

CHINA'S ECONOMIC REFORM PLAN WILL PROBABLY FAIL



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A M E R I C A N E N T E R P R I S E I N S T I T U T E

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By Derek M. Scissors

Executive Summary

Reactions to the Chinese Communist Party's announcement of major economic reforms in November have ranged from unbridled optimism to skepticism about the party's ability to implement sweeping change. In fact, the reforms themselves are flawed in multiple ways—most are inauthentic, uncredible, or nonviable. However, the areas of land and finance offer more limited prospects for true reform. The primary means of judging reform progress should be progress in reducing excess capacity. The most likely outcome is that the party will claim success but the economy will slowly stagnate, harming China's partners.

The 18th Communist Party Congress's third plenary sessions were the first such meetings for the government led by Party General Secretary Xi Jinping. The Chinese economic playbook is familiar to most: historically, the third party plenum is a key to understanding the leader's plans and priorities.

The plenary sessions gather the leadership of the Communist Party for up to a week once or twice a year, between the meetings of the full Party Congress every five years. Over the past 35 years, the most important economic decisions have been made at the third plenary meetings of the contemporary Party Congress.¹

At the 1992 third plenum, Deng Xiaoping signaled a resumption of economic reform, taking his now-famous southern tour. By the time of the 1993 plenary meetings, the framework of a "socialist market economy" had been approved. The ensuing reform paved the way for what seemed impossible two years earlier: accession to the World Trade Organization.²

In contrast, Fall 2003 featured accelerated lending by state banks. Official documents for that plenum foreshadowed the consolidation of large state-owned enterprises and a reversal of pro-market trends. Though at first obscured by an expanding economy, by early 2007, the consequences of the 2003 plenum course changes were manifest to all.³

The run-up to 2013 saw signs of meaningful reform and signs of disinterest. In light of those mixed messages, it was hardly surprising that the outcomes of the 2013 plenum fell well short of those of 1993. China's economic challenges are multidimensional and extensive, and the plenum was the best reform opportunity for years to come. While 2013 should not be viewed as a reversal of market reforms—as 2003 was—on balance it will come to be seen as ineffective at a time when bold reform is imperative.⁴

The plenum documents touch on an impressive range of issues. In particular, the party addressed property rights for farmers, recalling the inauguration of the reform era in the late 1970s. Implementation of serious land reform would make other steps easier.

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However, substantial reasons exist to doubt the authenticity, credibility, and viability of most of the other promises. A number of the supposed reforms are attempts to undo the harm from previous state intervention, typically connected to fiscal policy. The party's credibility is in doubt in some areas—for example, with respect to price liberalization. Most important, parts of the plenum documents are self-contradictory and thus unviable, chiefly in regard to corporate and financial reform.

This is not a consensus assessment; there may not be one for years and, even if established, it may change. Indeed, the consensus view of 2003 was stubbornly wrong.⁵

In weighing the present and future cacophony of claims concerning the adequacy of reform, the best metric is overcapacity—the excess of production capabilities beyond demand. Until now, attempts to grapple with this problem have failed. If the market is truly “decisive” in allocating resources, as the plenum communique indicated, there should be genuine, broad, and durable reductions in overcapacity.

Reviewing the plenum documents and the challenges before the party, however, the best bet is limited land reform. After two years of implementation, victory will be declared, and the reform effort will ebb. That will be insufficient to overcome the fixtures of the economic landscape: an aging labor force, depleted physical resources, continued anticompetitive policies, and still-inefficient finance.

There will be no short-term drama; it is entirely possible the economy will perform adequately through 2017. But it cannot last. Profound, not modest, reform is required. China is not headed for a cliff, but it is headed for a wall—and the 2013 plenum did little to tear this wall down.

Inauthentic Market Reform

Much talk has been devoted to Chinese economic reform, with little attention paid to the meaning of the term. If reform just signifies change, there will certainly be reform after the plenum. This is misleading.

There are only two fundamental types of pro-market change: greater ownership rights and greater competition. The most important ownership rights at

issue involve land and labor (the right to choose where to work). Intensified competition requires rolling back regulatory protection and financial subsidies received by state-owned enterprises (SOEs).⁶ The plenum indicated little intention to address these. Instead, many of the party's commitments were to fixing problems of state-led development, not moving toward the market.⁷

One set of commitments concerns fiscal policy. The challenge here is debt run up by local governments in response to central government orders for stimulus in late 2008. The party is now seeking the right level of government revenue to forestall more local borrowing. This is simply a continuation of the long-standing center-local struggle within the state.⁸ Stabilizing this situation would be helpful and important but is little more than an attempt to return to 2007. In itself, it is hardly market reform.

