Asia Society

An Asia Society Policy Institute Report

EXECUTIVE SUMMARY

Avoiding the Blind Alley

China's Economic Overhaul and Its Global Implications

DANIEL H. ROSEN

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FOREWORD

DURING THE PAST THREE DECADES, perhaps no country has turned in an economic performance as impressive and transformative as China's. China has emerged as the world's second largest economy and its greatest exporting nation, accumulating huge trade surpluses, vast foreign currency reserves, and enormous influence on the global economy. Despite all the attention that policymakers, business executives, and scholars have paid to China's economic rise, much debate surrounds China's future growth prospects.

For their part, President Xi Jinping and the new generation of Chinese leaders responded to the risk of a major economic slowdown by announcing a far-reaching reform campaign at the Chinese Communist Party's Third Plenum in November 2013. If Beijing shifts direction along the lines it has announced, the behavior of Chinese companies, government agencies, and individual members of society is likely to change in remarkable ways – and thereby create opportunities for the rest of the world. Should the reform program stall, the effects will be just as profound. Either way, China's new policy design, and its success or failure in achieving it, will have a major influence on the international economy and stability and security in Asia and beyond. With so much at stake, and an outcome that is far from certain, there is an evident need for greater clarity about what the reform program consists of, how it is progressing, and what it means for policy and business.

The Asia Society Policy Institute (ASPI) was established in early 2014 to address just such critical questions about Asia's future and its role in the world. To make effective decisions, leaders in government and business must comprehend how economic and political developments are transforming the settings in which they operate. ASPI not only commissions research that helps our stakeholders respond to uncertainty. We also convene senior figures in policy and business, from across Asia and the United States, to discuss complex issues and cooperate on formulating responses that will bring prosperity, security, and sustainability to all of Asia. We give particular attention to matters at the intersection of policy and business and central to intra-Asian relations.

This report is meant to give policymakers and business leaders outside China the insights they will need to understand, monitor, and adapt to China's economic reform program. It explains why China has set out to overhaul its economy and describes China's reform plans in terms of nine policy domains that will be familiar to Western observers. The report traces the progress that China has made to date in putting those reforms into effect and proposes quantitative and qualitative metrics that can be used to track the reforms going forward.

This project has been a collaboration between Asia Society Policy Institute (ASPI) and the Rhodium Group, following on a series of joint projects focused on Chinese foreign direct investment in the United States. The author of the report, Daniel H. Rosen, has produced a path-breaking guide to China's reform proposals and prospects by analyzing the economic reform announcements following the Third Plenum, assessing the likelihood of the reforms being carried through to completion, and estimating the impact of different outcomes on China's economic performance and the international economy. He has also offered recommendations for how policy makers outside China might formulate responses to the reforms as they take effect.

On behalf of Asia Society, we would like to thank Dan and his Rhodium Group colleagues for dedicating their expertise and an extraordinary level of insight and energy to this project. Our thanks also go to several members of the ASPI team for their commitment and effort over the course of this initiative: Debra Eisenman for supporting many practical aspects of this enterprise, Anubhav Gupta for coordinating the launch events around the world, and Josh Rosenfield for overseeing the editorial process. We are also indebted to Susan Shirk for contributing valuable feedback on early drafts of the material, and to Orville Schell for bringing his deep knowledge of China to bear.

In carrying out this project, we have benefited from the advice of the ASPI Honorary Council and Advisory Council. We are grateful for the continued support of the Asia Society's co-chairs, Henrietta H. Fore and Ronnie C. Chan. The directors of Asia Society's centers around the world have played valuable parts in helping this report to reach a broader audience. Finally, we owe our deepest gratitude to Jack Wadsworth, whose vision in urging ASPI to pursue this effort and generous assistance have allowed us to undertake and complete the study.

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EXECUTIVE SUMMARY

PRESIDENT XI JINPING ANNOUNCED a sweeping overhaul for China's economy in November 2013, with pledges to make market forces decisive, treat homegrown and foreign investors with the same laws and regulations, and change the mission statement of the government. The reform program, known as the *Decisions* plan and presented at the Communist Party leadership's Third Plenum meeting, is comprehensive and marks a turning point in China's modern history. The degree of boldness also indicates that after 35 years of world-beating economic performance, China's development model is obsolete and in need of urgent, not gradual, replacement. To justify the risks, President Xi quoted an impassioned plea for policy modernization by his predecessor Deng Xiaoping: the only way to avoid a dead end – a blind alley – is to deepen reform and opening both at home and with the world.

Despite this clarion call, observers in China and abroad have found several reasons to wonder what shape the reforms will take and whether they can be put into full effect. First, the announced program is idiosyncratic and difficult to benchmark against advanced-economy models. Second, as with earlier waves of Chinese reform, the 2013 program leaves room for experimentation, and the final design of regulations is not specified. Third, some of the same commitments have been promised before and not delivered, leaving analysts cynical. Fourth, and importantly, full implementation of the principles set out – such as a decisive role for market forces in allocating resources – portends a greater transfer of Party control over the economy than is thought to be palatable to China's leaders. Therefore, rather than bringing about a sea change in business and policy expectations about China's course, this new agenda has amplified debate.

China's leadership is moving ahead across all economic dimensions of reform with purpose and urgency.

To resolve uncertainties, this study assesses the content of China's economic reform program and indications of its progress during its first year. We find that the program's redefined mission statement for government and nine major clusters of regulatory overhaul are convergent with advanced-economy notions of economic governance. Moreover, we conclude that – on balance – China's leadership is moving ahead across all economic dimensions with purpose and urgency, though at varying speeds, and is simultaneously addressing the obstacles that have hampered systemic reform in the past and continue to complicate implementation today. That said, the consolidation of power, key to overcoming those impediments to reform today, creates its own problems for the future.

Based on available evidence, the success of this overhaul is not guaranteed. Leaders do not have the luxury of consensus among elites on many aspects of reform and have retained conflicting messages in their program because of custom and necessity. In many cases, new regulations and implementation guidelines are not well defined. While a decisive role for

All U.S. dollar and renminbi figures in this study are expressed in constant 2013 terms unless otherwise noted.

market forces in allocating resources is a central concept of Xi's *Decisions*, the meaning of this categorical imperative is understood differently in Tokyo, Washington, and Brussels, let alone in Beijing. The complete picture of what leaders intend is in flux, and it is uncertain whether the general thrust of marketization suggested by Beijing's current actions will remain on track and on pace to meet a self-imposed 2020 completion deadline. We examine actions to date and suggest metrics for distinguishing progress from derailment.

