

China's Economy: Complacency, Crisis & the Challenge of Reform

Barry Naughton

Abstract: China's economic success has bred a new complacency and resistance to change. This in turn has created a credibility crisis, as many Chinese citizens believe the opposition of vested interests makes reform impossible. However, proponents of economic reform argue that the current economic strategy is unsustainable. They point to reform backsliding, overinvestment, and financial fragility as problems that will collide with an inevitable economic slowdown caused by rapid demographic changes, and that will potentially cause economic and political crisis. Renewed economic reform is thus the only prudent and viable choice. The November 2013 Third Plenum shows that China's leaders have tentatively accepted the need for reform.

BARRY NAUGHTON is Professor of Chinese Economy and the Sokwanlok Chair of Chinese International Affairs at the University of California, San Diego. His books include *The Chinese Economy: Transitions and Growth* (2007), *Growing Out of the Plan: Chinese Economic Reform, 1978 – 1993* (1995), and the edited volume *Wu Jinglian: Voice of Reform in China* (2013).

At first look, it seems that China's new leadership assumed power at the pinnacle of economic success. Immediately upon putting their new administration in place, General Secretary Xi Jinping and Premier Li Keqiang made clear their belief that China's new economic clout entitles it to a position of greater respect and global influence than ever before. In fact, China's economy had already become a certifiable "growth miracle" when the previous administration of General Secretary Hu Jintao and Premier Wen Jiabao took power in 2003. At that time, China's economy had already sustained a torrid annual growth rate of 9.6 percent over twenty-four years, a period begun by the major economic reforms of 1978. But in the decade spanning 2003 to 2012, which included the global financial crisis, China's growth actually accelerated, reaching 10.4 percent annually.¹ China overcame the global crisis by pouring resources into investment and accelerating the already eye-watering speed of its infrastructure build-out. Per capita GDP has pushed over the upper-middle income threshold. Not surprisingly, then, an air of triumphalism began to creep into Chinese attitudes and government proclamations. Surpassing

© 2014 by Barry Naughton
doi:10.1162/DAED_a_00269

the Japanese economy in aggregate size, and becoming the second largest economy in the world, was a particular point of pride for China.

Transformation at this pace inevitably creates enormous stresses and strains. Besides the dislocation, the inequities, and the environmental costs, headlong growth also led to another problem: as incomes grew, the impetus for market-oriented economic reforms diminished. As Wu Jinglian, the dean of China's reform-oriented economists, put it, "As life got comfortable, reforms stopped."² During the 1990s, driven by profound economic and political crises, the Chinese government had pushed through a procession of fundamental economic reforms. Under Premier Zhu Rongji, China between 1993 and 1999 enacted a series of deep and difficult reforms of the fiscal, financial, and market systems. These reforms culminated in the massive downsizing of the Chinese state enterprises sector from 1996 to 2001, and were sealed by China's entry into the World Trade Organization in 2001, thereby locking in many of the most important reforms. As a result of these reforms, the Hu–Wen administration inherited a highly favorable economic position when it took power in 2003: the previous administration had paid a substantial price to break down the old system and lay the foundation for a new, better-functioning economy, but had only just begun to enjoy the benefits. Hu and Wen were poised, as the Chinese saying puts it, to enjoy the shade of the trees planted by the ancestors.

At first, the Hu–Wen administration seemed ready to follow the reform trajectory of the previous Jiang Zemin–Zhu Rongji administration, retaining many of the same economic technocrats. The administration's initial economic proposals were full of good ideas, and represented a robust program for a continuation of reform.

But nothing much happened, and there was no follow-through. Today, in Beijing, there is a widespread perception that the past ten years have been a "lost decade" insofar as market-oriented economic reform is concerned. This does not mean that Wen Jiabao presided over a do-nothing administration. Rather, on the social front, Wen cut taxes on the rural economy and boosted spending on education and medical care; he created the foundation for rudimentary national systems of health insurance and pensions; and he increased defense outlays, contributing to a stronger military, which most Chinese citizens certainly see as a positive. The Hu–Wen administration was energetic in spending money, which was acceptable simply because they had the money to spend. However, in terms of creating the institutional framework on which future prosperity would depend, the outgoing administration achieved almost nothing.

