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China's Economic Policymaking at a Time of Transition

By Matthew P. Goodman and David A. Parker

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Introduction

China's economy has grown rapidly for 30 years due to a combination of smart politics and favorable economics. By pursuing a policy of "reform and opening" and allowing the first green shoots of a market economy to flourish in the late 1970s, Deng Xiaoping united China's people and policymakers behind the pursuit of a single overarching goal: growth. Fuelled by a nearly unlimited supply of cheap labor, a high savings rate and massive investment, and access to large and growing export markets, the Chinese economy subsequently took off, averaging double-digit growth rates between 1980 and 2010. This enormous economic achievement has lifted more than 500 million people out of poverty, catapulted China into the ranks of the world's middle-income countries, and made it the second-largest economy and single-largest trading nation in the world.

But today these traditional sources of Chinese advantage are fading. Labor markets in China's coastal industrial clusters are tightening and wages are rising quickly. An unbalanced growth model favoring investment over consumption has produced rampant overcapacity in heavy industry and an underperforming service sector, along with mountains of questionable loans. External demand from advanced countries remains subdued and is no longer sufficient to absorb endless Chinese exports. The country is also facing the deeper structural challenges that then-Premier Wen Jiabao warned of as far back as 2007, when he called China's growth "unstable, unbalanced, uncoordinated, and unsustainable." These structural difficulties range from an aging population to the "middle-income trap," in which the benefits of surplus labor are dwindling before China can compete with advanced countries in high-value-added production.

At the same time, the negative consequences of China's breakneck development have undermined the consensus surrounding growth as a national project. Land seizures used by cash-strapped local governments to boost development and fund local investment have become a major source of social unrest. Income inequality has risen sharply nationwide and deepened the divide between inland provinces and richer coastal areas, between urban and rural citizens, and even within individual cities. Industrial activity has tainted China's arable land and waterways,

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while high concentrations of airborne particulate now routinely produce choking haze and grounded flights along the coast. Meanwhile, a parade of high-profile corruption investigations and numerous safety scandals over everything from tainted milk powder to disastrous train crashes have undermined public trust in government.

At the Communist Party's Third Plenum meeting in November 2013, Chinese leaders announced an ambitious program of economic and social reform designed to comprehensively address these challenges and give the market a "decisive role" in allocating resources. This 60-point vision statement, together with high-level institutional changes to the Chinese economic policymaking apparatus, provide early indicators of the seriousness with which the current leadership under Xi Jinping is approaching reform. Leaders have taken pains to stress that the 2014 national growth target of 7.5 percent – a far cry from the double-digit rates of the past but still too high in the view of many analysts – is non-binding, urging local leaders instead to place greater emphasis on job growth and price stability.

Alongside the broader array of economic challenges and built-up imbalances, Chinese leaders must also grapple with a more pluralized policy environment and an economy that is many times more complex than during the last major round of reforms that took place in the late 1990s. Today, influential state-owned enterprises (SOEs), large private-sector actors, empowered provincial leaders, fractious government ministries, and a more vocal civil society are all competing intensely to influence policy. Meanwhile, the Chinese economy has more than quadrupled in size since 1998, with the scope of its activities becoming ever more diverse, dynamic, and interconnected, thus making the design and sequencing of reforms significantly more complicated.

Whether China's policymaking institutions can steer the country towards a more sustainable and balanced growth path has major implications for both China and the world. Hundreds of millions of Chinese have yet to enjoy the full fruits of the nation's economic success, and the health of the global economy in the years ahead will depend on Beijing's ability to engineer a shift towards a new, consumption-led economic model. Against this backdrop, there is a rising premium on understanding how Chinese economic policy decisions are made and whether the current cadre of policymakers has the wherewithal to navigate the turbulent waters ahead.

China's Economic Policymaking Institutions

The State Council

As discussed below, the Chinese Communist Party remains the sole political authority in China and retains tight control over setting policy priorities, but most day-to-day administration of economic affairs is handled by the state. At the top of China's governmental policymaking hierarchy is the State Council, effectively China's cabinet. The State Council and its ministries directly issue many of the regulations that govern the Chinese economy, though major legislation formally requires the approval of the National People's Congress (NPC), China's legislature.[2]

The full State Council has 35 members: the premier, four vice premiers,[3] and five state councilors[4] – who together comprise the executive committee – and 25 heads of ministry-level bodies.[5] The executive committee meets weekly, and members rank above ordinary ministers. Their cross-cutting portfolios allow them to play a key role in mediating disputes and coordinating policy among China's panoply of government agencies.