The anticipated creation of a stronger social safety net is similar.⁹ State-led development has added huge amounts of wealth to the top of the distribution over the past decade, increasing the distance between stunningly wealthy party members and ordinary farmers.¹⁰ A safety net is much-needed, largely to offset another state excess, not to favor markets.

The pattern extends beyond fiscal policy to another serious challenge: ecological destruction. The plenum featured the leadership warning the rest of the party to slow the plundering of national resources.¹¹ While protecting the environment is vital, it does not enhance competition. Private ownership of resources would lead to far less depletion than has been seen during the past decade but was not discussed.

Directly related to both fiscal policy and environmental damage is state-led urbanization. Happily, this was not highlighted in plenum documents. Over the course of 2013, repeated statements by senior party officials and central government ministries suggested a state-led urbanization program, featuring huge outlays to support mass movement to old and newly built cities, was inevitable.¹²

Urbanization in the 1980s and 1990s was driven by the assignment of property rights in agriculture, freeing up excess labor, and by the opportunities created in cities by special economic zones and partial privatization.¹³ State-led urbanization is built on a different model, premised on the notion that “if you build it,

they will be forced to come.” Far from freeing up the market, forced internal migration diverts hundreds of billions of dollars to infrastructure for which there is no true demand.¹⁴ Abandoning this approach would be a victory for reform.

Uncredible Market Reform

China's gradualist approach is often praised. Pledges of future reform, however, are unreliable in any country and more so when present actions are inconsistent with the supposed future changes. For example, the state pledged a gradual rebalancing of investment and consumption as early as 2004, when public investment was soaring. The imbalance has become far worse since.¹⁵

A second set of plenum plans sees the existing record and deferral of meaningful shifts undermine the party's credibility. Nominal steps taken at the 2013 confab include the gradual opening of the capital account, lifting of price controls, and increases in market access, all connected to the foreign role in the economy. But none is likely to occur.

In 1993, as well as 1978, clear moves were not only announced at the plenum but also begun in advance. The 1970s agriculture reforms were implemented in multiple provinces before the plenum, and the decision made there to approve the first individual property rights was dramatic.¹⁶ In 1992, Deng ended the statist reversion in economic policy associated with the Tiananmen Square crackdown, and the 1993 plenum codified an entirely new development framework.

The diffident run-up to the 2013 plenum and its pronouncements suffer in comparison. In January 2012, Premier Li Keqiang associated himself with a World Bank reform report, a positive step. But in December 2012, Party Secretary Xi's pint-sized replication of Deng's southern tour offered little content. For the 2013 National People's Congress, Xi used strong language concerning their commitment to reform but, again, said little about what constituted reform.¹⁷

Adding to this is the present leadership's existing record, which argues against the likelihood of meaningful reform. The obsession with gross domestic product (GDP) continues, which necessarily inhibits achievement of other economic goals. After previously

indicating the accuracy of official GDP, Li embraced the old canard of a minimum GDP gain for job creation, pegging this at an absurdly precise 7.2 percent.¹⁸ Expansion can be labor-intensive or capital-intensive, and Li could easily get the same number of jobs at 5.2 percent GDP growth.¹⁹ His newfound GDP requirement can only warp policy.

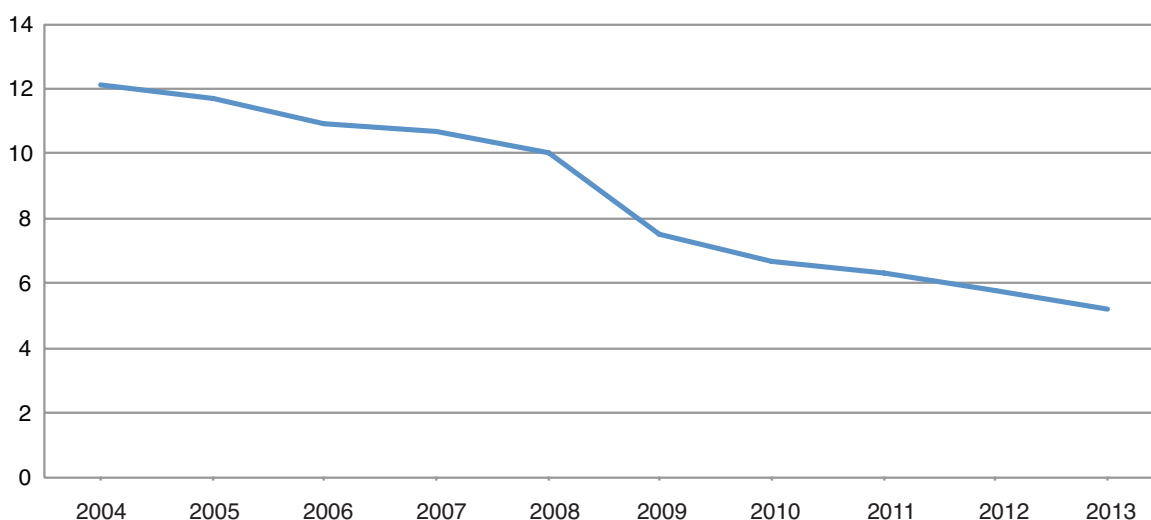
Another possible distortion is a renewed emphasis on what are termed free trade zones. The headline-grabbing Shanghai Free Trade Zone has very little to it as yet but has nonetheless been declared worthy of emulation.²⁰ “Free trade zone” is a misnomer, since the focus for Shanghai is instead on finance, especially the ability to move money freely in and out of the country via an open capital account. Fear of this has paralyzed policymakers for years, up to and including the present. The requirement of a timetable for an open capital account has long been clear and was ignored again at the plenum.²¹