It is common for Chinese citizens to explain reform stagnation, or the defeat of individual reform initiatives, by referring to the increased strength of "vested interests." Even the current Chinese premier, Li Keqiang, regularly refers to the need to manage and minimize interest group opposition if his current reform proposals are to advance successfully.³ But who, exactly, are these vested interests? The idea of "vested interests" covers a broad spectrum. At one extreme, the opposition of interest groups to reforms shades into and becomes identical with the problem of corruption. Some vested interests are well-connected families, corrupt officials, and even criminal gangs. But at the other end of the spectrum, the problem of vested interests is created by the stabilization of the entire Communist Party–dominated economic and governmental system. The easiest way to see this is through China's budgetary history

Barry
Naughton

(Figure 1). From the beginning of reform in 1978 until 1995, budgetary revenues as a share of GDP declined nearly every year. Indeed, the productive era of the 1990s reforms was driven by an acute budgetary crisis. Zhu's reforms included a new tax system and new financial discipline that staunched losses in the state enterprise sector. As state firms were chopped back and restructured, the few that survived made a sustained return to profitability, which increased resources available to national leaders both directly and indirectly. Figure 1 also shows that after 1995, the trend turned dramatically, and budgetary revenues as a share of GDP *increased* every year between 1995 and 2012. The result was an enormous increase in the volume of resources available to the system.

A few numbers can give a sense of the magnitude of this transformation. As Figure 1 shows, Chinese budget revenues increased from 10.8 percent of GDP in 1995 to 22.6 percent of GDP in 2012. Doubling the budget's take of GDP in seventeen years is a substantial achievement, but we must also consider the rapid growth of GDP itself: real budgetary revenues (deflated by the Consumer Price Index) were almost exactly *twenty* times in 2012 what they had been in 1995. In 2012-constant USD, the value of Chinese budgetary revenues has increased from \$113 billion in 1995 to \$1.86 trillion in 2012. These numbers look like some kind of spreadsheet error, but they are not.⁴ Chinese government revenues (central and local consolidated) are about equal to the U.S. federal government on-budget revenues, excluding social security, which are estimated by the Congressional Budget Office at \$1.97 trillion for 2012.

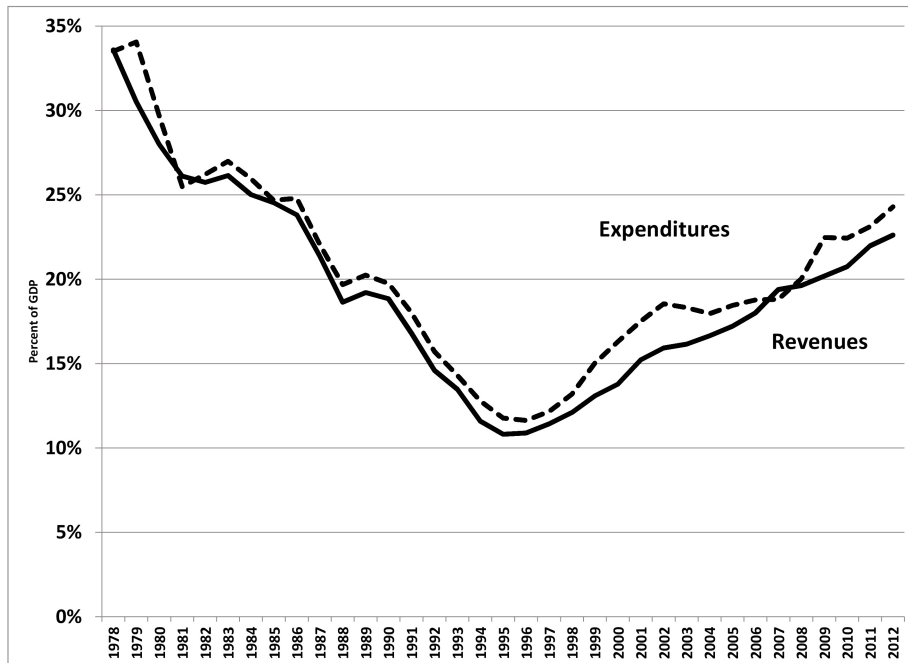
Less than two decades since the country faced a potential crisis of state capacity, the Chinese system is now awash in cash. Money is available not just for the critical necessities, but for elective projects as well.