The full State Council meets only twice annually. Between these meetings, the executive committee is the primary decisionmaking body, though a wide array of committees and working groups bring together representatives from relevant ministries to coordinate on specific issues.[6] There are also many ministerial- and vice-ministerial-level government agencies subordinate to (but not officially represented on) the State Council, which include official think tanks, policy research and legislative offices, news agencies, and other functional offices and commissions. Representatives from these bodies sometimes attend plenary meetings, but only when invited and generally in a non-voting capacity.

Government agencies also wield significant influence in their own right. They play major roles in conducting research, making policy recommendations, interpreting policy directives from higher levels of government, and promulgating regulations. Disagreements between ministries often create gridlock due to a combination of factors: equally ranked agencies cannot issue binding orders to one another; many ministries share overlapping mandates on functional issues;

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[2] The National People's Congress is formally the "highest organ of state power," authorized to approve the annual budget and to appoint or remove state leaders. Functionally, however, the NPC has little power and almost always votes in favor of state proposals. See Susan V. Lawrence and Michael F. Martin, "Understanding China's Political System," *Congressional Research Service*, March 20, 2013.

[3] Vice Premier Zhang Gaoli is frequently referred to as the "executive vice premier." While this is not a title used in official Chinese media, it reflects Zhang's position as both a vice premier and a member of the top-ranked Politburo Standing Committee (see below).

[4] State councilors frequently serve in multiple positions simultaneously. For example, State Councilor Yang Jing serves concurrently as the State Council Secretary General and manages the State Council General Office. State councilors Guo Shengkun and Chang Wanquan serve concurrently as Ministers of Public Security and National Defense, respectively.

[5] A full list of government agencies represented on or subordinate to the State Council is available at http://english.peopledaily.com.cn/data/organs/statecouncil.shtml. While the roles of many agencies are in flux, among the most important ministerial-level bodies involved in the economic policymaking process and represented on the State Council are the National Development and Reform Commission (NDRC), the Ministry of Industry and Information Technology (MIIT), the Ministry of Finance (MOF), the Ministry of Commerce (MOFCOM), and the People's Bank of China (PBoC).

[6] For example, the Anti-Monopoly Commission is an 18-member body constituted under the State Council to coordinate ministries that oversee implementation and enforcement of China's Anti-Monopoly Law. It is composed of representatives from over a dozen government agencies and was in the past headed by then-vice premier Wang Qishan. It has no formal law enforcement authority, and is managed by the Anti-Monopoly Bureau of MOFCOM. The Antitrust Source, "Interview with Anti-monopoly Bureau Director General Shang Ming," February 2009.

and decisionmaking is consensus-based.[7] Despite their importance, ministries at the central level are relatively lightly staffed: out of more than 40 million civil servants nationwide, only about 60,000 are posted directly to ministries and commissions in Beijing.[8]

Most policy implementation authority is delegated to the local level. There are four formal levels of administration below the center[9]; in descending order of authority: provincial, prefectural, country, and township.[10] There are 31 provinces, roughly 300 prefectures, nearly 3,000 counties, and over 40,000 townships.[11] While rules, such as those governing staffing, responsibility for public service provision, and taxation are made by the central government, cooperation from these local government units is critical to implementation. For example, units at the provincial level and below accounted for over 80 percent of official budgetary expenditures in 2009, and for the vast majority of spending in areas such as education and environmental protection.[12]

Local governments can also be important agents in the policymaking process; they compete for resources and attention from top-level leaders, either by conducting independent policy experiments or seeking support and funding for experimentation from higher administrative levels. Their superior local knowledge and *de facto* control over local branches of central-level ministries, such as the Ministry of Land and Resources, also means they have the capacity to subvert or covertly resist Beijing's policy objectives.[13]

The Communist Party

But setting those policy priorities remains the exclusive domain of Beijing and of the Chinese Communist Party (CCP). The CCP is led from the top down, starting with the seven-member

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[7] For example, the Ministry of Environmental Protection (MEP) is nominally the lead agency on environmental issues (along with the NDRC), yet it has little power to enforce its mandate. Not only is it competing with the interests of more growth-focused ministries and provincial leaders, but management of critical issues, such as water pollution or heavy metal contamination of China's farmland, fall within the portfolios of other independent functional ministries, in this case the Ministry of Water Resources and Ministry of Agriculture, respectively. Meanwhile, local branches of the MEP, known as environmental protection bureaus, receive technical guidance from the MEP, but are funded and their leadership appointed by local governments. For a more thorough treatment of this and other environmental issues, see Judith Shapiro, *China's Environmental Challenges*, Polity Press, 2012.

