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CHINA'S ECONOMIC NAVIGATORS ENTER CHOPPY WATERS

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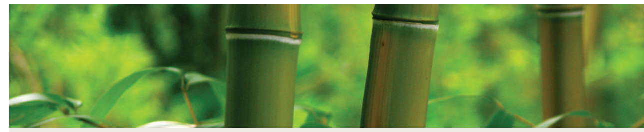
After 30 years of spectacular growth, has China hit a wall? Certainly the country's old growth model seems to be running out of steam: labor is no longer cheap, debt is rising at an alarming pace, and exports can no longer be the leading driver of growth. Even as the Communist Party leadership in Beijing has strongly signaled its commitment to rebalancing the economy toward more sustainable, consumption-led growth, policymakers face a staggering array of challenges. They must not only grapple with an economy orders of magnitude more complex than in the past but also respond to demands from an increasingly pluralized society. Do China's economic policymakers have the skill to navigate the more turbulent waters ahead?



Upcoming Events

- April 15: China's Economic Policymaking at a Time of Transition (CSIS)
- May 5–6: OECD Forum 2014
- May 5–15: APEC Second Senior Officials' Meeting
- May 12–13: WTO General Council Meeting

To be sure, the Chinese economy may well be able to grow for years to come at rates that most developed nations would envy. Policies to encourage balanced urbanization, greater reliance on services, and more consumer spending could yet unlock significant growth potential. These will also be critical in helping China to avoid falling into the "middle-income trap," shorthand for a World Bank finding that of 101 middle-income economies in 1960, only 13 have since graduated to high-income status.

But the policies needed to promote new drivers of growth will cut against vested interests, such as powerful state-owned enterprises (SOEs) and local government officials, who have benefited from China's old investment- and export-led economic model. An array of built-up imbalances, from growing debt burdens among corporates and local governments to endemic industrial overcapacity, will also constrain policymakers as they seek to introduce market discipline in key areas, such as financial markets, while avoiding systemic shocks.

Moreover, sustaining growth is only half the battle for Beijing. China's people are no longer united by the single-minded pursuit of wealth as they were in the past, meaning leaders must provide not only economic opportunity, but also clean air, clean government, and greater equality. They must do so at a time when the range of actors seeking to influence policy has dramatically expanded to include not only SOEs and private businesses, but also new or traditionally marginalized groups such as social media and civil society organizations. Together, these new players have made China's policymaking space increasingly messy, complicated, and, in a word, pluralistic.

President Xi Jinping and China's current generation of leaders have clearly taken notice. The 60-point resolution they released following the Third Plenum meeting last November constitutes a sweeping reform package designed to guide reforms through 2020. It promises to give the market a "decisive" role in allocating resources, to promote social equity, and to build a "beautiful China" through improved environmental management.

Statements from Premier Li Keqiang and key cabinet officials have further indicated a clear technical understanding of the challenges they will face in implementing this vision; however, it remains unclear how much of this will translate through a central policymaking apparatus that has been gridlocked for most of the past decade. Even if Li and his allies do succeed in wrangling Beijing's fractious ministries into line, they will still have to find new ways to change the incentives facing GDP-obsessed local leaders. Much of the nation's excessive investment is the result of these officials aggressively competing to meet central growth targets—while often lining their pockets along the way.

These challenges help explain Xi Jinping's aggressive centralization of economic policymaking following the Third Plenum. By creating and chairing the new "Leading Small Group for the Comprehensive Deepening of Reform," Xi is building a structural means for central leaders to bypass the state and drive reform through Communist Party

CHINA'S ECONOMIC NAVIGATORS ENTER CHOPPY WATERS *(continued)*

channels. The group, which will be headquartered in the secretive Policy Research Office and led by reclusive Politburo member Wang Huning, has been designated the primary body for ensuring major progress in reform by 2020, when its remit officially expires. In an unprecedented move, it will also be replicated at all lower levels of government, tightening Beijing's grip over the overall implementation of reform and helping leaders to more effectively impose top-level design.

Despite these structural innovations, many enduring characteristics of Chinese economic policymaking will likely remain intact. Skewed incentives and frequent jurisdictional overlaps will continue to hinder improved coordination among Chinese ministries. Nor will Beijing be able to fully bridge the gap between Zhongnanhai's policy pronouncements and local governments' policy preferences. Of course, this is not necessarily a weakness: local innovation has long been critical to China's development success. Indeed, in using experiments such as the Shanghai Free Trade Zone, as well as external pressure for change, Xi and the current generation of leaders are drawing from a playbook that many notable reformers, including Deng Xiaoping and hard-charging former premier Zhu Rongji, have employed to great effect in the past.

But leaders today also face one core tension as reform enters deeper waters. 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 success dating back to the beginning of the reform era in the late 1970s, when a process of agricultural de-collectivization begun at the local level touched off the country's economic miracle. Yet Xi's efforts to tighten central control could undermine his reform strategy; there is a clear danger that Beijing's dominance will erode the same market forces that reformers hope to unleash.

This is particularly important given the increased political necessity for leaders at all levels to balance competing—if not outright contradictory—objectives, few of which lend themselves to easy measurement. Beijing has had trouble enough setting reasonable GDP targets and ensuring that reported figures are accurate; top-down efforts to assess how well officials are protecting the environment or promoting fairness represent an even more daunting challenge.

It would be a mistake to count China's leaders out. Successive generations have proven famously adaptable and pragmatic, in keeping with Deng's famous dictum that "it doesn't matter whether a cat is black or white, as long as it catches mice." But clearly the number of policy objectives and policy actors in China has proliferated, and with them the complexity and risks of economic decisionmaking. Meanwhile, the question that will continue to loom 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 building. ■

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Simon Says…

Caijing magazine reported in March that Beijing was planning to relocate a number of central government offices to Baoding, a city best known in China as the "home of the donkey burger." The article prompted a flurry of speculation as to the motivations behind the move, which ranged from an effort to reduce Beijing's nightmarish traffic to a means of boosting a local economy suffering under twin anticorruption and antipollution crackdowns. Local authorities at first denied any knowledge of the plan, but by the time they copped to the truth a few days later, real estate markets in China's donkey capital had already received a sharp kick to the rear: average property prices in the area were up 10 percent. ■

Chinese dynasties throughout history were said to enjoy the "mandate of heaven"—that is, until they collapsed. An initial round of defaults has signaled that Beijing may be getting serious about allowing failure in Chinese financial markets, and many of the country's heavily indebted state-owned enterprises are wondering what kind of mandate they will face moving forward. As the chairman of one major state-owned enterprise told the *Financial Times*, "We will work very hard to achieve a good result, but sometimes men need help from heaven." Luckily for many Chinese CEOs, heaven is just a red phone call away. ■