The Rise of China's Reformers?

With China's political transition now complete, the country -- and the world economy -- is left with a pressing question: Does the new team in Beijing have the vision and the political will to revive stalled yet crucial economic reforms? Few observers are optimistic about the answer.

A growing chorus of pessimists, in China and elsewhere, has coalesced around three central arguments. The first group, call them the "economic cynics," argues that the bar for reform is just too high. This is because several underlying economic problems, including a real estate bubble, have worsened at precisely the moment that China's economic growth has slowed. Chinese officials' traditional solution to economic slowdowns -- accelerating exports -- has become harder in light of declining demand in advanced industrial countries.

More from this author...What is more, these pessimists argue, even if China's new leaders want to undertake bold reforms, economic problems have become so dire that they will overwhelm the new team's ability to forge consensus around a fresh approach. According to China's National Audit Office, for example, provincial, county, prefectural, and municipal governments are some 11 trillion yuan ($1.8 trillion) in debt. This problem could lead to another round of exploding bad loans that would constrain the banking sector and forestall financial sector reforms.

The second group, call them the "social doomsayers," argues that bad policies and poor governance are fueling unprecedented social unrest -- with more than 100,000 protests taking place each year by some estimates. This group insists that since preserving political stability is Beijing's top priority, the government will avoid undertaking reforms that risk short-term economic dislocation and might further exacerbate social discontent.

According to this group, China's leaders are caught in a bind: if they reform too much, they risk opening the floodgates to more protests; but if they reform too little, they risk leaving intact the underlying causes of the unrest. Two oft-cited examples of the latter dilemma are environmental degradation and land seizures by local officials, which have been the major reasons that ever more Chinese have taken to the streets. But local governments are still focused on economic growth at all costs rather than cleaning up the environmental costs of this growth. Unless Beijing devolves independent fiscal authority to provincial and municipal governments -- a very tough reform, by any standard -- and changes the political incentives that reward growth above all other objectives, local officials will continue to seize and sell land to developers to raise revenue. So under either scenario, this group insists, political caution will constrain the new leadership's options for reform.

The final group, call them the "political doubters," questions the new leadership's resolve to overcome powerful vested interests that will resist reforms, especially among China's state-owned enterprises. These powerful corporate players, this argument goes, will obstruct the leadership's well-intentioned goal of boosting household incomes, defeating efforts to force state firms to pay more dividends that can be redistributed into social welfare programs.

None of these three camps is entirely wrong. Each describes a certain facet of the considerable challenges China's new leaders now confront. But their pessimism ignores a central lesson of China's recent history -- one that undoubtedly resonates with at least some members of the new policy team: reform is possible when the right mix of conditions comes together at the right time.

Indeed, China has had significant bursts of economic reform in the past, most notably in the late 1990s during the premiership of Zhu Rongji. That era proved that bold reform is achievable when three conditions are present: a crisis of political credibility at home, vulnerability to an economic or financial crisis abroad, and a leadership savvy enough to recognize the need for change.

Today, Beijing does face enormous obstacles, and the forces arrayed against reform are numerous and entrenched. But each of these three conditions is once again present in China, potentially boosting the prospects for real and enduring economic change.

A CRISIS OF CREDIBILITY

Consider the first condition: a crisis of domestic political legitimacy. In the early 1990s, Beijing faced one of its toughest tests of popular support as it attempted to recover from a series of political challenges to the Chinese Communist Party (CCP) during the tumultuous 1980s. At the time, Beijing was in the throes of both a political crisis and a revenue crisis as dwindling tax receipts remitted by provinces and cities to the central government hollowed out the central government's coffers.

Throughout the 1980s, dizzying changes moved the country away from major elements of centralized planning toward greater reliance on market forces, including price liberalization. These changes ushered in a wave of inflationary pressures and rampant social discontent, which culminated in the protests of 1989.

In the aftermath of the political tumult, reforms were briefly shelved before being revived in 1992 as Beijing sought to restore economic momentum and win back popular support. By the late 1990s, a capable premier, Zhu, had begun to restructure China's weak and unwieldy state sector and to reform the banking system, notwithstanding the destabilizing effects of laying off millions of Chinese government workers.