[8] Christine Wong, "Toward Building Performance-Oriented Management in China: The Critical Role of Monitoring and Evaluation," *ECD Working Papers*, September 2012.

[9] The prefectural level is in fact not mentioned in China's state constitution, and some have argued it should be abolished to streamline interactions between levels of government.

[10] Sub-provincial, sub-prefectural, and sub-country-level units also exist, providing an additional level of complexity. For example, while both enjoy broadly comparable rights and responsibilities, a sub-provincial level city outranks a prefectural unit.

[11] For scale, an average county has half a million inhabitants. An average province has around 40 million.

[12] Xiao Wang and Richard Herd, "The System of Revenue Sharing and Fiscal Transfers in China," *OECD Economics Department Working Papers*, February 27, 2013.

[13] The exact reporting relationship between central government ministries and their local counterparts varies with the agency. For example, the NDRC directly supervises branches in all 31 provinces; MOFCOM functions are handled by both directly managed officials and locally managed commerce commissions at the provincial level; and, as discussed above, the MEP provides technical guidance to local environmental protection bureaus, but their funding and appointments are controlled by local officials.

Standing Committee of the Politburo of the 18th CCP Central Committee (more commonly referred to as the Politburo Standing Committee, or PBSC). These seven leaders concurrently sit on the full Politburo, which has 25 members and is next in terms of functional authority. Politburo members are in turn part of the larger Central Committee, a body made up of 205 full members and 171 alternate members. The full Central Committee represents the top leadership of an organization whose power and 82 million members extend throughout Chinese society.

Party organs, such as the Central Committee Organization Department, control key levers of power, ranging from personnel appointments to anti-corruption investigations. Party committees exist in every ministry, at all levels of government, in universities and unions, and in public and private companies throughout China – including many foreign enterprises.[14] Most senior SOE managers are Party members, and are linked to their counterparts in the government and Party via a network of secure red phones. Even outside of formal Party channels, officially sanctioned organizations, such as the Chinese People's Political Consultative Conference (CPPCC)[15] and Party-approved unions and trade federations,[16] provide a further means of monitoring and coopting groups not directly under the CCP umbrella.

The Party often takes a direct role in shaping policy, either directly through decisions released at key Party events, or through behind-the-scenes management. In particular, the Party has often used so-called "central leading small groups" (LSGs) to support policy formulation and coordination at the highest levels. Many of these secretive bodies are chaired by members of the PBSC and assist top leaders by conducting research and offering policy recommendations.[17] For example, much of the drafting of the reform plan released in November 2013 at the Third Plenum was performed by officials seconded from the Party's Finance and Economics LSG. The drafting committee was chaired by Xi Jinping and composed of other top leaders – including fellow PBSC members Liu Yunshan and Zhang Gaoli – and key experts. Meanwhile, the

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[14] In his 2010 book *The Party,* Richard McGregor quotes a professor at People's University as saying, "The Party is like God. He is everywhere. You just can't see him."

[15] The CPPCC is a political advisory body overseen by the United Front Work Department of the CCP. Delegates include members of China's officially recognized non-Communist parties, unions, trade federations, minority groups, and other segments of Chinese society. Local branches of the CPPCC exist in all jurisdictions down to the county level.

[16] For example, the All-China Federation of Trade Unions. For a fuller treatment of trade unions and government-business relations in China, see Scott Kennedy, *The Business of Lobbying in China*, Harvard University Press, 2005.

[17] While full rosters are not officially announced, state media have confirmed a number of members of the Finance and Economics LSG, including Xi Jinping as chair, Li Keqiang and Wang Qishan as vice-chairs, Liu He as head of the general office, and members Wang Yang, Ma Kai, and Wang Yong. This represents an unusual level of transparency regarding what has historically been regarded as highly sensitive information.

committee's day-to-day administration and work was overseen by Liu He,[18] a noted economist who simultaneously serves as the director of the office of the finance and economics LSG.[19]