Prices are even more fundamental than capital movement, and the promise to loosen price controls pales against the recent record. The party has long confused liberalization with changing prices more frequently to align with previous global movements.²² The latter is just a more active price control regime, which actually introduces more chance for error. What is needed is a complete end to most price controls, for example, on water.

Worse for credibility on prices is the singling out of foreign companies. Disregarding years of monopolistic pricing by SOEs, the present leadership has instigated investigations of multinationals, coercing them to lower prices.²³ Days before the plenum, a Chinese court handed telecom giant Huawei (revenue \$35 billion) a small financial award from InterDigital Communications of the US (revenue \$660 million), citing the latter's “monopolistic practices.”²⁴

Multinationals have other reasons to doubt pledges of market access. The importance of foreign investment declined sharply as the state role reexpanded under the previous government (figure 1). The present leadership has not only denied information to foreign regulators but also assailed in-country foreign information providers, moving backward on transparency.²⁵ Foreign banks face much higher capital requirements for new branches. Attacks on foreign intellectual property

FIGURE 1
FOREIGN SHARE OF FIXED INVESTMENT (%)



Note: Excludes investment from Hong Kong.

Source: National Bureau of Statistics, *China Monthly Statistics*, no. 9 (2003) and no. 10 (2013).

have, if anything, intensified.²⁶ If the new government intends meaningful reform, it does not intend for it to apply to foreigners.

Nonviable Market Reform

While treatment of foreign entities wins deserved attention overseas, it was secondary at the plenum. What matters for China is getting its own house in order.

The biggest and least-discussed problem with the plenum's announcements is not continued state action or even lack of credibility. It is that most implied reform will not work. Individuals' right to work is determined by the government's residence assignment—the *hukou* system. In light of contradictions in the documents and how the proposals would be implemented, the proposed changes in the *hukou* may not improve labor rights and will not spur the economy. Still more important, the competition so badly needed in the banking and corporate sectors will not occur.

The plenum gave indications of a particular modification of the *hukou* system to ease rural-urban labor

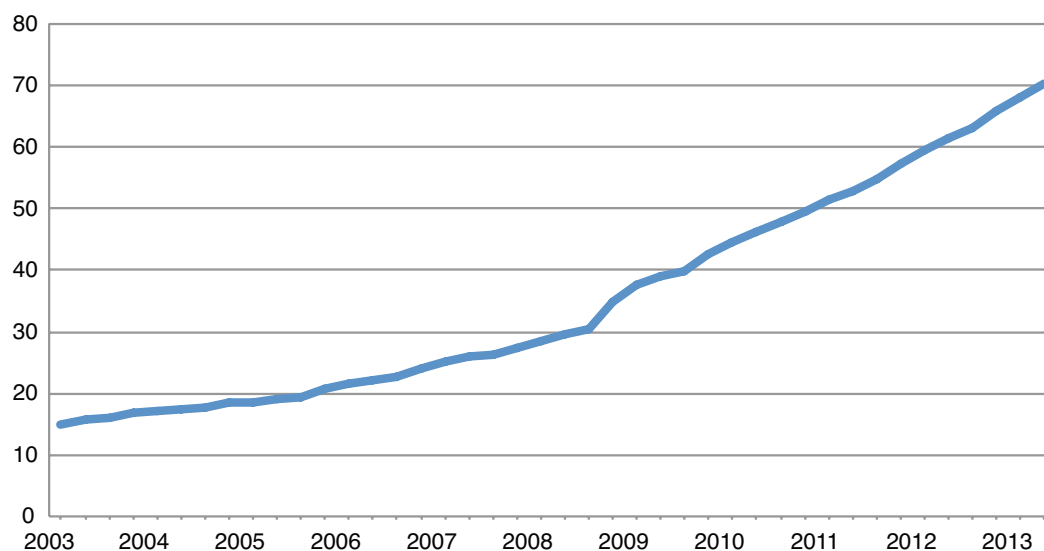
mobility to small cities.²⁷ As a sociopolitical matter, this could be very popular. But as an economic program, it is highly risky. Previous liberalization was only implicit but driven by market demand for labor. Now the government intends the state to determine when and where deregulation should occur.

