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China's Economic Reckoning

The Price of Failed Reforms

Daniel H. Rosen

Many observers look at China and see its leadership playing a masterful game. They see China refusing to bend its policies to fit global norms and successfully going its own way. The reality is that Beijing has tried to bend repeatedly under President Xi Jinping but has almost broken each time and has had to fall back on its old ways—which are not succeeding. The quantity and the quality of China's growth (looking past the anomalies of the pandemic period) have both deteriorated. And unless the leadership of the Chinese Communist Party finds its way back to the path of economic liberalization, China's future will look very different from the rosy picture the CCP paints.

The urgency of reform is a happy result of China's rise to middle-income status from the extreme poverty it experienced just a few decades ago. It is nothing to be ashamed of. But the applause that China has earned for its economic successes will subside if Xi fails to tolerate policy debate and accept more constrained political ambitions that admit the limits of the CCP's capabilities.

An honest assessment of recent setbacks suggests that time is running out. Investors and businesses in China and abroad, as well as other governments, have so far gone along with the pretense that China is either succeeding at reform or understandably choosing to defer it; few have been willing to conclude that China has tried to reform but failed. Xi may believe that he has another decade to tinker with the country's economic model. Taking stock of the many major policy plans that the CCP has launched but then abandoned indicates otherwise: there are at most a few years to act before growth runs out. If China's leaders wait until the last minute, it will be too late.

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STUCK IN THE MIDDLE

In recent years, China hawks in the United States have asserted that they were right all along: China has not reformed and never intended to do so. Some have even suggested that the CCP has been deceiving Washington since 1972, when U.S. President Richard Nixon went to China and normalized relations with Beijing. China, according to this view, was merely feigning an appetite for liberalization. That is a misreading of China's economic path. During the reform era ushered in by Deng Xiaoping in 1978, the party relaxed its control over economic forces such as inflation, internal capital flows, and unemployment. To stoke growth and innovation, Beijing let foreigners into strategically sensitive corners of the Chinese economy, such as telecommunications and aerospace. Sacred cows of communist ideology were sacrificed along the way. When Deng began the reform process, the state was setting almost all prices for goods and services; by the time China joined the

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World Trade Organization in 2001, all but a few prices were being set by market competition. In the 1990s, the CCP allowed more than 100,000 state-owned firms to close, resulting in more than 20 million layoffs. By 2020, the party had let foreigners build businesses in China worth $3 trillion, many of them in direct competition with Chinese incumbents.

As significant as these policy moves were, however, they were the easy part: they mostly required bureaucrats to simply get out of the way. Officials didn't grow a market; they let a market grow out of a morass of government planning. Reduced state intervention and the dismantling of cross-border investment barriers, internal fees, and taxes transformed China's economic trajectory. In the decades after 1978, annual GDP growth rates of 5.5 percent or less—typical for low-income countries—accelerated into the double digits, turning China into an economic juggernaut.

But by the time the global financial crisis hit in 2008, Beijing had picked all the low-hanging fruit. To ensure continued strong growth, the party needed to lean in, promoting good governance and fair competition and imposing hard constraints on wasteful investment—delivering on the challenges faced by any successful modern regulatory state. For the next four years, however, easy credit became Beijing's main tool, and annual debt service costs catapulted from an estimated three trillion to eight trillion yuan. When Xi rose to the top of the CCP in 2012, growth had slowed to single digits, and the return on state investments in infrastructure was falling. This is what economists call "the middle-income trap": once a country emerges from poverty, it becomes harder to deliver growth.

Xi came to power with a mandate to take charge. From the start, he moved to consolidate his own authority, shrinking the Standing Committee of the Politburo from nine members to seven and personally chairing virtually all the important groups responsible for policymaking. As his point person on the economy, Xi chose Liu He, a well-known proponent of marketization. Xi set a high bar for reform, issuing a manifesto in 2013 known as the "60 Decisions." He pledged to make the market "decisive" in guiding economic outcomes and to recast the role of the government in a manner that liberal Western economists would welcome: maintain macroeconomic stability, deliver public services, ensure fair competition and regulation, and address market failures. Xi was convinced by his economists that without bold action, China would face its own internal debt trap. If the party failed to transform the economy, Xi wrote during his first year in office, "we will find ourselves in a blind alley."