The Third Plenum also announced the creation of a new Leading Small Group for the Comprehensive Deepening of Reform (henceforth referred to as the "Reform LSG"), marking an enhanced role for LSGs in the economic policymaking process under Xi. Party documents have designated this body to play the central role in coordinating China's reforms through 2020, when its remit officially expires. Xi will head the body and three additional PBSC members will serve as deputy chairs, giving it unrivaled authority as it seeks to implement reform.[20] The Reform LSG will also have its own general office, or nerve center, led by Wang Huning, a Politburo member and head of the influential Central Committee Policy Research Office, where the staff for this office will be located. Below the main LSG will be six functional offices, each dedicated to managing a different aspect of reform, such as the economy and environment, and headed by a Politburo-level official.[21]

The creation of this group suggests that Xi has the clout to create structural solutions at the highest levels of China's policymaking apparatus to get around the gridlock that has characterized the state machinery for much of the past decade. In a move unprecedented for a LSG, the group will even be replicated at all lower levels of government in China and headed by the most senior official in a given administrative jurisdiction. That it is a Party body designated as the primary driver of reform, and that Xi is seeking to ensure implementation through Party rather than official state channels, underscores Xi's emphasis on the centrality of the CCP in both setting policy priorities and driving their implementation. Its creation may also have finally put to rest the enduring intra-Party debate running throughout the reform era over the wisdom and efficacy of seeking to separate Party and government functions.

The new LSG also suggests the nature of the challenges Xi and top leaders are seeking to overcome. Despite the CCP's continued monopoly on political power, various actors compete intensely to influence policy. Powerful vested interests, such as giant SOEs, fight to insulate themselves from reform. Government agencies, such as the influential NDRC, are divided over reform, and many seek to protect the interests of those they regulate. Scholars, think tanks, and government research institutes compete to shape the ideas of top leaders. Provincial leaders lobby for projects and initiatives that will support local priorities. Even institutions once less

[18] Liu He also provides an example of the many hats worn by high-level Chinese leaders. He is both a member of the CCP Central Committee, a minister-level vice director of the NDRC, and the director of the office of the Finance and Economics LSG.

[19] Leading small groups have typically been supported by offices with around 20-30 staff, which are overseen by an office director.

[20] The three are Li Keqiang, Liu Yunshan, and Zhang Gaoli. They are ranked 2nd, 5th, and 7th on the PBSC, respectively. For a list of their primary areas of responsibility, see Susan V. Lawrence, "China's Political Institutions and Leaders in Charts," *Congressional Research Service*, November 12, 2013.

[21] The six groups are economy and ecology; democracy and justice; culture; society; Party construction; and discipline and supervision.

influential in policymaking, such as traditional and social media, non-governmental organizations, and civil society groups, are finding new opportunities to advance their agendas.

All of this has contributed to making China's policymaking space increasingly messy, complicated, and, in a word, pluralistic.

Enduring Characteristics of Chinese Economic Policymaking

Despite the frequent structural changes to China's economic policymaking institutions, policymaking itself demonstrates certain enduring characteristics that provide useful insight in assessing the state of reform. Chief among these are persistent coordination challenges, dynamic central-local relations and official incentives, and the use of experimentation and external pressure as tactics for advancing reform.

Challenges of Coordination

All large organizations, especially governments, face coordination challenges, but China's are particularly severe – despite the top-down nature of the Chinese political system. This has improved as successive reform drives and the gradual retreat from direct state control over the economy have slimmed China's bureaucracy: in 1982, there were over 100 government ministries; by 2013, that number had fallen to less than 50. But serious problems remain.

One factor is the frequent jurisdictional overlap between government ministries. Combined with a strong emphasis on consensus-based policymaking, this makes cooperation essential to developing and implementing policy shifts. But because ministries often face competing objectives and cannot issue binding orders to bodies of equal formal rank, gridlock and stove-piping are common.[22] Politics also exacerbate this challenge: high-ranking officials must compete for future promotions and to gain the favor of top leaders, which often reduces the incentive to compromise.

Another issue is how China approaches coordination. When addressing issues that range across functional mandates, representatives of all relevant agencies (and others that deem the issue within their "turf") become part of an *ad hoc* committee. Either after extensive negotiation or based on a mandate from above, one agency is then designated as the lead and placed in charge of coordinating on the project. This usually results in the establishment of a specialized coordinating office within that ministry. But in the highly rank-conscious environment of

[22] This issue has been highlighted recently by reports of a dispute between the China Banking Regulatory Commission (CBRC) and the PBoC, which are responsible for regulating China's banks and ensuring overall financial stability, respectively. According to these reports, a Financial Stability Council chaired by the PBoC and established to improve coordination among China's financial regulators has met only once since its establishment in August 2013 due to opposition from the CBRC. This is the third time policymakers have made a dedicated effort to improve coordination among Chinese regulators since the CBRC was created in 2003, and reflects the deep divide on policy matters that exists between the CBRC and the PBoC. See Jamil Anderlini, "China bank regulators caught in turf war," *The Financial Times*, April 9, 2014.

