment of the population, and land as social security is not liquid enough to realistically be used to cover these expenses. Thus, the high savings rate by Chinese citizens is mainly driven by their need to pay out of pocket their medical and retirement costs.

The pressure to save has been compounded in modern times due to the one-child policy and the consequent aging population. The one-child policy was formalized in 1979 along with the economic reforms. It was used as a means to alleviate poverty, and has been accredited for keeping 400 million people from entering poverty[65]. However, the side effects of this policy are only becoming evident now. On the basic level there has been a change in the family structure. In general, there is one child for two adults[66]. This is a problem because without a social security system the family unit has been responsible for taking care of the cost of retirement and aging. In particular the children would help pay for their parents expenses. Now, that there is only one child for two parents these costs cannot be shared amongst multiple children, therefore there is a need for the working population to save more than in the past.

This is coming into full effect now because the first generation of the one-child policy is middle-aged and their parents are of retirement age. Thus, this dynamic has taken control over the savings habit of the current working population. This is the exact group that needs to be targeted in order to boost domestic consumption since they are the ones with earned income to spend. Thus, the government must consider how to reduce this cost burden on working-age children to support their goal of increasing consumption. The obvious answer here is for the government to develop some kind of national social security plan that addresses healthcare cost and retirement costs. The CPC is currently running pilot programs to develop such a national plan[67]. In 2004 the government expanded their coverage for both retirement and healthcare. However, there are limitations to both these plans due to their revenue base, demographic structure, and the immediate need to stimulate consumption. Thus, the 12th Five-Year Plan will have to look at these shortcomings of the established plans to better meet the need of fostering domestic consumption than just the goal of providing social services.

The retirement and healthcare funds are localized efforts by urban enterprises and workers. Urban employers and employees contribute to the social-pool-plus-personal-account scheme set up by the government. Retired workers who paid into the fund (8 percent of income), receive a base level of pension from the 'social pool', but can receive additional payments proportionate to how much they put into their 'personal account'[68]. This system divides the responsibility between the individual/employer or private contributors and the government or public contributor. The private contribution obviously comes from wages and profits, while the government's contribution is derived from revenues through "reducing state shareholding, stock ownership assets, funds from the central budget, funds raised by other means approved by the State Council, and investment returns". Using this revenue base is extremely important due to China's aging population, which would make a retirement fund unviable if it relied on contributions by the workforce for the retired like the social security program in the U.S. Therefore the current Chinese retirement plan that makes individuals pay for their own retirement is a strong point for the sustainability of the plan. Additionally, this plan has the potential to be modified for rural China. Rural enterprises can easily fit into this model because there is an employer who can contribute to the fund along with the employee. But this model is not adequate for the self-employed farmer of rural China. Without an employer contribution, the government would need to payout more to compensate. Thus, the government must consider new avenues of growing their social security fund.

One option is to invest the payments in the personal account into higher yielding options, so that the personal account will earn more in interest over the years. This will increase the amount in the personal account relative to the current system, and can payout more each month thus reducing the payout by the government upon retirement. All in all, this retirement plan can pay a moderate amount for retirement and eventually reduce the personal cost of individual retirement. However, it does not address the immediate savings issue due to the current retired population without adequate retirement benefits. Instead, expansion of this plan will exacerbate the high savings issue in the short-run and not achieve higher levels of domestic consumption.

The current retired population will not benefit from this plan, because they are out of the workforce. Therefore, the current government plan to expand retirement programs only reduces the burden of saving in the future. Additionally, this plan to expand retirement programs comes at a cost for the current workforce population, because they are faced with a double burden of helping their parents and saving for themselves. So what is needed in terms of retirement benefits in order to decrease the savings rate now? The goal has to focus on relieving the cost burden by working children for their parents who do not have basic pensions. The government can accomplish this in two ways: increasing taxes to payout social security for all retirees or reduce taxes on the working-aged population facing this double savings burden to increase their disposable income. If China approached this as a short-term fix, then raising taxes would be the likely solution. The government could increase individual income tax for the highest tiers of the tax bracket to pay for basic pension across the board until the retired population consists of pensioners who contributed to a plan throughout their working life. There are problems with this approach, because of China's income distribution. A greater proportion of household income is concentrated in a small population. Thus, the taxable base of the higher income group would not yield enough to payout for 60 to 75 percent of the retired population without a significant increase in taxation. Additionally, this form of redistribution may not have a net benefit on consumption because the highest income bracket increase in taxes would impact their current level of disposable income. Thus, the increase taxes may increase consumption of the middle to lower income tax base while decreasing consumption of the high income tax base, thus not having a significant benefit on consumption in China.