Liu got to work. In the spring of 2013, policymakers set their sights on parts of the financial system that were swelling with risky liabilities. Banks were issuing short-term wealth management products at high interest rates and using the proceeds to invest in riskier long-term assets. The People's Bank of China, the country's central bank, decided to shock those banks into better behavior by cutting off their access to short-term funding. The move had massive unintended consequences: the banks were so surprised that they

stopped lending immediately, causing short-term borrowing rates to rise from around two or three percent to between 20 and 30 percent. Chinese stock markets plummeted by more than ten percent as traders tried to access cash through any liquid asset available. The PBOC quickly backed down and restored short-term funding to banks. As the central bank had feared, however, this only invited more risk-taking. From 2013 to 2016, borrowing via the short-term money market quintupled, and there was an explosion of so-called shadow lending, with Chinese banks providing money to third-party institutions, which in turn sought higher returns by going through unregulated channels (such as offering margin loans for stock market speculation) and by lending to riskier borrowers.

TWO STEPS FORWARD, TWO STEPS BACK

This interbank market crisis was just the first sign of what has become a pattern during the Xi era: bold attempts at reform followed by retreats when those attempts trigger instability and upheaval. The pattern recurred in 2014, when Beijing took steps to make it easier for Chinese companies to invest abroad directly, a necessity if they were to graduate from manufacturing basic goods for export to running global businesses. And invest they did, with outward foreign direct investment rising from $73 billion in 2013 to a high of $216 billion in 2016. The explosion of outbound investment was far more significant than anyone had anticipated. Some of these investments earned China bragging rights as a global player—the acquisition by Anbang Insurance of the Waldorf Astoria, for example, and the financing of a venture with Carnival Cruise Lines by the China Investment Corporation, a sovereign wealth fund. But as these foreign assets piled up, China's foreign exchange reserves, built up over years thanks to consistent trade surpluses, fell by almost a quarter (from nearly $4 trillion to below $3 trillion) as Chinese players sought dollars to invest abroad. By the end of 2016, the CCP, anxious over the rapid outflows, decided that reform could wait and reimposed capital controls. Outbound investment has been stagnant ever since.

Tax policy was another area in which Xi moved aggressively at first. In June 2014, the Politburo approved a national fiscal and tax reform plan that, among other things, called for the Finance Ministry, headed by Lou Jiwei, to rein in the borrowing and spending of local governments and to introduce property taxes. Those tasks were supposed to have been completed by 2016. Five years past that deadline, however, the ministry has made little progress; local government debt has actually increased since the reforms were initiated, and the now retired Lou has publicly warned about the fiscal risks looming over the system.

Knowing that government spending could not fuel growth forever, Xi's team turned to the corporate sector. Xi pledged to reduce the overbearing role of the state and to make room for businesses to manage their commercial activity with less political interference. Pilot programs set out to empower independent directors to make decisions on strategy and leadership, paring back the role of CCP committees. Other

reforms were supposed to clarify which industries were well suited to market competition and which required continued state control. Both of those efforts stalled, however, and since 2017, the party has retained its hold on all corporate affairs at state-related companies and has sought to increase its influence over private firms, including foreign ones.

When Xi came to power, the party also tried to unleash equity markets to ease the financing burden on state banks. The debt levels of local governments and state-owned enterprises were a constant worry, and the prospect of using equity-market listings to deleverage was irresistible. Beijing envied the dynamism of Western stock markets. In 2013, the government simplified the requirements for initial public offerings, and within a year, 48 IPOs had been completed and another 28 had been cleared by regulators. Officials also lifted restrictions on margin trading, and editorials in state-controlled newspapers encouraged people to pile into increasingly bubbly stocks. Soon, China saw the downside of its gambit. In June 2015, after official support for the unsustainable trend was called into question, the bubble burst: within a month, the market lost a third of its value. Today, despite a substantial expansion of the overall economy, the market remains 25 percent below its 2015 high.

