Chinese Option

Anticipating the Third Plenum.

BY DEREK SCISSORS

In November, China's Communist Party will hold its plenary meetings. It is all but guaranteed the autumn plenum will see announcement of what are termed fundamental economic changes, as has occurred in several previous autumn plenums. What is in doubt is the nature of the changes and whether they will be implemented. Most attention is focused on likely opposition from Party cadres who benefit from the existing state-led development model. But there is a prior issue: What does the Party mean by "reform"?

Foreign governments, businesses, and experienced observers typically consider reform to be some variant of narrowed state ownership, increased competition, or both. That is, reform is market-driven. But a state-led model was adopted at the autumn 2003 plenum. It has generated a slew of economic and quasi-economic problems, with solutions that may not be market-driven, for example state action to encourage urbanization. What the Party chooses could well be important, even somewhat valuable, but involve little liberalization.

This would spur another debate about China's direction—optimists citing actions to address major problems and pessimists a liberalization failure as ensuring stagnation. This debate, however, would not extend to foreign decision makers. These are not interested in how wise the Chinese state might prove this time, they want it rolled back in their nations' commercial interests. If Beijing chooses the wrong kind of reform, no matter how it is packaged, the People's Republic of China could be seen as more trouble than it's worth. Exclusion from what could be transformative U.S.-led economic partnerships would be likely.

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Market reform need not fail. The Party has a range of options to choose from. The obvious one is to take a cue from the first step in 1978 and offer farmers more property rights. This would increase both land and labor productivity, the latter growing in importance as China's population ages. Labor could be addressed directly through reform of the household registration system, which determines place of residence and associated benefits. The unrealized benefits from (far) greater labor mobility are considerable, including to multinationals operating locally.

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The Party has been preoccupied with boosting innovation. Broad, sustained innovation relies on competitive pressure. Regulatory and financial protection of some state-owned enterprises could be rolled back, increasing the number of sectors where sustained innovation is possible. In particular, competition could be greatly improved through finance. If a schedule for opening the capital account is published and followed, even state-owned banks would face indirect competition from overseas and be forced to act as much more efficient intermediaries.

This is certainly not what Beijing has done, at least not yet. One reason to anticipate that the plenum will not generate market reform is the high ratio of public relations efforts to liberalization so far this year.

Most of the talk, along with some action, has been in finance. A bit of competition has been introduced in the form of removing interest rate controls on loans. Also, a series of pilot programs have been created—the latest being the much-heralded "Shanghai Free Trade Zone"—where outward investment is supposed to occur more freely, among other things. But pilot programs along these lines have failed, because the Party remains terrified of mass capital flight. The Party also fears internal banking competition and real deposit rate liberalization is moving very slowly. There have been anti-competitive steps, such as raising the capital requirement for new bank branches.

Elsewhere, even less is going on. Mixed signals have been sent on where exactly private investment is allowed, and the places where it is clearly solicited feature such established money-losers as railways. There have been piecemeal changes in rules affecting labor mobility but liberalization here must be uniform or it risks doing more harm than good. Limited efforts at land reform have to now studiously avoided any elements of private ownership.

An obvious possibility is that General Secretary Xi Jinping and the rest of the Standing Committee are waiting for the plenary meetings to adopt serious measures in one or more of these areas. But a Party leadership that to now has preferred market reform talk to action faces many distractions.

Two kinds of word and deed are all too likely to come out of the plenum. One is inauthentic market reform, the other is real change that is manifestly not market reform.

There are a number of actions that the Party will try to describe as market reform. The first is changing industrial structure—shrinking acknowledged overcapacity at state-owned enterprises and inviting more private participation. This seems promising but has and likely will continue to fail. Attempts to curb excess capacity through administrative edict, rather than actual competition, have failed for almost a decade on local opposition—"close someone else's factories." A March 11, 2004, China Daily headline: "China to Curb Bling Investment, Over-Capacity in Steel Industry." A July 24, 2013, China Daily headline: "Overcapacity Vexes Chinese Steel Industry in H1."

With chronic overcapacity across a range of industries, more access for private capital is largely a sham. There is already too much investment nationally and in major sectors. The investment is made by state entities which, thanks to subsidies, can indefinitely absorb losses from overcapacity. Private firms have been invited to participate in money-losing low-income housing, in price-controlled utilities, and in sectors where the State Council requires state-owned enterprises remain absolutely dominant, such as energy. This is not useful.