Mistakes of commission are inevitable—planners are slow and subject to political pressure. In this case, pressure from local officials will be high. The labor market could become more distorted rather than less as the central government responds to changing demand conditions rather than allowing the market to do so.²⁸

Because they have been identified as more sensitive areas for *hukou* deregulation, bigger cities could become relatively more isolated from the rest of the national labor force. The geographic allocation of labor could become more distorted, rather than less, and labor market efficiency could decline.

The bulk of interpretation of the plenum communiqué has focused on the contrast between the continuing “dominance” of public ownership and the newly “decisive” role for the market in allocating resources.²⁹ It is suggestive that we have already seen an example

FIGURE 2
LOCAL CURRENCY LOANS (TRILLION RMB)



Source: National Bureau of Statistics, *China Monthly Statistics*, no. 9 (2003) and no. 10 (2013).

of such a change. In Fall 2012, energy reform was to “give full play to the fundamental role of the market in allocating resources.”³⁰ The industry has not changed since. Evaluating the economy in full, starting with the financial system, shows the plenum offered little real departure from the status quo.

The People’s Bank has long led the reform camp, and pre-plenum reforms were concentrated in finance. Just before the plenum, it was made easier to establish private banks, and the formal minimum for lending charges was dropped.³¹ However, dominant public ownership remains crippling in banking; having a single owner (the state) bars genuine competition.

The foreign share of bank assets is below 2 percent, and higher capital requirements will keep it that way. There is only one private domestic bank of any size, but the plenum documents trumpet easier creation of small private banks.³² Any such banks would face a daunting task in competing with gigantic state institutions not permitted to fail. Would they even try? The plenum language suggests a discrete market segment, where private banks serve credit-starved small firms. While seemingly appealing, this would essentially create a sideshow,

nullifying benefits from competition. The system itself would remain indefinitely dominated by the state.³³

This, in turn, neutralizes interest rate liberalization. Eliminating the floor loan rate was a warm-up for eliminating the ceiling on yields offered to savers. But formally removing that ceiling will mean little when state banks still face off against only one another.

Small banks do not determine interest rates, hence the government’s standing interest in large financial market makers.³⁴ It is not credible that state banks, whose senior management is interchangeable at the orders of the party, will engage in true commercial competition.³⁵ They will continue to support SOEs by rolling loans over as needed, a key element in the suppression of private firms.³⁶

State-Owned Enterprises

At the heart of it all are SOEs. Of the 500 largest companies, SOEs account for 91 percent of assets. If the state sector does not retreat, the private sector is simply outmatched.³⁷ The reasons for optimism with regard

TABLE 1
WHERE PUBLIC OWNERSHIP STILL DOMINATES

Alternative energy and energy conservation	Materials
Autos	Media
Aviation	Metals
Banking	Oil and gas
Biologic science	Petrochemicals
Coal	Power
Construction	Railways
Environmental protection	Securities
Information technology	Shipping
Insurance	Telecom
Machinery	Tobacco

Sources: Zhao Huanxin, "China Names Key Industries for Absolute State Control," *China Daily*, December 19, 2006, www.chinadaily.com.cn/china/2006-12/19/content_762056.htm; Zhang Xiang, ed., "China to Nurture 7 New Strategic Industries in 2011–2015," Xinhua, October 27, 2010, http://news.xinhuanet.com/english2010/china/2010-10/27/c_13578293.htm; Central Huijin Investment Ltd., "Investments," www.huijin-inv.cn/hjen/investments/investments_2008.html?var1=Investments; Grant Turner, Nicholas Tan, and Dena Sadeghian, "The Chinese Banking System," Reserve Bank of Australia, September 2012, 53–64, www.rba.gov.au/publications/bulletin/2012/sep/pdf/bu-0912-7.pdf; Mu Xuequan, ed., "China Launches New State-Owned Railway Corporation," Xinhua, March 14, 2013, http://news.xinhuanet.com/english/china/2013-03/14/c_132234204.htm; Chinese Government, "State Tobacco Monopoly Administration," press release, October 3, 2005, http://english.gov.cn/2005-10/03/content_74295.htm; and Towers Watson, *The Chinese Insurance Market*, no. 19 (March 2012), www.towerswatson.com/en/Insights/Newsletters/Asia-Pacific/The%20Chinese%20Insurance%20Market%20Newsletter/2012/The-Chinese-Insurance-Market-Newsletter-No19.

to SOEs are overwhelmed by continued public dominance and the party's statements and actions in support of it.