UNINTENDED CONSEQUENCES

Banking was another area in which Xi hoped to make strides. In October 2015, the PBOC announced a long-awaited milestone: the full liberalization of interest rates on bank deposits and loans. Those rates had previously been set by the central bank with guidance from the State Council, the central government's chief administrative authority. That system prevented banks from competing with one another for depositors and borrowers. Until the early 2010s, rates were fixed far lower than market conditions would have dictated, which meant households were effectively subsidizing state borrowers: depositors should have received higher rates on their savings, and borrowers should have paid higher lending rates. That had the effect of encouraging overinvestment by state-owned enterprises in industries that were already dogged by overcapacity and reducing household consumption.

To address these problems, the central bank permitted banks to compete by offering depositors interest rates up to 50 percent above official benchmark rates; the ceiling had previously been just ten percent. Soon after, the deposit rate cap was eliminated altogether—in principle. In practice, banking officials worried that smaller banks would create instability if they competed based on market forces, and so they maintained an informal rule that deposit rates should remain no more than 50 percent higher than the benchmark rate. Those training wheels remain in place today: interest rates have been nominally liberalized, but little has truly changed, and banks are still restricted in how they can compete for customers.

Another goal of Xi's financial liberalization strategy was to secure the International Monetary Fund's recognition of the yuan as a reserve currency worthy of inclusion in the basket of currencies on which the IMF bases its Special Drawing Rights (SDRs), a unit

of account that central banks use to make transactions. The PBOC hoped that if the yuan had that status, it would encourage other central banks to purchase assets denominated in yuan, making China's markets more attractive to foreign investors.

The trouble, however, was that currencies in the SDR basket are supposed to be freely usable in international transactions and traded frequently. China's capital controls made it hard to meet those criteria. To get around that stumbling block, Beijing claimed that there was in fact a liquid market for yuan—in Hong Kong, which maintains an offshore yuan market where currency rates can fluctuate more than in China itself. The problem with this workaround became clear when Beijing suddenly depreciated the yuan in August 2015 in an attempt to unify prices on the mainland and in Hong Kong. Alarming capital outflows resulted, facilitated by the very Hong Kong market that the PBOC had been promoting.

The IMF did eventually agree to add the yuan to the SDR basket in November 2015. At that point, China's central bank backed away from liberalizing the Hong Kong currency market, squeezing the liquidity out of it and diminishing its role as a trading center. Six years later, the offshore pool of Hong Kong yuan remains small, the currency still accounts for only a limited share of international cross-border transactions and a modest proportion of global foreign exchange reserves, and China's capital controls are still in place.

By the summer of 2016, Liu and the rest of the CCP leadership had grown weary of the risky lending activity that had led to the stock market bubble and the interbank market crisis. China's financial system, they feared, was starting to look like that of the United States before the subprime crisis of 2007–8. So Beijing embarked on a deleveraging campaign to shrink the shadow banking system and reduce systemic financial risks. First, the central bank fixed short-term borrowing rates higher, which raised overall interest rates but did not significantly reduce credit volumes. Then, Beijing toughened regulatory rules to prevent banks from parking funds with third-party institutions in order to skirt regulations. As planned, the volume of new credit fell, but this had the effect of throttling the economy throughout 2018, because it turned out that borrowers from shadow banks were not only engaged in speculation but also investing in property development and local infrastructure. Once again, Beijing had to pull back, abandoning its aggressive deleveraging efforts and allowing credit to rise again, particularly for local governments.