Chinese public administration, the degree of coordination is then almost completely dependent on the lead ministry's influence within the broader policymaking apparatus.[23]

Efforts to solve this problem through institutional redesigns – such as the creation of "super ministries" with broad portfolios and explicit mandates to oversee coordination – have had little positive effect. The NDRC is the most obvious example of this: rather than improving coordination, its role as a "mini-State Council" became a major contributing factor to gridlock and helped concentrate and empower vested interests opposed to structural reform. Instead, most examples of effective coordination are the result of sustained attention from top leaders – typically at the vice premier-level and above – with both the authority and cross-cutting portfolios needed to overcome bureaucratic resistance.

Central-Local Relations

There is a Chinese saying that "the mountains are high and the emperor far away," reflecting China's history of decentralized government and the modern reality that much policy is made outside Beijing. This is clearest when looking at trends in public spending. Even after reforms in 1994 aggressively recentralized tax revenues, spending at the provincial level and below has regularly accounted for around 75 percent of official government expenditure, and the vast majority of spending on public services, such as healthcare, education, and social welfare.[24]

The center-local divide is even more important than the fiscal situation suggests. Since the early stages of reform, local leaders at all levels have been evaluated for promotion according to their ability to meet targets set by the immediately superior level of government.[25] The precise metrics used for performance assessment have evolved with time, but two targets have consistently remained top priorities: economic growth and social stability. This system carried distinct advantages in the early stages of China's development, spurring intense competition among local leaders to generate growth-boosting policy innovations in their jurisdictions, the most successful of which provided templates for pilot policies elsewhere. Even when tasked with conflicting objectives, such as environmental protection, local officials' incentives were clear. In addition to being a hard target and easily measurable, growth had the advantage of indirectly promoting

[23] Even a powerful ministry does not guarantee a speedy or coherent process of policy generation. For example, the NDRC, long regarded as China's single most powerful government bureaucracy, was the lead agency in charge of developing China's urbanization plan jointly with over a dozen additional ministries. But the plan, released in March 2014, nonetheless suffered multiple delays and arrived a year later than initially promised.

[24] These "unfunded mandates" have been a major factor behind the rapid buildup of local government debt and the growth of local government financing vehicles. While the central government does transfer a significant portion of fiscal revenues to the provinces, the process for deciding the size of transfers is opaque, largely subjective, and not directly tied to expenditure responsibilities. See Christine Wong, "Toward Building Performance-Oriented Management in China: The Critical Role of Monitoring and Evaluation," *ECD Working Papers*, September 2012.

[25] This so-called "one-level-down" management system entails the appointee at each administrative level being appointed and managed by the post at the next higher level. Under this system, promotion decisions and supervision are dependent on immediate superiors rather than central authorities. See Wang Xiaoqi, *China's Civil Service Reform,* Routledge, 2013.

social stability, enabling greater expenditure on public works, and providing officials with opportunities for personal enrichment.

But as Beijing has sought to balance a growing array of national policy priorities, such as improved social welfare and clean government, and to impose more “top-level design,” the downsides of decentralization have also become clear. Detailed local knowledge, which allows provincial leaders to interpret Beijing’s often vague policy pronouncements to suit conditions on the ground, have turned from advantage to obstacle as national leaders’ objectives have come into conflict with local priorities. Difficulties in addressing widespread air pollution are an example of this: while the pollution itself is widespread, the costs of addressing it in terms of reduced growth, lower revenues, and higher unemployment are borne locally. This makes the decision to impose anti-pollution measures highly political, requiring costly efforts (and compensation) to avoid instability and create incentives for compliance.