The Third Plenum program is a necessary but not sufficient step toward a new economic model. In the year since the program's release, hundreds of reform-branded policy documents have been handed down by the Party and government, the most important of which we analyze in this report. As evidence of follow-through has accumulated, doubts that China's leaders have the intention or ability to change the rules have subsided. Based on evidence of reform, interviews, and analysis of Chinese GDP growth, we conclude that leaders accept that old sources of growth are exhausted and bold steps to institute a new model are urgent if the nation is to avoid crisis. To substantiate this assessment, we identify the drivers of past growth and describe their diminishing capacity and catalogue the prescriptions set out in the *Decisions* and indications (and counter-indications) of implementation, as well as observable economic activity that will confirm whether commitments have been achieved.

We project that China's potential GDP growth in 2020 will be 6%. Half of this growth can be generated through continued investment in the country's capital stock, though only if that investment is focused on different assets than today. The other half can be achieved by more efficient and productive use of China's finite pool of human resources and capital: what economists refer to as total factor productivity, or TFP. Such growth through efficiency depends on new rules and institutions that let markets work to steer resources – people, money, and materials – to where they can generate the highest growth. Without this marketization – which depends on both the re-regulation described in this study and a new mind-set about the roles of the Party and the government – leaders could keep directing large investments to favored projects, but with diminishing effect, and the potential gains from productivity would all but evaporate. Growth driven only by investment would mean a hard landing in 2020: no better than 3% annual GDP growth. Falling productivity could easily pull private investment down with it, leaving GDP growth even lower at 1%, surely a crisis.

We use these three scenarios for growth potential in 2020, in combination with the analysis of nine clusters of regulatory reform, to explore the global implications of China's economic overhaul in terms of trade and financial flows. Building on that, we end with recommendations for foreign interests in light of the outlook for China.

WHY CHINA'S GROWTH MODEL IS NOT WORKING ANYMORE

Many of the drivers that contributed to China's rapid post-1978 growth are weakening, while new sources of growth require reforms yet to be delivered. Demographic dividends propelled China through the 1980s, 1990s, and 2000s, but the labor force is now at its largest and is poised to shrink. Over the past decade, capital formation powered investment-led growth, but finding productive uses for ever greater amounts of debt financing is increasingly difficult for financial incumbents. Existing investments are showing diminishing returns in many overcapacity sectors from steel to coal to property. New industries are hungry for investment, but they are less capital intensive than their predecessors and need an affirmative action program if they are to get the attention of state-owned banks. Total factor productivity gains are fading as the dividends from the last robust round of reforms from World Trade Organization (WTO) implementation dry up.

But China has not exhausted its growth potential. On the contrary, decades more high-quality growth are possible. Massive opportunities exist to upgrade manufacturing to make higher quality products with greater intangible value. Modernization of the agricultural sector holds tremendous potential to benefit the nation and the 100 million citizens likely to remain in farming rather than migrate to new cities. Service industries ranging from advertising to health care to engineering are ripe with potential. And hundreds of millions of middle-class Chinese are eager for investments in environmental clean-up. These growth opportunities depend on regulatory reforms that have been slow in coming but could be enacted more quickly than most people assume.

China has not exhausted its growth potential. On the contrary, decades more high-quality growth are possible – provided that reforms are made.

The external dimension of China's growth also requires an overhaul. Trade plays a critical role in the economy: China has tremendous comparative advantages to meet global demand and a vast internal appetite for imports of goods and services. Financial globalization has only just begun for China, with cross-border investment flows a tiny fraction of what they would be if Chinese and global savers could move money freely across China's borders. Foreign direct investment (FDI) in China holds future potential, if parochialism can be avoided. Outbound direct investment is essential if China's firms are to retain global market share and upgrade capabilities at home. And under any scenario, China will continue to be dependent on globally sourced natural resources even as the foreign policy environment becomes cloudy with geostrategic misgivings.

THE THIRD PLENUM ROADMAP

Analysts inside and outside China were skeptical that President Xi and his governing colleagues would move boldly on economic reform at the November 2013 Third Plenum of the Party Central Committee, the occasion at which new economic thinking is traditionally unveiled. They presumed that Xi, like his predecessors, harbored mixed feelings about reform and would shrink from the potential backlash against an attempted overhaul. They were mistaken: the Party issued a bold call for economic reform and attendant regulatory re-wiring that exceeded expectations. The core document, *Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening Reform*, or simply the *Decisions*, was accompanied by personal *Explanatory Notes* under President Xi's name alone. With this, the president was asserting his power and intention to drive economic change, rather than settle for a speed limit imposed by consensus. Xi's program set a hard date of 2020 for completing a broad slate of reforms.

At the highest level, the *Decisions* is a manifesto on modernizing governance. Typical Third Plenums stick to economic work, not political affairs. Yet like its 1978 predecessor, the November 2013 Plenum called for changes in all cones: political and security, as well as economic. The Third Plenum points to the need to fix the balance of power between levels of government (central and local), between state and Party, and between government and governed. The absence of political adaptation doomed economic reforms to failure over the past decade and is thus why the current program is more promising. A revised *mission statement* for government is the first important element of the *Decisions*, instructing that economic work be focused on eight tasks:

- Maintain macroeconomic stability
- Strengthen and improve public services
- Safeguard fair competition
- Strengthen oversight of the market
- Maintain market order
- Promote sustainable development
- Promote common prosperity
- Intervene in situations where market failure occurs

These objectives are echoed through the *Decisions*, as well as corresponding instructions to withdraw government from other activities that do not serve these purposes, such as running businesses in competitive industries, requiring unnecessary approvals, and preventing normal restructuring of markets. In short, the Third Plenum set out to make China more of a regulatory state, with regulators and regulatory institutions powerful enough – and well defined enough – to discipline the moneyed special interests that are a natural and even desirable result of economic modernization. China's new mission statement is generally consistent with advanced-economy concepts.

The *Decisions* presents well over 300 instructions in 16 idiosyncratic groupings that are hard to decode. We reorganize these instructions according to their principal purpose, and we find that in essence nine clusters of regulatory focus are at the heart of the program.