The pattern of restoring central control after failed attempts to liberalize may be reaching its apex in one of the most important stories to come out of China in the past year: Beijing's crackdown on financial technology firms. This has led to antitrust actions against the technology giants Alibaba and Tencent and the shelving of an initial public offering for Ant Group, an Alibaba subsidiary.

The CCP has presented these steps as pro-consumer reforms, which seems reasonable in a world where many other countries are looking to rein in their tech titans. But for Beijing, the moves mark the end of a crucial financial opening. In the early 2010s, these firms

were given a free hand by party technocrats who hoped that financial innovations would force ossified state-owned banks to become more productive. This succeeded, at least in fits and starts: the new firms made the financial system work for previously underserved customers. But innovation also came with new risks, such as peer-to-peer lending platforms that offered high rates to depositors and even higher rates to borrowers. When many of the borrowers defaulted, investors protested, believing erroneously that the platforms were guaranteed by the government. In August 2018, thousands of people showed up in the heart of Beijing's financial district to demand compensation. A regulatory crackdown on peer-to-peer lenders commenced, in a prelude to this year's scrutiny of Ant Group. The crackdown has been successful in reducing financial risks, but it has also reversed the benefits of reform, as many low-income consumers now have fewer choices in accessing credit.

The pattern of macroeconomic policy in the Xi era is clear: each attempt at reform has produced a miniature crisis that has threatened to become a bigger one, prompting the CCP to revert to what it knows best—command and control. The official line, of course, is that there were no failures and that China is inexorably marching forward with Deng's agenda of "reform and opening." In a speech in December 2020, Xi boasted of having launched 2,485 reform plans, meeting the party's targets on schedule. The next month, the official newspaper, the *People's Daily*, concurred, saying that 336 high-priority reform goals had been "basically accomplished" and lauding "significant breakthroughs in comprehensively deepening reform."

Privately, Chinese economists acknowledge that this is not the case. But they contend—not without merit—that the challenges afflicting market economic systems since the global financial crisis provide ample reason to proceed slowly. As Chinese Vice President Wang Qishan reportedly told then U.S. Treasury Secretary Henry Paulson in the midst of that crisis: "You were my teacher, but now here I am in my teacher's domain, and look at your system, Hank. We aren't sure we should be learning from you anymore." During the Trump era, even the United States—long the world's leading proponent of economic liberalization—seemed to call its free-market convictions into question.

But the real story is neither China's reform success nor its reform hesitancy. Xi has tried but largely failed to push ahead with the agenda that Deng launched in 1978 and that Xi's predecessors all sustained. The consequences of that failure are clear. Since Xi took control, total debt has risen from 225 percent of GDP to at least 276 percent. In 2012, it took six yuan of new credit to generate one yuan of growth; in 2020, it took almost ten. GDP growth slowed from around 9.6 percent in the pre-Xi years to below six percent in the months before the pandemic began. Wage growth and household income growth have also slowed. And whereas productivity growth—the ability to grow without needing to use more labor or resources—accounted for as much as half of China's economic expansion in the 1990s and one-third in the following decade, today it is estimated to contrib-

ute just one percent of China's six percent growth, or, by some calculations, nothing at all. All these data points signal a loss of economic dynamism.

HIGH STAKES

Why is it important to understand that Xi did not resist reform but instead failed at it? The reason is that when it comes to China's prospects, perceptions matter. If investors, businesses, and other governments believe that Xi has spurned reform but that China can deliver growth without it, then they will endorse and invest in Beijing's model. But if they understand that Xi has in fact attempted to liberalize but retreated to a low-productivity command-and-control economy, then they will hesitate, if not withdraw, and insist that Beijing do the hard work of policy reform before it can earn their trust.