Much of the responsibility for these problems also falls on Beijing. In attempting to bridge the central-local divide and establish specific metrics for how to govern 1.35 billion people, national leaders have often created incentives for their subordinates to meet measurable targets at the expense of policy outcomes, or to create new problems by blindly pursuing unrealistic targets. For example, central mandates for local governments to improve healthcare coverage and increase spending on public education and infrastructure that failed to provide any new sources of revenue were major factors behind the worrisome growth in local debt over recent years.[26] Despite Beijing’s promises that it has moved away from “GDP-obsessed” assessments and embraced a wider set of priorities, the continued posting of an annual growth target – even one that central leaders have stressed is non-binding[27] – underscores that Chinese leaders will face significant challenges in creating the right mix of incentives to implement more balanced policies.

Experimentation

Experimentation has been a hallmark of Chinese leaders’ approach to advancing reform ever since Deng Xiaoping’s famous decision in 1980 to open the Shenzhen Special Economic Zone and allow foreign direct investment into China. Experiments advanced from Beijing limit the political and economic risk of testing new policies. If these pilots prove successful, they provide evidence for those interested in implementing reform more broadly. If they fail, the failure is localized and cannot independently generate a large-scale threat to social stability. Ambitious local officials interested in improving their chances at promotion can also generate experiments independently, either by taking advantage of ambiguous directives from above or by securing

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[26] Another was the growth targets themselves, which incentivized local leaders to generate revenues from land sales and other extra-budgetary financing that could then be funneled into GDP-boosting investments.
[27] For an optimistic view of the changing nature of Chinese targets, see Stephen Roach, “The End of Chinese Central Planning,” *Project Syndicate*, March 27, 2014.

tacit support from higher-level leaders. This provides an important incentive to produce innovative policies based on knowledge of ground-level conditions.

Experimentation also carries risks. The decision to launch the Shanghai Free Trade Zone (FTZ) in September 2013 as a trial for capital market reforms and new policies towards foreign direct investment indicates that Chinese leaders are still most comfortable advancing reform through contained experiments. But there is some question of whether or not this approach of "crossing the river while feeling the stones" will work as reforms enter deeper water – and whether this preference for experimentation could become an excuse to avoid embracing bolder reforms. For example, the development of service industries that is at the heart of the Shanghai experiment is qualitatively different from the manufacturing-sector development that took place in Shenzhen. There is a distinct possibility that trying to isolate these industries and reforms from impacting the broader economy will undermine the increased service-sector competitiveness that Beijing seeks to encourage.

External Pressure

Despite the primacy of domestic drivers in Chinese policymaking, external pressure exerts an important influence on the incentives facing China's leaders. At the central government level, it can provide leverage for taking on domestic opposition. Former Premier Zhu Rongji famously used the process of negotiating China's accession to the World Trade Organization (WTO) as a club to beat back vested interests, downsizing a bloated state-owned sector to lay the groundwork for a decade of phenomenal growth. At the local level, competition for FDI has had an important impact in shaping leaders' incentives. Officials seeking to boost growth, generate employment, and move into higher value-added production areas have strong incentives to compete for foreign direct investment, particularly in technology-intensive sectors.

Today, growing momentum in international negotiations, such as those to establish a Trans-Pacific Partnership (TPP) and a U.S.-China Bilateral Investment Treaty (BIT), are creating changes in China's external environment that may be playing a similar role to the WTO accession process in encouraging Chinese leaders to advance new pilots, such as the Shanghai FTZ.

But as Chinese leaders consider how to pursue reforms in the context of new external pressures, they also face new challenges. Not only is the Chinese economy far larger than it was in Deng or Zhu's time, but it is much more deeply intertwined with the global economy than in the past. Thus, for example, the effort to liberalize and open China's capital markets is complicated by the risk of rapid capital inflows and/or outflows in a globalized financial system.

Key Challenges and Tensions in Reform

These dynamics provide a backdrop for understanding the challenges currently facing Chinese economic policymakers. Top leaders have governed for 30 years with two overarching goals:

preserving Communist Party leadership and enhancing the country's wealth and power, which Xi has branded the "China Dream." Growth has historically been a means for achieving both ends. Now reform is once again critical to sustain China's growth, as well as to address a widening array of imbalances and maintain the legitimacy of Party leadership.

The current generation of leadership has demonstrated that they understand this reform imperative. The reform document released following the Third Plenum represents a vision statement for the "major progress" leaders aim to achieve by 2020, and offers a to-do list for reaching these goals. It promises to give markets a "decisive role" in resource allocation, "perfect a mixed public-private economy," and "build an ecological civilization," all the while avoiding major instability and strengthening Communist Party leadership.