Center-Local Fiscal Reform

Center-local relations are at the core of China's fiscal affairs, tax policy debates, resource allocation concerns, and many other developmental matters and are, in fact, the true bellwether of China's direction. An imbalanced division of power and responsibility between central and local authorities has given rise to pressing misallocations of resources and provincial resistance to central reforms. The *Decisions* pledged to address this, but in general terms, not specifics, leaving readers uncertain following the Third Plenum. But in a pattern we identify in most other regulatory areas as well, evidence of follow-through was apparent in 2014, confirming that the *Decisions* was a starting point, not an empty text. Most importantly, in June 2014 Party leaders approved a top-level national plan for deepening fiscal and tax reforms; specifying reform priorities and tasks; and, to the surprise of some, setting an interim deadline of 2016 for "basically" finishing major tasks. Finance Minister Lou Jiwei elaborated on implementation plans at his Ministry, emphasizing measures to reform budget management, improve the taxation system, and rationalize the center-local fiscal system to align responsibilities with resources. Center-local reform was one of the first areas of work cleared for action by the Party leadership because it is foundational to many other areas of reform.

Competition Policy Reform

Robust competition policy enforcement is a hallmark of advanced market economies, which works to ensure that *competition* is maximized rather than the gains of certain privileged *competitors*. With China's *Decisions* pledging to withdraw government from much of its traditional intervention, it is natural that competition regimes will be strengthened as well. At each level of China's economy, special interests opposed to competition are common, and the Third Plenum calls to change that. But regulators have been told to act before the government has solidified institutions responsible for protecting due process and evenhandedness, leading to a difficult start in this area. In practice, competition authorities have used new tools in a manner that strikes many in China and abroad as discriminatory, especially to foreign firms. This could be the best of times or the worst of times for creating a pro-competitive environment: Beijing needs to demonstrate whether it is committed to extending due process to all market players.

Financial System Reform

Control over the financial system helped China manage growth for decades, but at the cost of slow progress toward domestic efficiency, and consumers are paying the bill today. Key financial variables remain government determined, including deposit rates, access to banks and lending, exchange rates, equity and debt issuance, cross-border portfolio capital flows, and countless decisions about insolvent assets. Officials speak at length about the importance of systemic reform, and much was already happening prior to the Third Plenum. The *Decisions* rounds up most of the work remaining: authorizing private small and medium banks, restarting the market for new equity listings, completing exchange rate and interest rate marketization, and much else. In terms of implementation, the exchange rate band has been widened, IPOs have restarted (but in an on and off manner), and shadow banking has been squeezed while new online banking businesses have been permitted. A plan for insurance sector rationalization with interim timetables has been issued. The governor of China's central bank, the People's Bank of China (PBOC), has expressed hopes of completing deposit rate liberalization by 2016; the Ministry of Commerce has withdrawn almost entirely from policing outbound direct investment flows; and by the end of 2014, regulators intend to implement a deposit insurance scheme. There has been pushback against many of these goals, and the PBOC softened somewhat its rhetoric about monetary discipline in light of pressure to provide some stimulus. Overall, few people doubt that financial system reforms are proceeding, but many worry that action might be too slow to stave off mounting liabilities.

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Foreign Trade and Investment Reform

China is deeply connected to the world economy through goods trade; inward direct investment; and, increasingly, services trade, outward direct investment, and two-way portfolio investment flows (investments in stocks, bonds, and other securities). Early in the development process, China stood out for its embrace of foreign trade and investment, but as it has risen to middle-income status as the second-largest economy in the world, the goal posts have necessarily moved. Foreign partners expect more reciprocity today because China is a peer, and the *Decisions* sets out the goal of further trade and investment reform because it is in China's economic self-interest to do so. There are pledges to enforce the same laws and regulations on domestic and foreign investment, and to put market forces at the center of the economy except in exceptional cases. Rules are to be fair, open, transparent, and conducive to providing a level playing field for all firms. Progress so far has been mixed. The Company Law and its onerous registered capital requirements have been fixed, and reform to the three foreign invested firm laws is on the horizon. The Shanghai Free Trade Zone and other next-generation pilot free-trade zones have been rolled out, but poorly and with much disappointment. Opening for some cross-border investment flows has been completed. However, progress toward local negative lists that explain which industries are to be withheld from decisive marketization has been scant, and a national negative list is not yet in sight. More generally, dark clouds have thickened over the foreign invested business community, where even long-time China boosters believe that the pain of inevitable adjustment and re-regulation is being directed to non-Chinese business disproportionately and discriminatorily. So while there is forward progress, it is watered down with misgivings.

State-owned Enterprise Reform

State-owned enterprises (SOEs) and state shareholding are a smaller part of China's economy today than in the past, but these sectors still dominate the marketplace in many ways. State-owned firms permit Beijing to steer growth in terms of projects, industrial policy, and aggregate demand, and they generate needed revenues for the Party and the government. Observers outside China perceive little interest in drawing down the role of these SOEs, and prior to the Third Plenum, Chinese reformers feared that SOEs would scarcely be addressed. In the end, the *Decisions* called for meaningful SOE reform, though it is mixed with counter-indications that require clarification. The goals include dilution of state shareholding through the introduction of private shareholders; extracting more profit from SOEs to finance public expenditures; specifying which industries legitimately require state control; and making clear that when the state remains a non-controlling shareholder in a competitive industry, normal market competition should apply.

Readers of the *Decisions* were skeptical that these changes would be implemented – or *could* be implemented, given the power of these firms. Reviewing efforts to date, we note that Xi's team has successfully gone after recalcitrant management at many of the most powerful SOEs, raised SOE dividend payouts to the government, cut executive compensation, and sent auditors to smoke out corruption and special interest dealings. By late August 2014, the State

Asset Supervision and Administration Commission (SASAC) in Beijing was broadening implementation of governance reforms at central SOEs, and more than 20 provinces had published SOE reform plans that involved listing or selling off assets in up to 70% of provincial SOEs by 2017. While the end point of this process is not clear – at minimum Beijing surely intends to retain significant stakes in certain firms – change is underway that exceeds expectations and demands careful tracking. The Third Plenum deliverable we consider first in importance, a national negative list explaining where government control will endure, has not been produced; until it is, observers must reserve judgment in spite of other positive movements in this area.