Before the plenum, minimum capital requirements for new firms were largely dropped, boosting the private sector. Coincident with the plenum, the state-owned Assets Supervision and Administration Commission announced that private investors would be permitted to take stakes in SOEs.³⁸ This will not change their status—firms where a state entity or entities are by far the largest shareholders are SOEs even if their ownership is nominally mixed. Moreover, powerful disincentives to creating new private firms exist, and more public-private cooperation would be harmful.

New private firms will not be created unless there is an opportunity to make money. The reported profitability of larger private firms fell in 2012. New private investment has been invited in areas where price controls guarantee losses, such as railways, utilities, health care, and low-income housing.³⁹ Existing private involvement in the state-dominated finance, energy, and telecommunications industries is often private in name only.⁴⁰ Even if there was genuine interest,

throwing private money after public and public-private collusion is hardly what is needed. What private firms offer is competition to the point of bankruptcy for the less efficient, including at least some SOEs.

This remains unacceptable to the party. Instead, excerpts from the plenum communiqué repeated the requirement of orderly competition, a term used in the past to justify state-directed consolidation.⁴¹ Among the other features of "orderly competition," SOEs never lose. The National Development and Reform Commission has previously sought consolidation in a range of industries exactly along these lines via government edict.⁴²

The state is already required to lead in an ever-growing list of "strategic" industries (table 1). Perhaps worst, what are called natural monopolies must be state-owned.⁴³ The definition of natural monopoly is malleable; in early 2012, all state monopolies were defended as occurring from economies of scale rather than subsidies.⁴⁴

Some claim that forcing more SOEs to pay larger dividends back to the government constitutes an important change.⁴⁵ But the only way dividends can signify

market reform is if they are tiny. If SOEs continuously return large dividends over time, it can only mean state firms continue to make outsized profits because of regulatory protection and financial subsidies.

The obvious step at the plenum was to cast off public ownership in some sectors. Instead, space was created for private-sector activity, but in a way that does not permit competition with SOEs. Dominant public ownership indicates state firms will not have such privileges curbed to let the private sector advance.⁴⁶

Some Good News

The strength of the plenum's work is not its overly broad sweep but a few proposals that might cut through the Gordian knot of public dominance. Reminiscent of 1978, the most important of these may be rural land reform.

The plenum endorsed more property rights for farmers and offered at least a bit of detail on how they would work. The documents indicate the rural property market will be pushed closer to the situation in cities, where individuals have stronger rights to their land. In particular, farmers could be given the crucial right to sell the land they are assigned, subject to conditions.⁴⁷ This qualifies as authentic market reform and is less vague than most other proposals.

There is still a danger from public ownership, in the form of state-led urbanization and party cadres' desire for revenue.⁴⁸ But this kind of urbanization was almost invisible at the plenum.

As compared to efforts in the banking and corporate sectors, land reform does not face immediate contradictions within the party's new stance. And even partial land reform could considerably strengthen the economy.

The benefits of land reform are proven: it would again raise agricultural productivity and free up labor. This is especially valuable as the labor force ages and shrinks.⁴⁹ The early 1980s offer a guide: excess rural labor makes both greater labor mobility and privatization more inviting. The extra labor must be able to go where it is needed, and private firms are superior to SOEs in quickly finding productive uses for fresh labor.

At that time, labor movement remained sharply limited and privatization was encased in special economic zones, yet results were dramatic.