This would be an ambitious task for any government, and implementation remains fraught with challenges. China's leaders must break through powerful vested interests, many of which have strong influence within the Communist Party itself, from corrupt officials to powerful SOE bosses. Even where progress is possible, reform carries risk. Beijing must walk a tightrope between introducing market discipline in key areas, such as capital markets, while avoiding systemic shocks by liberalizing too quickly or in the wrong order. Other reforms, such as those designed to guide a difficult urbanization process, remain highly contentious and could provoke strong public backlash if not managed properly. Invariably mistakes will be made, and short-term volatility will likely rise.

Already in the first quarter of 2014, some of these challenges and tensions are evident. Several widely publicized bond defaults have been alternately hailed as a sign of Beijing's commitment to introduce market discipline, or bemoaned as worrisome indicators of a rough ride ahead. Weak industrial production numbers have provoked calls for stimulus, even as analysts have highlighted the continued importance of rebalancing towards greater reliance on domestic consumption. Beijing's challenges in reducing air pollution have also revealed the limits of command-and-control style tactics in enforcing solutions that are at odds with local aims. For example, leaders from Hebei, the poorer industrial province that geographically surrounds Beijing and causes much of the capital's pollution, are already complaining about the need for more central government compensation to blunt the pain of factory closures.[28]

Moreover, economic policymaking in China faces one core tension. Xi Jinping is aggressively centralizing political control. He has invested enormous political capital establishing reform as a necessity for China's success, and made clear his intention to drive towards this vision on an ambitious timeline. He has also engineered an institutional redesign that will strengthen Beijing's hand in implementing reform based on "top-level design." The decision to replicate the Reform

[28] For more on the challenges facing anti-pollution efforts in the Hebei-Beijing-Tianjin industrial cluster, see David A. Parker and Matthew P. Goodman, "China: Reform in the Air?" *Global Economics Monthly*, CSIS, February 2014.

LSG at all levels of government represents an ambitious attempt to improve local compliance with central mandates and consolidate lines of reporting.

But at the heart of market efficiency is democratized decisionmaking: allowing those closest to a situation to act according to their best interest. This has been a central component of China's economic success dating back to the beginning of the reform era in the late 1970s. The agricultural de-collectivization that touched off the country's economic miracle may have ultimately gained Beijing's approval, but it began as a local initiative undertaken without the central government's knowledge or permission. Likewise, the success of Shenzhen and other early special economic zones resulted primarily from opening to market forces and benign neglect rather than from top-down directives. And today the Chinese economy is orders of magnitude larger than during the last major round of reform, and many times more fast-paced, complex, and interdependent than during Deng's era.

The Third Plenum document clearly demonstrates Beijing's understanding of the need to rebalance the relationship between the state and the market in order to achieve CCP objectives. But Xi's efforts to tighten central control as a means of unleashing market reforms risk undermining the strategy: Beijing's dominance may well erode the same qualities of democratized decisionmaking and innovation that central reformers hope to unleash. This is particularly problematic given the array of objectives leaders have put forward, many of which contain contradictory elements. The question that will continue to loom over Chinese economic decisionmaking is whether there is an inherent contradiction between centralized authoritarian leadership and the "modern, harmonious, and creative society" that leaders in Beijing have committed to build.

Prospects for Reform and Growth

It would be a mistake to count China's leaders out. When it comes to achieving economic success, successive generations of Chinese policymakers have proven themselves highly adaptable and pragmatic; they have adhered to Deng Xiaoping's famous dictum, "It doesn't matter whether a cat is black or white, as long as it catches mice." Today's leaders have already taken a running start at reform, demonstrating a level of ambition and urgency not seen for over a decade. They have gathered a core cadre of respected economic policymakers to help guide them, sought advice from a global community of experts to inform their decisionmaking, including prominent international institutions and Nobel Prize-winning economists,[29] and made dedicated efforts to learn from their own history and the experiences of other countries.

[29] For example, the Development Research Center of the State Council, a central government think tank, and the World Bank have jointly authored two major reports on China's development in the past two years: "China 2030: Building a Modern, Harmonious, and Creative Society;" and "China: A New Approach for Efficient, Inclusive, Sustainable Urbanization." One prominent economist and Nobel Prize-winner who has advised China's leaders is A. Michael Spence. See Jonathan Schlefer, "Nobel Winner's Frank Advice to China's Leadership," *New York Times*, February 17, 2014.