Land Policy Rationalization

In advanced economies, the topic of land reform seldom rises to the attention of policy makers today. In China, it is as important a source of future growth potential as any other factor. Without land reform, it will be difficult for Beijing to realize its goal of bolstering the urban labor pool with as many as 300 million permanent new workers, 200 million of whom are already in towns and cities but are reluctant to relinquish their ties to rural land and commit to urban futures. In recent years, poorly governed local expropriation of land to finance budgets has fostered an unsustainable fiscal system, while displaced tenants are a source of constant social protest. While most foreign observers think little about these links, the *Decisions* addresses them at length. It pledges to discipline local government's stranglehold on villagers' ability to lease out and otherwise employ their land, not just keep small farmers at the till – although those wishing to do so will have their rights protected – but to offer them fair prices, creating an incentive to transfer their rights to more efficient farm operators and seize the opportunity to move to towns and cities. Land policy advocates, long accustomed to sluggish reform in this area, are not holding their breath for implementation. However, a comprehensive land registration system announced in August 2014 is encouraging, with interim deadlines for 2014, 2015, and 2016 along the way to a complete national database by 2017. This system would help improve the foundation for property rights and due process and get incentives to urbanize back on track. Ultimately, fast overall marketization that drives the growth of household income and hence farmers' wages for their products is the most important support for rural development, and there are limits to what land policies per se can accomplish.

Labor and Shared Welfare

China's demographics were positive for GDP growth through the Communist era: from 1982 to 2013 China's working-age population (15 to 64 years old) increased by 375 million people, to just over 1 billion – a *marginal* increase equivalent to two and a half times the entire U.S. labor force. Today, this demographic dividend has run its course, and China's labor force size is on the brink of long-term shrinkage. At the same time, 35 years of steady income gains and absorption of surplus rural workers into cities have brought China to a turning point with profound implications for competitiveness and social stability.

The *Decisions* addresses labor and shared welfare in many respects: education, health care, worker rights, minimum wage, and income inequality. Encouragingly, efforts focused on improving the dynamism of markets and private job creation are being emphasized, and the connection to the importance of safety nets including unemployment insurance is drawn. Reforms to the *hukou* system, which ties all Chinese citizens to their home addresses for access to public services and benefits, and has constrained internal migration by workers since the 1950s, will be implemented, and the One Child Policy will end for one-third of the population. Beijing also pledges to establish something so basic that it is remarkable that it still needs doing: real public statistics on unemployment rates to guide macroeconomic policy making.

We identify new steps on education and vocational training, insurance, and health care, but action to date remains meager compared to what is needed. Evidence of a real entrepreneurial takeoff is apparent – the number of new business starts, overwhelmingly private, more than doubled in the first half of 2014 to more than 2 million – but labor and shared welfare policies need to be ramped up just as steeply.

Environmental Policy Reform

After 1978, Beijing's permissive stance toward environmental pollution made it financially easier to build an industrial economy, attract firms that faced mounting environmental compliance costs overseas, and generate outsized profits for firms because of China's low operating costs. The negative impacts of that stance are now eating into GDP, let alone broader measures of economic well-being that reflect quality of life. The imperative to reform China's environmental management is stated in the first sentence of the first decision in the Third Plenum manifesto. Promoting sustainable development is one of the eight missions of government, and this necessity is cited to justify SOE reform, tax reform, judiciary reform, and numerous other overhauls. A full tenth of the Third Plenum program is dedicated to environmental concerns. The program promises to put environmental criteria ahead of GDP growth in scoring local officials for promotion and to make polluter emissions transparent to the public through reporting, a tried and true method used in advanced economies.

The Third Plenum manifesto includes promoting sustainable development among the eight missions of government and uses that mission to justify numerous reforms.

Though Chinese conditions are likely to get worse before they get better because of the lag between policy changes and environmental gains, we identify some important implementation moves. Populist steps to tear down polluting plants have been publicized, the environmental protection law was amended to allow non-government organizations to bring public interest lawsuits, and tens of thousands of industrial firms are seeing their emissions disclosed to the public on smartphone apps. On the energy front – the biggest source of emissions – meaningful steps to manage coal production more systematically are underway, again focused on public information registries. China's environmental problems are probably the worst the world has seen, and it is easy to be pessimistic about the prospects for change.

However, the advanced-economy world offers many promising examples of livable, appealing places where conditions were noxious not long ago.

Innovation Policy Reform

Land, labor, and capital are finite. Innovative capacity is infinite and constitutes the real difference between high-potential and low-potential economies. China has a storied history of innovation over the millennia, and Chinese people make great contributions worldwide. Yet modern China has emulated more than invented, and recent decades have been fraught with tensions between China and foreign governments over lax intellectual property rights (IPR) protection. As with environmental protection, loose IPR regulation may have added to China's GDP growth in earlier years but is likely subtracting from growth today. The *Decisions* emphasizes greater empowerment of market mechanisms to improve innovative capacity in China. It also stresses improvements to the culture of education and the importance of making publicly supported R&D results more widely available. The document goes further and notes that defense sector integration with civilian innovation is important, and that China's public sector must be attractive to global talent. As for implementation, greater legal support for innovators, including due process and regulatory attention to protecting IPR, is being pushed, though after years of assurances in this area more demonstrative results are needed. Steps to modernize the outmoded reliance on a single national college admissions test – the dreaded *gaokao* – have been rolled out for 2017 implementation, but habits of rote teaching will take time to alter. The chilling effect of recent pronouncements about national security is palpable, especially in the information technology sector and on the way people communicate online. China, like many nations, is clearly challenged in finding the right balance between security and innovative potential.

IS IMPLEMENTATION EVIDENT?

In each of these nine regulatory clusters, the commitments in the *Decisions* are important, and there are at least initial signs of follow-through. While we concentrate on implementation, we also consider counter-indications. All clusters show signs of resistance, ambiguities about intentions, and ongoing internal debates about the end point of regulatory reform. We recognize these patterns from previous periods of reform in China: rather than use political capital to *excise* long-standing verbiage from policy documents, leaders add new terms while reinterpreting old ones to suit their needs. For instance, China is hardly communist any longer, yet the Party retains that label rather than stir up ideological disputes by trying to change it. Therefore, we put more weight on what is new than what is old.