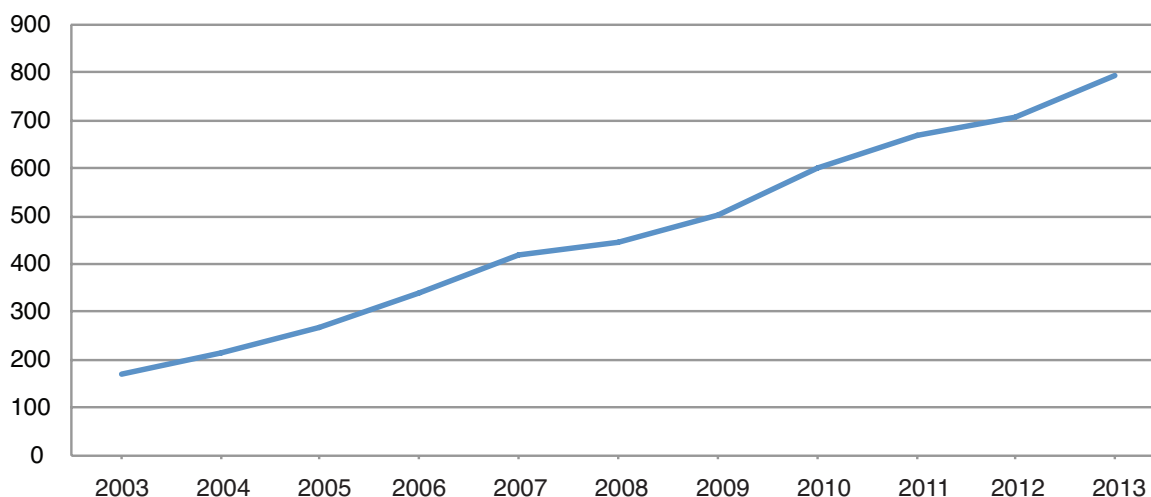
Land reform in 2014 and beyond will not be as profound as in the late 1970s, but labor is now a scarcer and more valuable asset, making the ensuing labor mobility and privatization potentially more fruitful. If partial privatization for the sake of labor absorption occurs, it would reduce the need for SOE subsidies. This, in turn, would make financial reform considerably easier, given the existing drain placed on banks by SOEs.

The timetable for this sequence of changes is extended. After the plenum, the party warned that land reform might not start in earnest until 2020.⁵⁰ That may be an attempt to control expectations, but, even in the best case, it will take several years of land reform before complementary actions like a reduction in SOE subsidies would occur. Fortunately, China is not facing imminent stagnation, and the economy would be bolstered at each step along the reform path. The final result might not match those of the 1978 and 1993 plenums but would still be quite valuable.

If land reform is too slow, finance offers the possibility of much quicker change. Capital account opening remains distant. Effective banking privatization is many years away and may never occur. But this does leave the bond market. Before the plenum, there were minor enhancements of the interbank bond market, allowing more foreign players and tentatively reintroducing futures.⁵¹ The crucial step is to allow much greater access for existing domestic private entities. This fits the plenum language and can proceed far faster than creation of new banks from scratch.

If eventually permitted, broad bond market participation would change the financial system. Allowing foreign money to exit the bond market freely would be a step toward capital account opening. More important, a highly participatory bond market would be true competition for state banks in corporate fundraising. It would create a market price of capital for the rest of the economy, even as state banks continue to subsidize SOEs. As with land, it is an indirect reform route and will take time, but it could ultimately give the market a more decisive role.

FIGURE 3
 CUMULATIVE OUTPUT OF STEEL PRODUCTS (MILLION TONS)



Source: National Bureau of Statistics, *China Monthly Statistics*, no. 9 (2003) and no. 10 (2013).

The Overcapacity Guide

Disagreement over the implications of the plenum is unavoidable. A partial antidote is to watch the level of overcapacity.

Overcapacity means, essentially, wasted labor, unproductive depletion of physical resources, and debt, as sales prices are forced down by too much supply. It discourages innovation by deterring new entrants into already too-crowded industries. Overcapacity thus lies at the heart of China's economic problems. Indeed, the desire for a "decisive" market is for resource allocation that prevents sustained overcapacity. The Central Economic Work Conference after the plenum also emphasized overcapacity, if in a somewhat incoherent fashion.⁵²

China has pressed partners to grant it market economy status in trade laws before 2016, when it will gain this status by the terms of World Trade Organization accession. But market economies do not suffer from overcapacity for extended periods, because commercial firms go bankrupt. Command economies do not have this corrective device and, for the last decade, neither has the state sector of the Chinese economy. In 2004, the steel industry was acknowledged to