They also have significant advantages. Top Chinese leaders may face a more pluralized policymaking environment, but they also maintain control of all major levers of power and have access to enormous financial resources, providing an array of options for coping in the event of a crisis. They also have various means of sidelining potential opponents of reform, from overseeing personnel reassignments to targeted corruption probes and the buying off of vested interests. China's still-emerging status also means that significant potential remains to outgrow core challenges, such as the buildup of local government and corporate debt. Meanwhile, the greater labor intensity of the service sector relative to heavy industry means that Chinese leaders may be able to meet their job-creation targets even with lower GDP growth.

Yet the risks and challenges facing China's leaders have clearly grown with the country's success. It is not a foregone conclusion that Xi Jinping and the current cadre of leaders will have the skill to navigate the narrow and treacherous course they have embarked on. A crisis is not inevitable, but neither can it be ruled out.

At a minimum, Chinese growth is likely to remain slower than the sizzling pace of the past three decades. This will result from both structural factors – tightening labor markets, declining returns on investment, and slower growth in external demand – and the near-term impacts of reform. While a shift towards more services- and consumption-led growth is essential to both providing jobs today and sustaining a high potential growth rate for the Chinese economy over the long-term, rebalancing will require a slowdown in the traditional sources of Chinese growth, chiefly investment. Indeed, a return to the 8-10 percent annual growth rates of the past should raise questions as to whether needed reforms are actually taking place. Some analysts argue that even the 2014 growth target of 7.5 percent is too high and will only be achievable through a further expansion of credit in the economy, setting the conditions for an eventual crisis.

Implications for U.S. Policy

The trajectory of Chinese growth and reform will have enormous implications for the U.S. economy and U.S. foreign policy. The United States has a strong economic interest in China making a successful transition to a more sustainable, market-led development model. Over the past decade, China has played an increasingly important role in driving global economic growth, accounting for roughly 30 percent of worldwide GDP growth in 2013. A rebalanced Chinese economy and robust Chinese middle class will offer significant new opportunities for U.S. investment and exports. Moreover, an economically successful China is likely to be a more stable China.

In light of these stakes, the U.S. government has a strong incentive to understand and support the process of economic reform in China. Given the characteristics of Chinese policymaking described above, Washington should continue to place priority on regular, high-level economic engagement with Beijing both to enable that understanding and to advance U.S. policy interests. Bilateral initiatives such as the Strategic and Economic Dialogue (S&ED) and Joint Commission on Commerce and Trade (JCCT) provide an opportunity to rise above the stove-piping endemic to Chinese decisionmaking and ensure top-level engagement on policy priorities. Ministerial-level engagement by itself is insufficient to address most key issues in the U.S.-China economic relationship; it is critical to secure cooperation from top leaders – i.e., vice premiers and state councilors – with the cross-cutting portfolios and level of authority needed to provide credible commitments that will be honored and implemented.

On key issues, Washington should also enhance its engagement at the local level. In addition to the embassy in Beijing, there are five other U.S. consular posts in China at present, four of which are located in major coastal cities. Given the diversity of China's regions and the important role played by local governments in economic policymaking, Washington should ensure that the "reach" provided by these posts is used to maximum effect in understanding reform dynamics and in pursuing U.S. economic interests.

U.S. policymakers should not be reticent about advocating forcefully for their interests with Chinese interlocutors. Despite the occasional appearance of indignation, Chinese leaders, as discussed above, use external pressure as a tool to drive reform. While avoiding the appearance of lecturing Beijing, U.S. policymakers should not hesitate to press their objectives in private or to hold China to progressively higher standards. Consistency of messaging is critical in this regard: Chinese officials listen carefully for differences of emphasis among their U.S. interlocutors and are quick to exploit these gaps.

In addition to bilateral engagement, multilateral economic initiatives such as TPP, the Transatlantic Trade and Investment Partnership, and the trade-in-services negotiations in Geneva can be other useful tools to encourage reform and opening in China. Indeed, they appear to already be having an effect; in addition to expressing interest in eventually joining TPP, there is some evidence that Beijing's decisions to move ahead with the Shanghai FTZ and to accelerate BIT negotiations with the United States were driven at least in part by Japan's entry into the TPP negotiations.

Of course, China's reform process will continue to be driven primarily by domestic imperatives, and there are limits to U.S. influence on events there. But given the stakes, it behooves Washington to continue closely monitoring the evolving institutions and processes of policymaking in China, and to actively seek engagement at all levels to understand these developments and, where possible, to shape them. ~