Movement has been relatively strong in center-local fiscal reform and financial system reform. Serious initial steps have been taken on SOE reform and environmental policy, although it remains to be seen whether Beijing will pursue these programs comprehensively. On competition policy, action has been dramatically stepped up but not evenhandedly. Foreign trade and investment reform have gotten some attention, and some elements have been liberalized (such as outbound FDI regulation), but there is a lack of clarity about directions given a host of conflicting signals about the attitude toward foreign businesses. Land, labor, and innovation policies are more difficult to describe as having broken with business as usual, although each case shows at least some indication of new directions.

President Xi is setting timetables for change, so we will not have to wait indefinitely to see what the *Decisions* means and whether optimism is justified. In important cases, Beijing has moved ahead and established near-term interim deadlines to get on track to 2020, such as a 2016 deadline for center-local fiscal reform, a 2015 start to permitting NGOs to file public interest environment lawsuits, and an immediate increase in central SOE dividend payment rates.

China's economic reforms will be real if they have desired effects on economic flows. We therefore explore observable metrics that should reflect reform implementation for each regulatory cluster. For instance, center-local fiscal reform will show up as an increase in central transfers to local governments as a share of centrally mandated local expenditures. Competition policy modernization should result in a transparent reduction in the number of industries exempted from normal market disciplines, including state-related enterprises. Interest rate liberalization will be reflected in convergence between formal bank lending rates and informal curb market rates for borrowers.

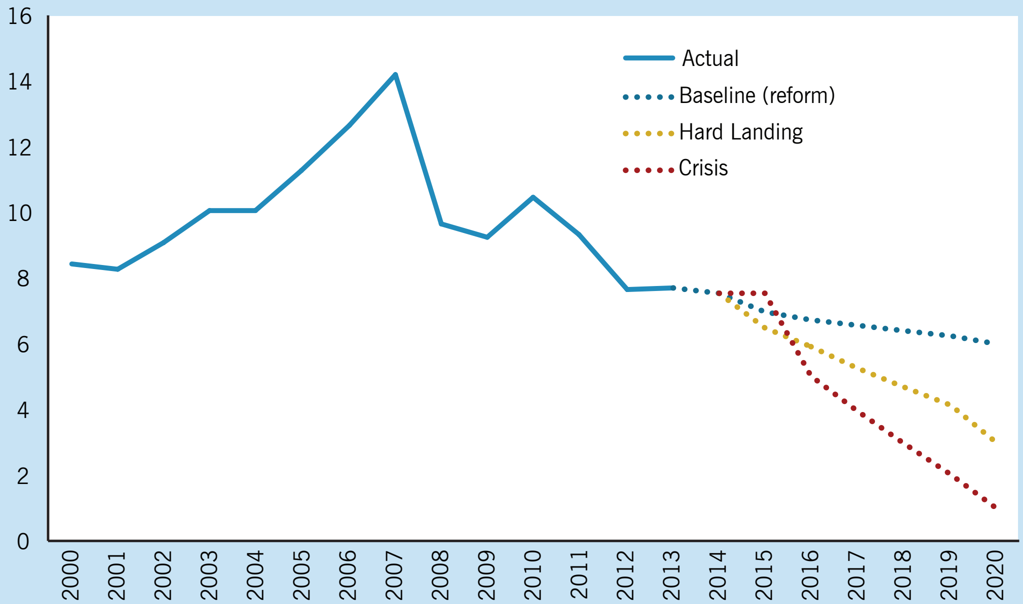
IMPACTS AT HOME AND ABROAD

Building on our assessment of the scope, pace, and prospects for economic overhaul in China, we explore the impacts both domestically and internationally. China has made many policy breakthroughs over the past 35 years, and these have been felt abroad in various ways. But when China set out to reform and open up in 1978, only 2% of world GDP was at stake; today, China accounts for a hefty 15.4% of global GDP. China's marginal contribution to global growth was near zero in 1978 and was inaccessible to other countries. By 1989, China's share in global growth was 4%, and by the Asian Financial Crisis in 1997, it was 11%. For the past three years, this share has averaged 28%. China is more interdependent with world markets than nations going through a middle-income policy shock have been in the past. China's announced timetable to make the proposed changes is short. All this means China's current reforms will shock the world economy.

To explore China's long-term potential growth in light of the promised regulatory adaptations, we use a growth accounting framework that combines assumptions about inputs and efficiency gains. This is a stocktaking of labor, capital, and total factor productivity, or additional gains in GDP that come from technological change or a better policy environment. We conclude that in the best-case scenario – a soft landing through 2020 – reforms permit the redeployment of capital from wasteful uses to high-return sectors, so capital stock growth and TFP improvements deliver a combined GDP growth rate of 6%. That is something to be proud of, though lower than past and current rates. If reforms stall, the productivity gains from adjustment will be lost, and increasingly private capital may or may not continue to invest, leaving China with at most 3% growth in a hard landing scenario or 1% at best in a crisis. Figure 1 illustrates these three conjectures.

Figure 1: China's GDP Outlook with and without Reform

GDP growth (% change year-on-year)



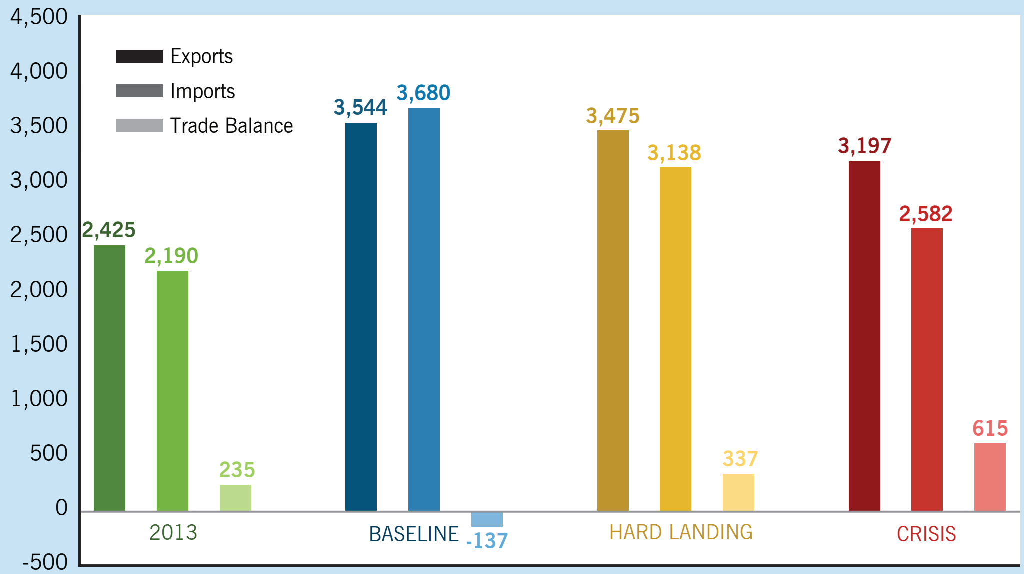
Sources: Chinese National Bureau of Statistics, Rhodium Group estimates. Projections begin after 2013.

