China Economy On Track For Sweeping Reform, Asia Society Report Finds

By Michael J. Casey

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China’s leadership is making real headway in an ambitious program to liberalize its economy and if all goes according to a new detailed analysis of the reform agenda laid out at last year’s third plenum of the Chinese Communist Party.

The study by the Asia Society Policy Institute in collaboration with the Rhodium Group stands in contrast to a pessimistic take by U.S. think tank the Conference Board, which on Monday predicted China’s government would fail to push through a difficult economic overhaul and cause growth rates to slow to 3.9% over the coming decade. Such a sharp decline from a current annual rate of 7.3% — according to a third-quarter GDP report released Tuesday — would likely have dire consequences.

As the Asia Society report notes, there is much at stake in these competing projections. With its share of global growth having gone from 4% in 1997 to 28% now, “China is more interdependent with world markets than [other] nations going through a middle-income policy shock have been,” the report’s author, Asia Society Policy Institute fellow Daniel Rosen, wrote. “China’s current reforms will shock the world.”

In coming up with a 6% forecast for what Mr. Rosen describes as “potential growth” — that is, if all reforms are fully implemented — his report focuses on nine “clusters” of economic and political reform aimed broadly at reducing centralized control over the Chinese economy and opening it up to more market...
influence.

In all, Mr. Rosen's analysis finds that quiet progress is being made in some politically sensitive areas of reform, a view that contrasts with critics who say that a lack of key developments such as the creation of a deposit insurance scheme are stymying vital liberalization of the financial system.

Mr. Rosen said the starting point for the reform agenda is not the interest-rate liberalization proposals or plan to open up cross-border capital flows that many economists focus on, but a more fundamental overhaul of the fiscal relationship between the central government and the provinces. This is "the true bellwether of China's direction," he wrote in the report.

The current arrangement has allowed "an imbalanced division of power and responsibility between central and local authorities [which] has given rise to pressing misallocations of resources and provincial resistance to central reforms," Mr. Rosen wrote.

But on a positive note, he added, "In a pattern we identify in most other regulatory areas as well, evidence of follow-through was apparent in 2014."

In an interview, Mr. Rosen said he viewed the anti-corruption campaign orchestrated by President Xi Jinping as a sign of a serious commitment to shake up an inefficient and privileged bureaucracy rather than as a political score-settling exercise as some have described it. That and the other political reforms set the stage for a more comprehensive overhaul that's needed to shift the economy from its current, unsustainable dependence on investment-led growth to a more consumer-focused model.

Mr. Xi has been a key driver of this process, Mr. Rosen said.

"Xi is the first leader since 1998 who didn't come in with [economic] tailwinds behind him," Mr. Rosen said. "Xi Jinping really did understand that it wasn't going to be business as usual anymore. China was going to need a radically different set of policy reforms and regulatory tools if it was to meet its potential."

But Mr. Rosen warns that if Mr. Xi fails to properly shift the Communist Party and government away from a role as central planner to one of regulating a market economy and providing services such as health and welfare, it will pay a heavy price from the waning productivity gains to be had from continuing its investment-led economic growth model.

"Growth driven only by investment would mean a hard landing in 2020: no better than 3% annual GDP growth," he wrote. "Falling productivity could easily pull private investment down with it, leaving GDP growth even lower at 1%, surely a crisis."
Figure 1: China’s GDP Outlook with and without Reform

GDP growth (% change year-on-year)

Credit: Asia Society

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