What would be a better approach and a sustainable approach is to allow aging parents who do not have pensions to be claimed as dependents by their working child so they can receive an additional tax deduction. China calculates taxable income by deducting a set amount or a 'quick deduction' from individuals' total income and then applies the tax rate[69]. By allowing the deduction to increase based on how many parents an individual supports, it will increase the current disposable income of working children. This deduction should not be based on how much the child actually paid in that year to support their parents, but rather a set amount that the taxpayer can depend on. This certainty of how much they are relieved from taxes can offset the double burden the current working age generation is facing, and release more income to be used for their own consumption now. Additionally, the population that is tax exempt because their monthly income is below 500 *yuan*, should be able to claim their parents as dependents (if they are supporting them) and receive a government refund the amount they could have deducted if they had a higher income[70]. This would relieve the level of savings for this group, because they can save the annual government refund instead. Therefore, reducing taxation based on the retirement situation of working children parents can be used as a new policy to stimulate more immediate consumption compared to large structural changes to retirement policies for the overall population.

Now, medical care is another significant out of pocket cost for Chinese citizens that require a high current savings rate. In China there are very few private insurance companies, and for the most part they specifically cater to the wealthy population. The current State medical insurance plan is similar to the retirement plan but with even more restrictions. The medical plan develops a pool of funds to pay for medical care for urban workers. Employers pay 6 percent of the wage bill while employees pay a minimum of 2 percent of their wage to be part of the plan[71]. The problem with the plan is that it is even more exclusive than the retirement plan. The medical coverage only extends to urban residents and the funds can only be used for medical services used in that city. This without exception excludes migrant workers. So this population of 150 million people has to save for their own, their children, and their parents' healthcare costs. The migrant population is not the only segment without adequate medical coverage; basically the entire population with rural-registration cards does not have sufficient medical insurance coverage. This is a significant issue for consumption, because it amounts to about 53 percent of the population[72]. Additionally, medical costs are rising in China like the rest of the world. The cost of wages, technology, equipment, and pharmaceuticals are all driving up the cost for basic medical coverage. Thus, this trend of increasing costs reinforces the savings habit in China that saves more than they need now, because of the uncertainty of cost in the future.

Tackling a medical insurance program to reduce the cost of healthcare on the individual will likely be more effective in increasing domestic consumption rather than the retirement plan, because this will impact people's immediate expenditures and therefore their immediate need to save. For the population that is covered under the state insurance plan, the uncertainty they face is that they lose coverage if they lose their job. Thus, the State plan should pool the money into individual accounts that can be accessed and contributed to by the individual even after losing employment at an enterprise and transferred upon finding new employment. This will reduce the uncertainty of medical insurance for this population and potentially reduce their savings habit for emergencies. The more pressing issue for the medical insurance plan is the lack of coverage for non-urban residents and self-employed urban residents. Self-employed in this case are all the family-run businesses like restaurants and no name clothing stores. This majority is not formally included in the state medical plan because they are not classified as enterprise employees. For this group the government must create a program that is not solely tied to enterprise employment, and is potentially transferable as people change places of employment. This is especially necessary for the migrant population, because their short-term contracts means that they do not have consistence medical coverage and changing places of employment means that they cannot access the established medical plan in the other the city. The State plan may have to coordinate on a larger scale to make sure that people covered under a particular urban plan can access their benefits outside that area. For example if the current State plan could divide the payments into a federal and a city account, the federal account could used outside the place of permanent residence, while the city level account can be accessed for internal use.

Reforming the medical insurance most likely will take years to impact consumption practices in

China. Thus, the government needs a small-scale reform in their 12th Five-Year Plan to reduce the burden of saving for medical expenses in order to stimulate domestic consumption in the short-run. One suggestion is for the government to require medical facilities to offer payment plans for medical services rendered. The government could develop a standardized payment schedule for common medical procedures that can be applied to different areas of the country with varying medical cost and wages that specifically aims to reduce the incentive to save at the current rate of 49 percent. For example, an overnight stay at a hospital in Chengdu costs around ## *yuan* which is about a month's worth of wages for a construction worker. Since, people without coverage are required to pay in full and in a single payment for these services, it requires at least a month's income to be kept in savings at all times (8.33 percent of income). However, if the government developed a payment schedule for this medical service it would require a smaller percentage of income savings to remain in their account. For example, if the government developed a schedule that said that only 20 percent of the cost has to be paid upfront, followed by a monthly payment of 20 percent plus a certain level of interest over the next four months would only require that construction worker to have 20 percent of their monthly wage consistently in savings (1.67 percent of income). By instituting standard payment plans, individuals can expect to pay less for their medical care as an upfront cost and may reduce the pressure on saving enough for the complete cost of medical services. This reduction in savings can then be used for consumption in China. If the 12th Five-Year Plan aimed to reform the medical system in this way they would have to support this policy with education and publicity of this change in the medical system. The consumer base has to be made aware that they are not required to have the total cost of medical services in order to receive it, and can affordably pay for those services without saving almost half their income.