Those differential growth rates add up, and the stakes are high. China's 2020 economy will be more than $2 trillion larger with reform than without – a difference the size of the *entire* Russian economy today.

We combine these scenarios – baseline (reform), hard landing, and crisis – with the picture of regulatory reform to help us think about China's trade and financial interaction with the world in 2020. These projections are rough approximations of potential outcomes, but are valuable for exploring how today's reforms impact tomorrow's growth in China and abroad. Substantial implementation of regulatory reform is our baseline scenario: reform is difficult, but not as difficult as dealing with growth collapsing to 1–3% levels. Under reform, China adjusts to a roughly balanced current account position by 2020, from the 2% of GDP surplus it runs today. This results from a trade *deficit* of $137 billion (in 2013 dollars) and a net investment income *surplus* of $145 billion because of a better external asset portfolio: both of these are reversals of current conditions. Imports rise faster than exports, helping alleviate trade policy pressures, and China earns higher returns on external assets as a result of more *direct* investment by firms rather than low-interest government debt bought with foreign reserves. By the end of the period, China's official foreign exchange reserves will be decreasing modestly, which is consistent with Beijing's stated intentions.

The hard landing and crisis scenarios illustrate the erosion of benefits that foreign economies and firms would encounter if reform derails. Figure 2 summarizes the trade

Figure 2: China's Trade Profile in 2020 under Baseline, Hard Landing, and Crisis Scenarios
Constant 2013 $US (billions)



Sources: People's Bank of China, State Administration of Foreign Exchange, Rhodium Group estimates.

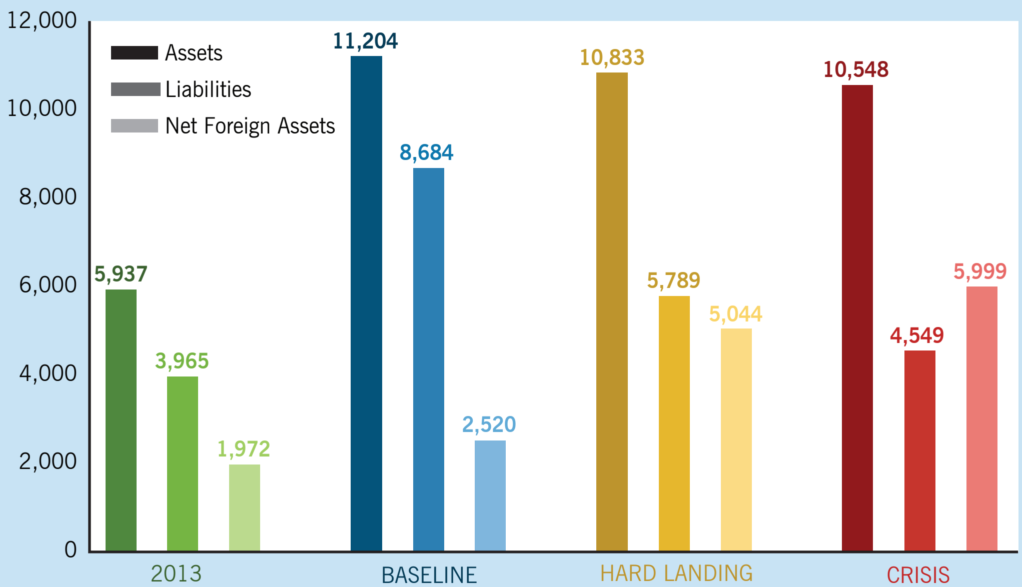
scenarios compared with the 2013 starting point. Imports and exports fall in both downside scenarios; the growth of China's imports of foreign goods and services is hit particularly hard. Instead of the good news trade *deficit* under reform, in the crisis scenario China reverts to big trade *surpluses* that reach more than 5% of GDP, a level last seen in 2005–2008.

On the financial side, still greater adjustment lies ahead because cross-border financial flows have been more heavily restricted to date. Under a reform scenario, China continues to attract a growing level of FDI, while outbound FDI continues to boom, roughly doubling by 2020 to an annual level of $160 billion. (These are conservative estimates.) Investments in securities (portfolio investment) in both directions increase dramatically as a result of financial account and capital market liberalization, so that by 2020 more than $1.1 trillion in *annual* two-way flows takes place. Under these assumptions, roughly $3.5 trillion in capital flows from China into foreign stocks, bonds, and other assets, while $2.4 trillion in foreign savings pours into improving Chinese capital markets over the next seven years. That $3.5 trillion of outbound investment is almost 20% of the entire U.S. stock market capitalization today, or roughly the entire value of the NYSE Europe's stock market capitalization. This presents a tremendous opportunity for financial intermediaries, and for savers both inside and outside China to diversify their portfolios to healthy effect.

The outlook for China's financial interaction with the world is even more sharply affected

Figure 3: China's Global Assets and Liabilities in 2020 under Baseline, Hard Landing, and Crisis Scenarios

Constant 2013 $US (billions)



Sources: People's Bank of China, State Administration of Foreign Exchange, Rhodium Group estimates.

by a failure to stay the reform course. Figure 3 illustrates the differences. In a hard landing, China's 2020 external assets grow to $10.8 trillion instead of $11.2 trillion, and liabilities hit just $5.8 trillion instead of $8.6 trillion. These changes result from lower GDP, a slowdown in inbound FDI as foreign investors are scared away and market opening is delayed, substantially lower two-way portfolio flows, and renewed capital controls and other measures to soak up foreign reserves because of the current account surpluses. In the crisis scenario, asset growth is smaller still. In addition to a lower GDP, a crisis triggers restrictions impeding flows in all categories, but especially short-term portfolio investment, and leads to substantial capital flight through grey channels. Typically in such crises, this would deplete foreign reserves, but we assume that outflows are not large enough to offset the ballooning trade surplus as a result of crashing demand at home and a drop in commodity prices globally; thus, we see reserves increase further to $5.9 trillion by 2020.