This period is instructive because today's Chinese leadership -- under pressure from rising expectations, social dislocation, and popular discontent -- again finds itself trying to bridge a credibility gap with the Chinese public. And the new team, not least the new president, Xi Jinping, has publicly recognized that the stakes are high. With worsening social and economic inequality, abysmal food safety, corruption, and rising middle-class expectations, Chinese governance is being tested in unprecedented ways. And since merely delivering growth is no longer sufficient to assure the government's mandate, the leadership has good reason to look to reforms as a means of addressing social cleavages and environmental degradation.

EXTERNAL ECONOMIC SHOCKS

A second important factor that drove China's reforms in the 1990s involved the aftereffects of the Asian financial crisis of 1997-–98, which exposed the inherent vulnerability of the Chinese economy to such shocks. Zhu and other Chinese leaders leveraged the moment of that crisis to move China toward its long-standing goal of membership in the World Trade Organization. They successfully pushed for a credible package of reforms that both prepared Chinese companies for global competition and opened the door to foreign capital inflows. Put simply, an external crisis enabled homegrown economic reformers to push forward serious economic and institutional changes.

That formative experience is especially pertinent today, as China continues to deal with ripples from the global economic crisis that began in 2008. Despite emerging from the crisis earlier and stronger than nearly any other major economy, China remains vulnerable in two ways: it can no longer rely on exports, and it lacks the flexible monetary and financial tools that could help it fight inflation and forestall the shock of another financial crisis.

Beijing has weathered the most recent storm largely because it injected huge sums of cash into the economy -- about $600 billion in stimulus and billions more in other bank lending, both of which helped to stave off a wholesale collapse in economic growth. But the effectiveness of these tools will diminish in the years ahead. The government cannot simply rely on stimulus after stimulus, and such a strategy would only further deepen imbalances in China's economy. In the five years since China achieved its peak GDP growth rate of 13 percent in 2007, its growth rate has dropped significantly and the leadership now targets a more balanced 7.5 percent.

TOUGH-MINDED LEADERSHIP

Many of China's reforms in the 1990s would not have been possible without a few hard-nosed leaders who not only correctly assessed the country's economic ailments but also had the political will to take strong actions. Zhu, for instance, was known to berate local officials for their mistakes and inefficiencies -- and his confrontational style was supported by a number of his colleagues in Beijing. It is already apparent that Xi and the new premier, Li Keqiang, differ from their immediate predecessors in both style and tone. But more than that, their programs and speeches suggest that, at minimum, they have accurately diagnosed the ills that currently beset the Chinese economy. And on paper at least, they have prescribed many of the right solutions. In March, Li invoked "reforms" nearly two dozen times during his first press conference as premier.

But translating rhetoric into credible actions will be more difficult. China's new leaders have risen to the top only to inherit a growth model that is running out of steam, undermined by a combination of aging populations and weak consumption in developed countries. At the same time, many Chinese companies, especially in the state sector, remain uncompetitive or could face serious financial difficulties if state subsidies, including for energy and land, are withdrawn.

It is important to consider, moreover, why the last group of Chinese leaders seemed to overlook structural maladies in the Chinese economy. Despite a recognition that, in former Chinese Premier Wen Jiabao's words, the economy was "unbalanced, uncoordinated, unstable, and unsustainable," previous leaders could rest easier in the knowledge that China could still mostly grow its way out of its immediate problems. In fact, growth was so stellar in the 2000s that the leadership cohort under former President Hu Jintao judged that it could probably afford to coast on the reform dividends of previous decades.

But although China's economy grew rapidly throughout the first decade of the twenty-first century -- largely on the basis of investment and soaring exports -- it did not grow much stronger in a fundamental sense. It remained relatively exposed to disruptions in global demand because domestic demand in China was too low, and it reflected new inequalities and imbalances. The costs of the capital-intensive and export-led growth model are now so obvious and startling that they can no longer be ignored or swept under the rug. For instance, recent estimates have put the environmental cost of China's growth at at least $230 billion, or about 3.5 percent of China's GDP in 2010.