Now there are special circumstance impacting subgroups of the population and the reasons why they have low consumption rates. First is the migrant labor population. Beyond their plight of being low income and not receiving government assistance for medical and retirement benefits, they also have an unstable lifestyle. Migrant workers are temporary workers and either work under short-term contract of at most a year or without a contract at all[73]. The changing landscape of employment for this segment of the workforce also encourages internal movement to look for better jobs. Finally, most migrant workers leave their families behind due to the high cost of living in urban areas. Children in particular are left at home; so migrant workers live communally. All these factors discourage consumption for even basic goods. Migrant workers cannot have too many possessions because it would complicate moving around, nor would they want to have valuable possessions if they are living with many people who they do not know. Finally, the lack of certainty of future income beyond a one-year horizon makes it difficult to rationalize spending in the moment. Thus, some policy must go into creating a sustainable lifestyle for migrant workers to encourage spending, with the even better benefit of improving their standard of living. The government can reduce the cost of education for migrant children and subsidize housing migrant families. This will promote migrant workers to live as a family unit due to the decrease in cost. By living separately, this may encourage more spending by migrant workers because there is a sense of security and a reason to spend. Also, requiring a minimum 3-year contract for migrant workers in enterprises, with increasing annual wages and/or benefits that can reduce the income insecurity of migrant workers. These policies on the whole may have the additional benefit of reducing the current issue of absentee employees after their annual vacation, because migrant workers will have established some kind of a life in the urban area to have both social and financial incentive to return. Thus, the next Five-Year Plan can focus even more on stabilizing the lifestyle of migrant workers to encourage consumption.

The second sub-group is the upper-middle and high-income population. Their income far exceeds the lower income brackets, but they still save basically the same portion of their income[74].

Additionally, about half of their increase in consumption in the past ten years has been in other forms of investment. Their disposable income will largely be unaffected by the policy a changes mentioned because they are mostly urban residents and are already covered under the current plan and tend to have private coverage on top of that. So to promote consumption within this group of people, credit may be the answer. Individual open-ended credit, or in other words credit cards are a rare thing in China. Only about 3 percent of consumer spending in China is on plastic accounts. Cash is the predominant method of paying for items in China. This requires individuals to save more money now in order to purchase big ticket items in the future such as electronics, which typically are purchased with the assistance of a credit card in developed countries. This lack of credit use is partially an accessibility issue, but the greatest barrier to consumer credit in China is the lack of a universal system. The magnetic strip and billing system is fragmented due to the differences in systems used by banks. This has prevented retailers from acquiring the technology necessary to use credit cards. As of 2002 only 2.7 percent of merchants in China accept card payments. Thus, there needs to be an effort to standardize the billing system for card payments, and increase the number of retailers that accept credit. The government can facilitate this movement by subsidizing the Union Pay system, which is the effort by credit card companies in China to create a standard system so that bankcards can be converted into a single system. Additionally, the government can give some kind of rebate for retailers that purchase a bankcard reader so as to increase the opportunity to use credit in China. This will be a mid-term to long-term policy goal for the next Five-Year Plan, because it requires reforms and investment across multiple industries and provinces of China. However, there is great potential of increasing consumer credit across all segments of the population to further consumption in the future. Therefore, it would be a good investment for the CPC and credit companies in China.

All of these policy options address the issue of high savings in China that hinders domestic consumption growth due to expenditure constraints. However, the International Monetary Fund (IMF) is proposing that high saving is a result of the type of income Chinese locals depends on. Compared other countries like the U.S., as the country develops the proportion of disposable income due to wages declines relative to disposable income from investment[75]. The fact that China's stock market is underdeveloped limits an average citizen's access to invest in stocks and bonds. China has one of the lowest rates of investment contribution to individual disposable income in the world. This stagnation of investment as part of disposable income prevents a change in the savings habits of a country, and therefore their consumption regardless of their expenditure responsibilities. This is a new analysis of the barrier to consumption in China, and should be considered by the CPC in their upcoming economic plan. This suggestion by the IMF would require greater access and confidence building in the stock and bond market in China. The market must take into account the typical income of Chinese citizens, which is relatively lower than the average income in developed countries. This might be an issue because companies may have to offer a new kind of stock option that pays out lower dividends to make it affordable in China. It seems with the conservative financial practices in China mutual funds would a great place to start to develop investment income. The established commercial banks in China may have to take on this new role or develop partnerships with investment firms to bring these services to people across the country. Over, the past ten years the commercial banks have been successful in selling bank products that are catered to the needs of the typical Chinese citizen, saving and checking accounts that only require a small balance. Thus, if the CPC is able to deregulate their stock market (Shenzhen and Shanghai) to allow more firms to register and trade stocks, and help the big banks develop a investment segment of their operations investment as an income option will likely become more prevalent in China[76].