CONCLUSIONS

We finish our exploration of China's reforms with reactions to two questions. First, what broad conclusions can be drawn from the matrix of facts and inferences we amass? Second, what recommendations can be offered to foreign readers contemplating what these conclusions mean for them and their economies? China's awakening over the past 35 years has already affected global workers, consumers, investors, and the environment in profound ways, and the shock that current reforms portend will greatly amplify this connection. It is incumbent upon business and policy leaders abroad to understand the economic overhaul underway in China.

We draw five conclusions.

1. A Game-Changing Reform Program

The program of economic reform President Xi and the Communist Party leadership issued in November 2013 is game changing – far more than a minor adjustment of business as usual or an attempt to stall for time. Foreign reaction to these developments so far has been fragmented, fractious, and divisive, with a good deal of the China-watching community still maintaining a wait-and-see attitude. This is not hard to understand: past reform commitments have often not come to fruition or have been implemented in a manner less consistent with advanced market economy norms than hoped. Ambiguous terms or counter-indications to market-oriented reform remain in the new *Decisions* on comprehensive reform. However, based on our analysis of the drivers behind China's new approach, new imperatives laid out in the program, and initial indications of implementation following the Third Plenum announcement, we conclude that a decisive break in policy formation and the Chinese economic model is underway.

This new policy trajectory will have profound implications for the international economic system, and foreign officials and business leaders will need to adjust their expectations and responses accordingly. A firmer consensus in understanding these developments will be helpful, and it is hoped that this study contributes to the formation of such a consensus.

2. A Convergent Economic Picture – with Idiosyncrasies

Clearly, Beijing does not believe that different principles of market economics apply in China, any more than gravity applies differently in the Middle Kingdom. The governmental mission and regulatory priorities being pursued in China today are largely consistent with the prescriptions set out by the advanced-economy establishment. There is no Beijing consensus or other alternative economic theory at work here.

But this characterization must be qualified. Wide policy differences on market-oriented precepts exist *among* advanced economies, and China may be all the more idiosyncratic given its extreme population size, social and developmental challenges, low per capita income level, and political challenges. China's reforms will make it both convergent with advanced economies and unique, and that contradiction will be discomforting, considering that China will likely be the largest economy in the world in a decade or so. If China hews to the more interventionist end of the advanced-economy policy spectrum, difficult questions will arise for other economies.

3. Plenty of Exceptions and Counter-indications

A related point is that with such a broad reform agenda, and so many conflicting pressures to be managed, China may require time to work through adjustments at different speeds in different areas, even without attempting to argue that certain exceptions to the overall reform effort are market friendly in the long term. Most nations reserve some sectors from the normal logic of regulation because of internal politics, despite their general principles to the contrary and the welfare losses entailed with taking such exceptions. The United States diverts from free trade when it comes to Mexican sugar because of politics, not economics. China will have its own sacred cows; we can only hope that the herd will be small. The most promising early sign of reform would be the release of a negative list explaining which industries are meant to be protected from competition; this would help show that Beijing is serious about ensuring that the market becomes the dominant, overriding factor governing economic activity.

4. A Notably Fast Start, and a Move to Transparency

The pace of reform and structural adjustment in China today is far faster than was expected a year ago, or than most people believe today. However, the evidence for this – less than one year after the kickoff – is necessarily partial, anecdotal, and contestable. The target of 2020 for completion is ambitious, and shorter timetables of one-to-two years in the cases of foundational elements such as interest rate liberalization and center-local fiscal reform are bold. Reform includes opening to the outside – in terms of foreign trade and investment – not just opening on the inside, and in some cases external liberalization is quickening compared to recent years. However, if the pace of internal adjustment is substantially faster than external opening over a prolonged period of time, then severe international economic tensions are likely to ensue. Foreign investors, for instance, have $2.35 trillion in operations running in China, much of it in the form of joint ventures they might like to restructure and buy out, just as Beijing and the provinces are proposing to permit changes to SOE ownership structures. It is important that they be allowed to do so and not be asked to sit by and wait for the second round. Similarly, reform means the advent of stepped-up competition policy enforcement, but the due process and evenhanded treatment promised to private Chinese firms in the *Decisions* are owed to foreign investors as well. Other than designated special cases, there should be no reason why "private" should not include "foreign private" firms today, as reflected in the national treatment principle Beijing embraced for policy going forward.

The most promising early sign of reform would be the release of a negative list explaining which industries are meant to be protected from competition.

5. A Real Prospect for Political Adjustment?

Many analysts assume that China's economic overhaul is simply designed to sustain the Communist Party's authority. If the Party is to endure, then indeed achieving potential economic growth is necessary – China's leaders state this unambiguously. But Xi's economic program entails significant devolution of regulatory authority to lower officials with pro-competitive missions. We see four drivers of political evolution in this. First, as the ongoing anti-corruption campaign makes plain, abuse of political power to use state assets and state regulatory authorities for private gains was endemic in the old model of vested interest economics. Xi has disrupted that on a scale great enough to change politics. Second, reform will require a different – though not necessarily Western – approach to separation of powers and checks and balances: these are in the policy mix, and they too change the political equation. Third, public information disclosure registries are proliferating for government fees, administrative powers, real estate property, financial securities, land title and use rights, environmental impacts and pollution emissions, employment levels, and other domains. While the upper echelons of the Party have no interest in using sunshine as a disinfectant, the political implications of this transparency campaign will be hard to reverse, as the public availability of air pollution data has proven. Finally, reform is bolstering GDP growth and thus building the ranks of the middle class. While the small pool of bourgeois Chinese in the past was apt to be conservative and apolitical, the relationship between per capita wealth and political expectations is strong, even in China. So, ironically, accelerating growth also speeds expectations of individual protection from arbitrary political behavior.

But finally, despite signs of economic liberalism driven by necessity, the Party clearly does not intend for China's political system to converge with Western norms. President Xi has demonstrably tightened the reins on civil society, embraced opportunities to show China's teeth abroad, and doused expectations that due process would play a significant part in his administration. These moves might be seen as necessary to suppress resistance to economic reform during this critical early period, but there are no guarantees that the Party will reverse course and reestablish a modicum of civil liberties once adjustment has passed. One is hard pressed to find historical examples of single-party, uncontestable political systems that were able to build market-oriented economic systems. It is reasonable to worry that implementation of the Third Plenum economic reforms could fall short or diverge from expectations, including Beijing's own expectations.

