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## Recent Events

- **Cross-Strait Relations Re-examined: Toward a New Normal?** Co-hosted by Freeman Chair China Power Project, and IIR (July 13, 2017)
- **Managing U.S.-China Relations: American and Chinese Perspectives** Co-hosted by the Freeman Chair in China Studies and Asia Program (July 6, 2017)
- **Export Financing in an Increasingly Competitive World: Challenges from China and Beyond** (with U.S. Ex-Im Bank president Charles J. Hall) Co-hosted by the Freeman Chair and Simon Chair in Political Economy (July 6, 2017)
- **Handicapping China's Credit Risks: A China Reality Check Event** Hosted by the Freeman Chair in China Studies (June 28, 2017)
- **20th Anniversary of Hong Kong's Handover: Reflections and Expectations** Hosted by the Freeman Chair in China Studies (June 13, 2017)
- **The Fat Tech Dragon: Baseline Trends in China's Innovation Drive** Co-hosted by the Freeman Chair in China Studies and the Technology Policy Program (May 25, 2017)

## CHINA'S ECONOMIC REFORMS HAVE HIT A WALL

SCOTT KENNEDY

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By almost any measure, China's economic performance over the past four decades is as impressive as the Great Wall is long. Since the late 1970s, the People's Republic of China has grown faster for longer than any country in history – ever. But just as the Great Wall wasn't as effective as popularly imagined, the foundation of China's economy is weak. Because of China's sheer size and its integration into global production networks, one thing is for certain: as China's economy goes, so goes the world's. Furthermore, the dangers of a malfunctioning Chinese economy are monumental, not just for China but for the United States and everyone else.

### An Unsustainable Model

From the late 1970s until 2010 China averaged more than nine percent real growth, but growth has fallen considerably since, coming in at **6.7 percent for all of 2016**. More troubling than the country's dive in growth is its collapse in productivity. All of China's growth now is achieved through mobilizing more money and labor, not improvements in human capital or technology. It now takes three times as much capital to generate a single unit of economic growth as it did in 2008. The result is an **explosion of debt** that now accounts for at least 280 percent of GDP, and could break through the 300 percent mark by year's end.

China has three strategies to arrest this trend. The first is to shrink the size of the old economy by reducing capacity in heavy industrial sectors dominated by lethargic state-owned enterprises, including steel and aluminum. The second is to expand the new economy by supporting high value-added services and advanced technologies. And the third is to reform local government fiscal systems while tightening regulation of new financial instruments such as wealth management products. The headline figures do reflect economic restructuring; services now count for more than half of the economy,

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high-tech manufacturing is expanding rapidly, and the issuance of new credit is slowing. But despite these efforts, productivity is still flagging.

The culprit is massive state intervention. In 2013, Chinese President Xi Jinping promised that the market would play a decisive role in the allocation of resources. In fact, Communist Party and government bureaucrats have increased, not decreased, their role in the economy via industrial policy and mercantilism, and factory closures and production cuts are now the purview of policymakers rather than businesspeople. Under the “Made in China 2025” plan and other similar initiatives, billions, if not trillions, are being thrown at strategic industries from semiconductors to artificial intelligence. That is why, for example, almost two dozen Chinese provinces are investing simultaneously in fabrication facilities to pump out memory chips. Companies and research institutes are filing worthless patents in record numbers because they receive a fee from bureaucrats for doing so. And state-backed credit is still flowing freely to high-priority projects around the country, which is why the economy grew at 6.9 percent in the first quarter of 2017 despite tepid private-sector enthusiasm.

The era of economic reform and openness that Deng Xiaoping launched in 1978 was built on a foundation of gradual liberalization at home and greater openness to the outside world, albeit with the caveat that the Communist Party’s monopoly hold on power would not be threatened. Under President Jiang Zemin and Premier Zhu Rongji China entered the World Trade Organization in late 2001 with the aim of using globalization to liberalize China’s economy and make it more efficient. That commitment waned under the next leader, President Hu Jintao, but he was weak and was pushed and pulled by conservative and liberal forces, leading to policy that bounced between various goals and tactics.

### An Unlikely Liberal?

Xi Jinping not only does not believe in markets, but he is also far more powerful than his predecessors. Despite the promises of reform he made in 2013, he was always a fair-weather liberalizer, and as soon as clouds formed over the housing sector in

## In the News

“The U.S. will need help from its allies to convince the Chinese to slow production of goods like steel... but so far the Trump administration has criticized them, too.”