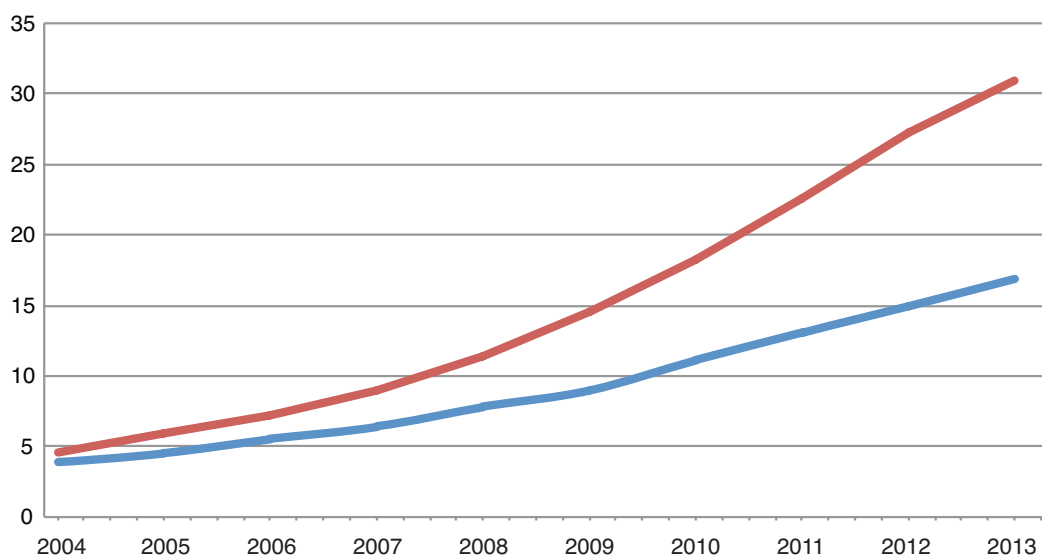
suffer from considerable overcapacity. It still did in 2012 (figure 3).⁵³

Steel is not alone: across the range of industries, capacity utilization has not kept up with investment for at least a decade. Over one-fifth of capacity was said to be idle in the first half of 2013, even while fixed investment maintained its 20 percent annual growth pace.⁵⁴ Some have said, with cause, that there is an oversupply of cities themselves.⁵⁵

The State Council has issued consolidation edicts for years, often with little effect. Before the plenum, the Xi government seemed less interested in reducing overcapacity, decreeing only minor capacity reduction.⁵⁶ As soon as the plenum ended, the failed Suntech Power was bailed out by ostensible rival Shunfeng. The company's capacity was untouched, and domestic creditors were happy to get 30 percent of what was owed them. (Foreign creditors will likely get nothing.)⁵⁷

The only solution is genuine competition and, ultimately, bankruptcy. Firms, even if state-owned, must contract or fail entirely, as was allowed to some extent following the 1993 plenum.⁵⁸ Exit from afflicted industries need not be complete; a partial reduction of overcapacity will mean the plenum triggered a vital

FIGURE 4
INVESTMENT AND CONSUMPTION MEASURES (TRILLION RMB)



Source: National Bureau of Statistics, *China Monthly Statistics*, no. 9 (2003) and no. 10 (2013).

improvement. But unless there is a durable and multisector reduction of overcapacity in major sectors, via competition, China is not moving toward market economy status, and the plenum's dictates are not important market reforms.

Forecast: Declaring Pyrrhic Victory

The contradictions contained in actions and statements before and during the plenum partly stem from internal opposition, which will affect implementation.⁵⁹ This opposition has been much discussed, but one variant is largely overlooked: sound steps could be taken initially but then reform effectively halted as soon as the 2015 National People's Congress. This would pose a serious economic risk.

A common reason cited for anticipating sustained reform is pressing need. But countries frequently choose bad policies. Market reform from 1978 to 2002 created an economic miracle yet was then sacrificed for state-led development. The reversal started in late 2002 with expanded lending by state banks heralding Hu Jintao's

incoming government. In 2002, the economy faced no investment-consumption imbalance; the imbalance is a creation of policy.⁶⁰ In 2009, Beijing again intensified the state role, to broad praise. A lending spree financed continued corporate activity, but the problems with high leveraging soon were unmistakable.⁶¹

Outside experts missed the reform imperative for years, and true acceptance will be far harder for the party. State dominance of major sectors puts enormous resources in the hands of cadres, and their personal wealth has skyrocketed.⁶² Many thus oppose procompetitive change, instead supporting programs which rely on SOEs.⁶³

Ideological and self-interested opponents of reform may have lost some ground at the plenum but will not simply acquiesce.⁶⁴ It is natural that the easiest reforms, politically and economically, are implemented first. As reforms become more difficult and the internal contradictions in party positions become clear, opponents will be emboldened and it will be increasingly appealing to declare victory.