In finance, there are multiple avenues for genuine reform, but there are also multiple other policies to be offered instead. Despite a stock of wealth approximately one-third that of the United States, the People's Republic of China has a larger stock of broad money. It needs both less money and more market, but deleveraging is not the same as reform. Deleveraging does not enhance creditor rights, it does not increase competition, and it may clarify but cannot create a proper yield curve.

Another set of actions involves greater compensation for workers and farmers through pensions, health care, and prices for land. This is entirely reasonable but it is not market reform—greater allowances from the state cannot substitute for greater property rights. Until the household registration system is abolished and both labor and earned benefits are transportable, workers do not have full rights to their own labor. The situation is much starker in land, where individuals have very limited ownership rights and continue to be immiserated by land seizures, despite a promised fig leaf of higher payments.

After a decade adhering to a poor development model, China faces self-inflicted wounds. The wisdom of doing so aside, the Party is likely to address these through additional state action.

The reactionary turn against increased competition after WTO accession, as well as continued weak protection of intellectual property, has harmed China's ability to innovate. The policy response, state-decreed innovation, has been modified but not abandoned. It is likely to be modified again in connection with the plenum, with new sectors possibly identified for state support. Beijing has established a pattern in industrial policy: new, promising sectors should receive state support and old, struggling sectors must receive state support.

State-led development has also increased income inequality and worsened environment degradation. Populist policies could therefore be a centerpiece of the plenum. Some sort of tax, whether direct or indirect, on China's newly wealthy and new welfare programs is eventually possible. Cleanup and regulatory limits on pollutants are long overdue, but are rear-guard actions at best if the Party cannot end its bias in favor of state-owned heavy industry. They hardly constitute reform, more like attempted remediation of continued statism.

The current king of state intervention is described as "urbanization." As an organic process, urbanization entails increases in productivity and wealth that stem from scale advantages in cities. For China, it is typically marketed as assisting macroeconomic rebalancing through the higher consumption of an urban population. The process by which the Party seeks these benefits, though, involves huge volumes of investment, huge amounts of waste, and wealth opportunities dictated by political actors, not economic. It is not market reform.

China now matters a great deal to the world. If reformers can navigate the many obstacles, perhaps assisted by fear of increasing international economic hostility, there would be considerable benefits. Renewed Chinese economic reform would turn back the clock to 1999—a cooperative government in Beijing, an economy with much allure for multinationals, negotiations for membership in the Trans-Pacific Partnership (TPP), and perhaps even a World Trade Organization (WTO) revitalized by a less obstructionist China.

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With the nature of "reform" in doubt, however, it is unlikely the plenum will constitute a turning point. Market reform measures could be inauthentic; statist or populist policies could outweigh truly market-driven initiatives; and even a market triumph at the plenum could fail to be implemented. These are dangerous outcomes for the PRC's foreign economic relations.

How the United States treats China has plainly set the tone for others, from WTO accession to potential TPP membership. The American business community's support for bilateral economic ties has been eroded by the perception of unfulfilled potential, by "indigenous innovation" and other industrial policies, by commercial cyber attacks, and by a slew of lesser pains. Hopes for change have been pinned on the new Party leadership. If progress is not made toward greater competition and non-state ownership, the business community will find different lobbying priorities than a bilateral investment treaty or other negotiations with Beijing. Without pressure from the business community, Washington will tilt against the PRC.

To some extent, the story will be similar elsewhere. If the EU Chamber of Commerce and many European multinationals become disenchanted, it would dull the Sino-European relationship. Japan is already struggling with China on multiple fronts and will need little urging to oppose its inclusion in the Trans-Pacific Partnership. The PRC will still have very strong ties to most of the major commodities exporters, but the WTO will continue to flounder and China will be cut out of the TPP and any trans-Atlantic partnership.

The plenum is therefore likely to trigger a shift in the international economic environment. The timing of shift is uncertain, as most observers did not identify the statist relapse under the Hu Jintao government for years after it began and still do not recognize the ensuing structural weakening of the Chinese economy. The United States and others may not interpret the plenum and ensuing policy implementation correctly for some time but, as with 1993 (positively) and 2003 (negatively), it will nonetheless change the world. Unfortunately, fake reform means the change is more likely to be for the worse. ◆