Based on Xi's own belief that without reform China will hit a dead end, a reckoning appears to be inevitable. The question is when it will arrive and whether Beijing will take the bold steps that every country that has escaped the middle-income trap has been forced to take. Skeptics of China's continued progress have been wrong before, and they must explain what is different now to justify their bearishness. Three factors are most compelling. First, in recent years, interest on debt alone (never mind principal) has grown to double the value of annual GDP growth: this situation is causing bank failures, restructurings, and major defaults of state-owned enterprises. Second, for the first time since the mass starvations of the catastrophic Great Leap Forward, the working population is shrinking, which will result in a smaller labor force and fewer people buying property in China's oversupplied housing market. And third, from 1978 to about 2015, the United States and other world powers went out of their way to engage with China and smooth its path to global opportunities. That is no longer the case, even if open-market democracies have not formed a consensus about the right stance to take on China going forward. In many ways, the tailwinds China enjoyed from global enthusiasm about its rise have become headwinds.

If Beijing cannot induce private firms to ramp up their investment and cannot persuade major economies to remain engaged with China, then the country's clear economic outlook will cloud over. Xi-era reform efforts have already precipitated a series of minicrises, each one shrinking the space for trial and error in the future. The high-tech wizards whom the CCP was so recently celebrating as the heroes of a new digital future are now scurrying to prove their fealty to the party rather than pushing officials to allow them to compete and innovate more aggressively. With business and household debt levels already extremely high, China can scrape out perhaps two or three more years of economic stability by piling on further loans, as long as global capital flows and supply chains do not dry up. If firms and investors do pull back, or if China needs to raise interest rates more aggressively at home, a reckoning could happen much sooner.

Beijing has options to ease this transition, but it cannot avoid it. Unlike Japan when its asset bubble popped in 1991, China is not a mature, high-income nation. Growing rural incomes will make China stronger but will not

produce trophy cities or high-tech machines. Xi's "dual circulation" campaign envisions a revolution in consumer spending. That, too, is a possibility, provided Beijing shifts from supporting firms to forcing them to serve consumers. And by selling off state enterprises, China could raise trillions of dollars to retire debt, fund health care, and pay for carbon abatement, all while stoking healthy private competition. These and many other avenues to sustainable growth are available. But in each case, the party's insistence that in "government, military, civilian, and academic; east, west, south, north, and center, the party leads everything" would have to be sacrificed—and to date, that has been a bridge too far.

At some point, China's leaders must confront this tradeoff: sustainable economic efficiency and political omnipotence do not go hand in hand. Throughout history, leaders faced with this conundrum in China and elsewhere have tried to hide falling productivity to buy time and keep searching for a way to have it all. And indeed, a number of statistics have lately been made unavailable in China. Beijing will point to its record of exceptionalism, but if it were to find a way to maintain stability, state control, and economic dynamism all at once, it would be the first country in history to do so. In light of the muddled reform record of the Xi years, skepticism seems justified.

If China meets the fate of other middle-income nations that failed to reform their way out of declining productivity, the picture will darken. Asset prices for property and corporate bonds will fall significantly, causing political discontent as people see their wealth evaporate. With faltering confidence and too much riding on the credibility of government promises to ensure stability, new investment will dwindle, job creation will slow, and the tax and revenue base will shrink. All of this has already begun to happen, but Beijing will be forced to make much harder choices going forward.

That will mean a time of painful austerity for China and also for its partners abroad, who have come to count on China as a buyer of iron ore, a purveyor of development assistance, and a direct investor in startups and many other enterprises. This will have immense geopolitical consequences, as a recalibration of great-power competition takes place. Beijing could turn more belligerent in search of solutions. Conversely, it could return to the domestic development focus of prior years, reverting to Deng's admonition to keep the party's focus limited.

Economists are not well equipped to predict which grand political choices leaders will make. History does demonstrate, however, that every nation graduating to high-income status has gone through systemic crises, especially in banking. Those that accept the necessity of adjustment and jettison the fantasy of efficiency without reform come out more competitive. China has a strong legacy of embracing reform and adjustment, which has accounted for its rise. Reform is not a Western agenda being pushed on China: it is China's modern birthright. After a decade of failed efforts to carry it out, Beijing is looking for an easier way. Xi must rediscover that reform is the hardest route, except for all the others.