POLICY RECOMMENDATIONS FOR FOREIGN CONSIDERATION

We have taken care to avoid normative prescriptions in this assessment, preferring to stick with describing – as objectively as possible – the economic challenges arising from 35 years of rapid growth, the program of reform to government's mission and specific regulatory clusters, and the indications that China is moving ahead on that program. Uncertainty about the Third Plenum program, and different interpretations of Xi's muscular leadership to date, led to a wait-and-see attitude. In year 1 of Xi's economic program, a strong down payment of new economic thinking was made. Our conclusion, stated earlier, is that China's reforms are game changing, market oriented, destined to be fraught with compromises temporary or enduring, and connected to geopolitical strategy beyond the economic realm. In light of these considerations, we offer five recommendations for foreign observers.

1. Gauge Incremental Progress

Discordant views on the pace and direction of reform in China and confusion about the implications if reform does play out as fully as we expect undermine policy formation and implementation abroad and distract from the urgency of a response. This is true within firms and governments. An effort to assess reform may leave decision makers unconvinced or in disagreement, but it still holds value even if certainty remains elusive. A promising strategy for overcoming this hesitancy is to define and track economic metrics that respond to reform. President Xi's *Decisions* and subsequent implementation orders have called for a wealth of new economic data to be collected and made public in a timely manner, supplementing a rich foundation of real and financial economy indicators that are already observable. Foreign officials should encourage and applaud this trend, for it facilitates a shared understanding of China's economic directions. With solid enough consensus around metrics indicating Chinese reform – for instance, on the number of industries listed for exceptional treatment by Beijing – it becomes much easier to build a positive bilateral or multilateral economic agenda with China based not on where conditions stand today but on mutual expectations about where China will be in three or five or seven years.

2. Demonstrate Support for Reform

Acknowledging the existential stakes of reform for China supports the reform process by strengthening confidence that goals are shared. Governments and firms in advanced economies have wrestled with many of the adjustment challenges China is encountering, including rising operating costs, calls for protectionism, opposition to environmental policy enforcement and other aspects of regulatory reform, and myriad other obstacles in the political economy. Many bilateral and multilateral programs of capacity building are in place, but some have lost momentum because China's reform had stalled over the past decade; these should be reinvigorated, or in some cases replaced. There is no shortage of disagreement among advanced economies about the details of reform: more liberal and statist OECD nations have bickered about proper economic policy since the organization's founding 53 years ago. Supporting reform in China will require patience and self-confidence. In China, as in the United States and Europe, some oppose marketization out of fear or insecurity or have legitimate concerns about the limits of materialism as the measure of social welfare. These voices should not all be lumped together as anti-reform: it is a challenge of our era to encourage traditional marketization at the same time our advanced conception of the goals of public policy is evolving.

If China's reform program is to be taken seriously, and it should be, then advanced and emerging nations alike need to strive to remain competitive.

3. Focus on a Domestic Response

Given China's mixed political and international security signals, there will be a powerful temptation to view China's reform-driven economic strength as a threat, and to respond by focusing on external power and influence. Foreign policy must certainly evolve in light of China's domestic reforms, but if China's reform program is to be taken seriously, and it should be, then advanced and emerging nations alike need to strive to remain competitive. After adjustment, a more competitive China will emerge. Reforms will include policy changes that respond to long-standing requests from China's business and trading partners: financial account liberalization, two-way investment opening, a more level playing field for internal competition, and the withdrawal of government from much intervention in the economy. Nations have often defined their past China policies in terms of what China needs to do differently, or what they will do at their borders to manage integration with China. Looking ahead, the policies of other nations toward China must include better enabling environments to keep pace with China's productivity gains. This will require top-led national conversations about competing effectively in a global environment.

4. Include a Multilateral Element

While competitiveness begins at home, it often ends abroad in today's global economy. In many areas, including international direct investment and competition policy, no robust international organizations and norms guide behavior, and the need to build new regimes is likely to be enhanced by expanding Chinese weight in the system. Economies, especially incumbent leaders, should prepare to help facilitate such undertakings. And as they do so, they should welcome Chinese participation without either excluding Beijing or conceding to Chinese views and seek to maintain confidence in the market-economy principles that have worked in the past.

5. Stop Negotiating for What Beijing Is Already Doing

A typical bilateral or plurilateral negotiation with China has become a set piece in recent years, with China's partners asking for market access, intellectual property rights protection, and a litany of other policy reforms. The broad slate of domestic reforms in the *Decisions* tells us Beijing knows these reforms are *in its own national interest* and must be achieved regardless of foreign pleading. It makes sense from China's perspective to negotiate concessions from abroad for reforms that must be taken in any case. Those concessions may in turn be good for China's partners as well, such as reductions in their barriers to Chinese trade and investment; also, the logic of an international negotiation may be mutually valuable for reformers on both sides to make the case for reform to their less change-friendly compatriots. However, it is important to recognize that China is pursuing market-oriented economic reforms for the simple, self-interested reason that it is the smart thing to do.

ABOUT THE AUTHOR

DANIEL H. ROSEN is the Fall 2014 Jack Wadsworth Fellow at the Asia Society Policy Institute and cofounder and China Practice Leader at Rhodium Group. Mr. Rosen is affiliated with a number of American think tanks focused on international economics and serves as an Adjunct Associate Professor at Columbia University's School of International and Public Affairs. From 2000 to 2001, he was Senior Advisor for International Economic Policy to the White House National Economic Council and National Security Council, where he played a key role in completing China's accession to the World Trade Organization. Focused professionally on China's economic development and its global implications since 1992, he has authored or coauthored nine major books and reports and an extensive set of shorter publications well known to policy and business professionals as well as academics. Mr. Rosen is a Member of the Council on Foreign Relations and serves on the Board of the National Committee on U.S.-China Relations.

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In mid-2013, during the rollout of a study on Chinese direct investment in the United States that he had helped bring about, Jack Wadsworth challenged me to draft an assessment of the most critical China questions confronting economic researchers today. Among many narrower topics, I pointed to the value of a broad assessment of the chances that China's new leaders would recognize the inevitability of near-term decline if they did not change economic models rapidly. Jack immediately got behind this most difficult, unwieldy undertaking. Not only did Jack prompt the study, he once again made it happen, and first acknowledgments go to him.

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