So it is beyond doubt that Xi and Li understand, and even acknowledge, that reform is no longer a choice but a necessity. The scope, scale, and depth of those reforms, however, will ultimately depend on whether the new team shows some of the nerve and sense of timing that yielded the ambitious decisions of the 1990s.

DEVOLUTION, CHINESE STYLE

What are the signposts of real economic reform? Several indicators will be important to watch over the next year and a half. One major indicator will be the degree to which Beijing reduces the state's role in the economy by devolving fiscal and budgetary authority to local officials. Steps in this direction would include passing off the power to approve infrastructure projects to local governments, cutting unnecessary administrative red tape, and prohibiting ad hoc administrative fees levied by local governments.

Some form of decentralization will also likely take place on the fiscal side. Many provinces have seen their fiscal coffers wither in the years since 1994, when a major tax overhaul redirected revenues toward the central government in Beijing. Local governments now depend on transfers from the central government to pad their budgets. And when these transfers prove insufficient, as they usually do, they often turn to selling land to developers and relying on debt financing through shadowy lending channels to secure the revenue they need. Given that China lacks a well-developed municipal bond market or a strong independent local tax base, it is easy to see how a local fiscal system in disarray -- one that provides incentives to sell land for housing development -- has contributed to the country's overheating property market.

Another area ripe for reform is energy pricing. Throughout China's economic boom, Beijing has artificially suppressed energy prices because energy is a critical input in China's capital-intensive growth model. So with Beijing's persistent fear of spiraling inflation, the government has often intervened to ensure that the prices of electricity and coal, among other energy sources, remain stable. But the fact that energy is cheap means that Chinese industry has little incentive to improve efficiency. Instead, the country's companies have turned into energy guzzlers and decimators of the environment. Raising the price of energy to reflect its true cost would force Chinese businesses to improve efficiency and develop cleaner production methods.

A third area to watch is China's social welfare system, particularly health care and pensions. Beginning with reforms in 2009, China's broken health-care system has been gradually stitched back together and will likely enter a new stage under the new government. Similarly, the fragmented and woefully inadequate pensions system will also need to move beyond its current state as a large-scale unfunded mandate. Both reforms are necessary if Beijing is to deal with an aging society and to support consumption by drawing down precautionary savings.

BEIJING DREAMIN'

In isolation, each of these reforms would be modest. Yet their cumulative effect could be enormous. It is worth noting, however, that expectations for economic reforms should be tempered by the reality of China's present economy -- an $8.3 trillion behemoth that is more complex and mature than it was 15 years ago. In this sense, windfalls from today's reforms will likely be more limited in scope than when the country was starting from a lower base in the 1990s.

But that is what the new leadership confronts -- a wide-ranging set of reform alternatives that include, but are not limited to, the options noted here. The constraints on reform in China have never been intellectual -- there are plenty of good economists in the country pushing a wide array of creative ideas. The principal obstacles remain political. The lesson of the 1990s is that it takes the right mix of domestic and external challenges, combined with a healthy dose of bold leadership, to induce significant reforms.

But those conditions are again present today. And recent statements suggest that a longer-term reform agenda is likely in the works and could be unveiled during the CCP's third plenum this fall. (Capital market reforms, such as an expanded use of corporate and government bonds and a further relaxation of restrictions on foreign institutional investors, are thought to be probable.) If Chinese leaders do choose the third plenum as the place to announce new reforms, it will be because it is pregnant with political symbolism: it was at another third plenum, in 1978, that Deng Xiaoping, the architect of China's market reforms, won consensus around the vision that set China on its course to becoming the world's second-largest economy.

It would be impossible for any Chinese economic reform program to be completed expeditiously and without resistance. Reform, by definition, will rearrange the playing field for powerful political and economic interests. But if the new team is serious about revitalizing China's economy and realizing its much-touted "Chinese dream," then deeper economic reforms are necessary. Beijing would do well to heed the words of Li, its new premier: "It's useless screaming about reform until you're hoarse. Let's just do something about it."

This article was originally published by Foreign Affairs.

Evan A. Feigenbaum

NONRESIDENT SENIOR ASSOCIATE
ASIA PROGRAM