It is clear that there are several major underlying pressures that have sustained a high savings rate in despite growing affluence. The most common areas identified as obstacles to savings less are the lack of a social safety net (retirement and health insurance), low consumer credit access, and income uncertainty. Additionally, there is a new idea put forth by the IMF that Chinese income needs to include a greater presence of investment income to diversify their disposable income and change their savings habit to focus more on consumption. The CPC for each of these issues have multiple policy options that can be implemented in tandem to expand the consumer market in China in the short-run to the long-run. However, for consumption to be used as a sustainable method of growth it has to be directed to domestically produced goods and services. This does not mean buying products made by Chinese owned companies, but rather buying China-made goods. This will shift Chinese employment from depending on foreign demand to domestic demand. The government can achieve this by preventing significant appreciation of the *yuan*. By doing this, domestically produced goods will be relatively cheaper than their imports. This will help maintain the competitive advantage for domestically produced goods over imports, and direct consumption to support their own economy rather than foreign economies. Currently, the U.S. has been pressuring China to revalue its currency under the pretext that it is undervalued and is hurting other countries economies. However, the CPC has to be protective of its own economy, as the next phase of their development will depend on domestic consumption currency valuation is the greatest tool at their disposal to prevent the potential adverse effects of increasing domestic consumption.

Thus, we can expect to see a marked policy shift in the 12th Five-Year Plan by the CPC. The will be greater emphasis and money allocated to expand the social security and medical insurance plans across the country. Additionally, amongst the short-term solutions to promote consumption quickly, the most likely policies that the CPC will enact based on their tendencies in the most recent plans are to increase consumer credit access and usability and stabilize the lifestyle of migrant workers. These policies have a touch of egalitarian or redistributive politics, which has been a greater influence on the current leadership's policies. However, the top leadership in China is scheduled to change in the middle of this next plan. The new generation is largely viewed as more market minded, thus their influence on this plan may be able to push forward the reformation of the investment market. Ultimately, this next plan will focus on developing the domestic consumer market rather than just industrial growth via social and financial reforms.

Conclusion/Summary

The 'China plus one strategy' that took hold amongst low-end manufacturers in China in the early 2000s was partially orchestrated by the Chinese government. The CPC's policies since 2004 have compounded the increase in operational cost for low-end manufacturers, which encouraged them to use this strategy for their future growth. This fit nicely into China's overall economic plan, because it kept established low end manufacturing jobs in China while leaving excess resources such as labor to grow higher-end manufacturing and services. However, when the Financial Crisis in the U.S. became a global recession, this strategy was exacerbated and a majority of low-end manufacturers completely left China for their newer operations in countries with lower operational costs. This caused mass unemployment across the country and a decline in economic growth in China. Thus, the reaction of the 'China plus one strategy' to the Financial Crisis exposed a serious fault in the Chinese economic structure in that it depends too heavily on foreign demand to drive growth.

The problem with China's dependence of foreign demand is that Chinese jobs have become too responsive to external forces. So when the Financial Crisis took full effect, unemployment elsewhere like the U.S., was matched by unemployment in China. This is a very unsafe place for the CPC, because it does not have significant independent control over the employment landscape in the country. Thus, the next set of CPC policies will focus on remedying this issue by increasing the share that domestic consumption plays in GDP growth.

CPC policies will have to look at the reasons that there is a high savings rate in China that has in fact increased slightly as per capita income has increased. Scholars have identified both expenditure and income side barriers to releasing savings for consumption. The main problems identified to higher consumption are high personal cost of retirement and healthcare, low credit access, and stagnant investment income contribution. Thus, the next national economic plan for 2011 to 2015 will focus on developing the social and financial reforms that will help shift China's dependence away from foreign consumer demand. This will give China back a certain level of autonomy and will drive their growth as major world economies recover from the crisis.

In the end China's economy will be stronger after these reforms. It will promote healthier growth, and will more effectively redistribute income to combat the growing instability due to income inequality. So, although the 'China plus one strategy' did not work the way the CPC had intended since the Financial Crisis worsened the impact of CPC policies on low-end manufacturers costs, it revealed a problem and its severity on the Chinese economy that may not have been seen otherwise. Thus, the CPC can change the nature of its economic growth now rather than later when it will be much harder and more expensive to reform as China faces growing competitive pressures from developed and developing countries.

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