—Scott Kennedy on CNBC, “The US alone can’t end its trade deficit with China, expert says”  
July 19, 2017

“The consensus of the US group is that the recent meeting between our two presidents in Mar-a-Lago, Florida was a good start. Mutual understanding was deepened, especially on sensitive issues like the DPRK and bilateral trade relationship. It requires bold action and risk taking from both our two countries to achieve the type of win-win result.”

—Christopher K. Johnson in CGTN News, “China and US explore new pathway to a win-win partnership”  
May 22, 2017

“China is happy with the status quo, it benefits tremendously from the current economic relations with the United States and wants to keep it. It tries to avoid any big problems, and [the dialogue] will achieve China’s baseline results of limiting the potential for a major trade war.”

—Scott Kennedy in *Market Watch*, “U.S. and China have diverging goals ahead of trade talks”  
July 17, 2017

“Guo would certainly be a very disruptive wild card at Mar-a-Lago.”

—Christopher K. Johnson in the *New York Times*, “As Trump Meets Xi at Mar-a-Lago, There’s a ‘Wild Card’” April 4, 2017

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2014, Xi quickly resorted to intervention to shift money into the stock market the following year. The sudden fall of the Shanghai and Shenzhen bourses that summer was met with ham-fisted measures that beget additional intervention. Reform now means not marketization but strengthening the state.

Some elements of foreign industry are benefiting from Beijing's state capitalist approach. American companies selling consumer durables and services, transport goods, and construction equipment are doing quite well in China, thank you. But a growing number of foreign producers -- particularly those at the high end of the value-added chain -- now find targets on their backs placed there by China's industrial policy dons. Survey after survey shows foreign companies feeling less welcome. Although even obtaining a small slice of the massive Chinese cake brings substantial income, China's claim that it supports win-win outcomes with the world is now wryly understood to mean "China wins, China wins."

However, if China, Inc. continues to compete and win unfairly, all will end up losing, especially China. Its economy can't continue to run on a fattening diet of industrial policy stimulus. The global competitive landscape and business models of industries, even when operating far beyond China's borders, also will be harder to sustain in the face of bottomless financing from Chinese sources. And all of this could translate into macroeconomic instability and volatility around the world.

There are several ways this trajectory could be reversed, but none are highly likely. Some believe that Xi may be intentionally acting as a conservative nationalist for now so that he can consolidate his power and unleash a program of liberalization at a later time, perhaps after this year's 19th Party Congress. This is probably little more than wishful thinking, however, and the Xi we see is likely the Xi we will have to live with. He is more likely to double down on state intervention in his second term than to reveal himself as a true liberal.

An economic crisis might also present Xi with a stark choice, but China has many ways to avoid a full-blown meltdown; it boasts a huge pool of savings and holds very little foreign debt. Even if a crisis emerged, perhaps as the result of a chain reaction involving

## Podcasts

**LISTEN** Carnegie Council for Ethics in International Affairs Podcast: "Scott Kennedy of CSIS: Worst Case Scenarios for China's Global Economy" (June 27, 2017)

**LISTEN** CIPS Podcast: A Conversation with China economist Arthur Kroeber on China's High-Tech Drive (June 20, 2017)

**LISTEN** CIPS Podcast: A Conversation with China tech explorer Alberto Moel (June 8, 2017)

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the collapse of housing prices and defaults on bonds and other financial instruments, it isn't clear how Xi would respond. The 1998 Asian financial crisis is instructive. Kim Dae-jung of South Korea broke up several of the country's leading conglomerates and banks and opened up the economy. By contrast, Malaysian Prime Minister Mahathir Mohamad inserted capital controls and strengthened state involvement in the economy. Xi clearly more closely resembles the latter figure.