The means to declare victory is GDP growth. At best, official GDP growth is smoothed, and a few tenths of

1 percent means nothing.⁶⁵ At worst, the State Statistical Bureau simply does the party's bidding. Considerable reason exists to doubt GDP as an indicator, yet GDP growth remains the unchallenged barometer of success.⁶⁶ Minor twitches are treated as profound.⁶⁷ The plenum documents ostensibly deemphasized GDP but offered vague substitutes. The party has talked of higher-quality growth for years, but the development model is as yet unchanged.⁶⁸

Much of the domestic and foreign audience would approve if Beijing merely claimed reforms were implemented and GDP growth was rapid. This would be a major error. A sharp downturn is unlikely because so many assets are state-controlled. (For example, the counterparty risk that froze American finance in 2008 does not translate.) But the economy must shift toward the market, or it will stagnate. It will not collapse or stagnate immediately, and stagnation will not be acknowledged. But only sustained reform will bring another generation of rapid wealth gains.

China is a mixed command-market economy—at close to 50 percent, the ratio of annual gross fixed capital formation to GDP would be unprecedented for pure market economies.⁶⁹ If state-led urbanization revives to become the lead development program, investment will again outpace consumption (figure 4), and its share of GDP will rise toward 60 percent. This would push the economy toward command status. Command economies respond poorly to changing environments, and comparative living standards stagnate.

If China is considered a market economy, it still faces stagnation. Despite shelter from competition, state firms cannot self-finance such high investment. Bank credit fills the gap, increasing from RMB13.13 trillion in 2002 to RMB62.99 trillion in 2012. Average annual loan growth of 11 percent from 1998 to 2002 gave way to close to 20 percent from 2008 to 2012.⁷⁰ Adding to this is nonbank lending (shadow finance). The expansion in total credit in the past decade is, on some measures, steeper than in 1980s Japan.⁷¹

What level of government debt harms an economy is a contentious matter. It is probably more useful to consider corporate debt.

A Bank of International Settlements paper put the danger point for corporate debt at 90 percent of GDP. Standard Chartered estimated Chinese corporate debt

at 117 percent of GDP at the end of 2012.⁷² China's corporate debt burden is the highest among a sample of 20 peer countries, and the average corporate debt of large Chinese enterprises is far greater than that of their American counterparts.⁷³ This is a sign not of imminent crisis but of failure—China's rebound from the global downturn has been fueled by debt to an extent greater than any other major economy.

Putting aside market status, structural factors are deteriorating. Ecological depletion is erasing the contribution of physical resources to growth.⁷⁴ An aging society reduces the quantity and perhaps quality of labor. The need for efficiency is rising, but efficiency can be delivered only by the market. Declaring victory in 2015 or 2016 will thus bring stagnation in 2018 or 2019. The most likely positive outcome is partial success concerning land and general failure concerning competition. Given the role the plenum needed to play, this is not much to rely on.

Impact: Two Paths

Given the many and disputed interpretations of the plenum meeting, it is perhaps foolhardy to discuss its global implications. But two reasonable paths, distinguished ultimately by the pervasiveness of overcapacity, seem to emerge.

One is, essentially, a lack of forward movement. Though victory would be declared, the contradictions evident at the plenum bar most useful action. The second is that moderate land and financial reform will be implemented, making further steps more appealing.

The second path has more forks. A benefit of the multiple economic challenges the party faces is that there are multiple ways to succeed. If land reform turns out to be the driver, it simultaneously would mean greater output through higher productivity and thus higher personal income for farmers.

Higher personal income would support demand, and the world economy would clearly benefit from greater Chinese purchases of goods and services. The former could help limit inflationary pressure. More subtly, there would be partial rebalancing away from an excessive share of capital in national income, toward labor. This would be globally stabilizing.⁷⁵ Finally, if

corporate and financial reform ultimately follow land reform, they would make Chinese participation in multilateral economic accords such as the Trans-Pacific Partnership far more likely and beneficial.

The stagnation route is simple. The structural flaws that began to be introduced in 2003 and the visible economic weakening since 2008 eventually created a consensus outside the party that China faces a struggle.⁷⁶ There are differences of opinion concerning timing and nature of the struggle, but the risk is broadly accepted reminiscent of Japan in the 1990s, China's economic dynamism would end.⁷⁷

This outcome has multiple implications for the global economy, but an especially notable one is a more difficult balance between growth and inflation. China was a powerful deflationary force in finished goods for more than a decade.⁷⁸ Without land and labor reform, and even perhaps with it, demographic change will end this. At the same time, without reform, anticipated strength in Chinese consumer demand will not materialize.⁷⁹ The world economy would then need a growth engine elsewhere, while surges in consumer inflation remain possible. Absent unexpected good news from a different quarter, global economic performance would suffer.

Which path the economy is on will be largely identified by actions, not words, with regard to production capacity. Capacity growth must be halted in some sectors and start to be rolled back in others. That process will have to be sustained but, for 2014, it merely needs to start in earnest. Otherwise, the world economy must brace for a slowly stagnating China.

Notes

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