### Wrongheaded Protectionism

This leaves foreign influence as the last way to encourage economic liberalization and a more balanced relationship with the rest of the world. Unfortunately, the Trump administration threw away the best tool to incentivize China to change when it abandoned the Trans-Pacific Partnership, an agreement that would have lowered barriers for trade in goods, agriculture, and services, and would have created entirely new rules to govern the behavior of state-owned enterprises, e-commerce, investment, and government procurement. With China on the outside looking in, it would have had to reform on the world's terms to avoid being shunted from the superhighway of the global economy into a cul-de-sac. It is unlikely that similar bilateral agreements between the United States and individual TPP states would be nearly as effective, and although other multilateral and regional deals are under negotiation -- such as the WTO's Environmental Goods Agreement and the Asia-based Regional Comprehensive Economic Partnership -- Beijing has enough leverage to ensure that such pacts produce limited concessions.

With little domestic pressure and no substantial multilateral or regional tools, the entire burden appears to be on the shoulders of high-stakes U.S.-China negotiations. President Trump talked a mean game during the campaign but has moderated his tone since, including refraining from labeling China a currency manipulator. At the Mar-a-Lago summit in April, Trump and Xi agreed to a 100-day negotiating period in pursuit of initial progress in rebalancing the relationship between the two powers. Chinese officials believe they have tamed Trump and can avoid major penalties by taking token steps to shrink the trade surplus -- perhaps by buying more American beef, fossil fuels, and Boeing jets. Given the need for China's help on North Korea, it is

## Interactive Website

**China Innovation Policy Series (CIPS):**



**DID YOU KNOW?** Launched in late 2016, CIPS analyzes technology innovation trends in China, both generally and in specific areas, including the Internet, new-generation vehicles, semiconductors, artificial intelligence, commercial aircraft, and pharmaceuticals. CSIS hosted a roundtable event on May 25, 2017, to discuss the findings of the first project report, which examines general trends in innovation in China. The event featured CSIS Technology Policy Program director Denise Zheng, who served as moderator, and guest speakers Albert Moel (Sanford Bernstein), Arthur Kroeber (Gavekal Dragonomics), Ted Dean (CSIS nonresident senior associate), and Lubing (Larry) Lian (U.S. Patent & Trademark Office). The full report will be published in late August 2017. [LEARN MORE](#) about the project here.

## Recent Publications

**“Chinese Politics Has No Rules, But It May Be Good If Xi Jinping Breaks Them,”** *CSIS Report*, August 9, 2017.

**“The Stalemate in U.S.-China Economic Talks: Turning a Corner or Going Around in Circles?,”** *CSIS Commentary*, August 3, 2017.

**“No Rabbits Pulled Out of Hats at the Comprehensive Economic Dialogue. Now What?,”** Claire Reade, *CSIS Commentary*, August 1, 2017.

**“President Xi Jinping’s Belt and Road Forum,”** Christopher K. Johnson, Matthew Goodman, and Jonathan Hillman, *CSIS Critical Questions*, May 9, 2017.

possible Trump may take the easy deal. However, because of his longtime complaints about unfair trade and the arrival of U.S. Trade Representative Robert Lighthizer, it is just as likely that Washington will insist China demonstrate a real commitment to constraining its industrial policy machine.

Enlightened decision-making appears to be in short supply on both sides of the Pacific these days, and a failure by China to return to a reformist path could do irreparable harm not only to its own economy but to the liberal international order, and set the two superpowers on the path toward a trade war.

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## Recent Publications *(continued)*

**“Donald Trump’s First Summit with President Xi Jinping of China,”** Victor Cha, Bonnie Glaser, Matthew P. Goodman, Michael J. Green, Christopher K. Johnson, and Scott Kennedy. *CSIS CogitAsia*, April 3, 2017.

**“Did Tillerson’s Beijing Visit Box Him in, or Start a Reboot?,”** Scott Kennedy and Shen Dingli, *Foreign Policy*, March 29, 2017.

**“Tomb Sweeping Day: Deadline for a U.S. China Policy,”** Scott Kennedy, *CSIS CogitAsia*, March 14, 2017.

**“The WTO in Wonderland: China’s Awkward 15th Anniversary,”** Scott Kennedy, *CSIS Commentary*, December 11, 2016.

**“How the United States and China Can Avoid Greater Tensions,”** Scott Kennedy, *CSIS Commentary*, November 10, 2016.

**“Now China’s ‘Core’ Leader, Xi Jinping Looks to Dominate Leadership Shuffle,”** Christopher K. Johnson and Scott Kennedy, *CSIS Critical Questions*, October 28, 2016.

## FREEMAN CHAIR IN CHINA STUDIES

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