Technology megaprojects, cultural vanity projects, global propaganda initiatives: if a top leader wants it badly enough, the money can be found. Even the universities have plenty of money. Virtually everyone in a position of authority has a bigger budget, is better off, and has plenty to do. Bitter disputes over resource allocation are less salient, and side payments can be made to buy off dissenters. As the flow of resources through the party- and state-dominated sectors of the economy increased and stabilized, the system naturally became organized around that flow. State-owned enterprises returned to financial health, benefiting from the radical downsizing and restructuring that Zhu Rongji had pushed through at such cost in the late 1990s. With a few entry barriers, and a little manipulation, combined with genuine bottom-up economic growth, the state-owned enterprises were transformed from a burden to an asset. The most extreme example is China Mobile, the state-run company that not only is by far the largest telecom operator in the world, with over 700 million subscribers, but also sits on one of the biggest corporate cash piles in Asia, with \$64 billion in the bank.⁵

At the same time, the reconstruction of the party apparatus and the rationalization of party-state career paths have given the system a new stability and predictability. Trajectories of a career in government have become more knowable, as the requirements for promotion have become increasingly routinized. Steady promotion, in turn, leads to abundant and increasing opportunities to earn outside income. Students in elite universities have increasingly come to see government as the most attractive career option. In other words, the stagnation of reform was not merely short-run complacency and procrastination; rather, it reflected the long-term stabilization of the system. The hierarchical Chinese political system, which had to be

Figure 1
China's Budget Share in GDP, 1978 – 2012

Barry
Naughton



Source: Chinese official data, updated most recently with the National Bureau of Statistics, *Zhongguo Tongji Zhaiyao* 2013 [*China Statistical Abstract* 2013] (Beijing: Zhongguo Tongji, 2013).

constantly remade in the 1980s and 1990s in order to adapt to new challenges, is today no longer driven by any immediate, internal sense of crisis. Instead, the Chinese system – perhaps like most systems in the world – is engaged primarily in reproducing itself more or less as it is. The biggest vested interest, then, is the interest represented by the Communist Party itself.

The new stability of the system is viewed warily by those outside its embrace. In the first place, there is a widespread perception – both inside and outside China – that it is increasingly difficult to do business in China without political connec-

tions. Of course, at the same time, the private sector has grown tremendously; and while the state sector has stopped shrinking in absolute terms, the growing private sector makes up a steadily larger share of the overall economy. However, private business owners now sense increased competition from state firms, and an increased need for accommodation with savvy power holders – with “vested interests” – who can help extract benefits from the booming economy and from private businesses.

Even more important, an awareness of the stagnation of reform in China over the past decade has gradually seeped into

public consciousness, producing an interesting disconnect. Over the past ten years, the government's propaganda organs have continued to trumpet the indispensability of economic reform. Every few years, major new reforms are discussed, and policies are implemented, but they have little impact. As a result, official pronouncements have lost credibility, and this loss, combined with the stabilization of China's system and the greater influence of interest groups, has led to a crisis of confidence in China's ability to change. This type of credibility crisis is something quite new in China, although it has been commonplace in the United States and other economically developed societies for some time. Such a crisis in confidence is characterized by the belief that problems are peculiarly entrenched and intractable, and nothing really can be done about them, with only the extremely naive believing otherwise. This type of cynicism was, until recently, almost completely absent in China. China had been changing so rapidly that it was apparent to everyone that the future was, if nothing else, full of different possibilities, even if the present was impoverished. That sense of confidence about the future seems to have vanished in China.

Understanding this facet of the public mood is important to understanding the recent pronouncements of China's new leaders, and their reception. Both Xi Jinping and Li Keqiang made rather bold pronouncements in favor of restarting market-oriented reforms in the early stages of power transition in late 2012. Yet the popular response to these proclamations was only mildly positive: "Really? We'll believe it when we see it." A palpable skepticism about reform is thus part of a broader crisis of confidence. Can China change? Has government and policy been captured by interest groups, such that no change is possible? Is China slip-

ping backward? Acutely aware of this public sentiment, both Xi Jinping and Li Keqiang have been critical of the gap between rhetoric and action: Xi spent his first months in power denouncing "empty talk." It is clear that those engaging in empty talk are, in fact, Xi's predecessors, but is it clear that Xi will be any different? More broadly, why would those who benefit so abundantly from the current system act to change it? Why would anybody change a model that seems to have delivered such abundant resources and success?

Remarkably, economic reform is not dead in China and is in fact experiencing a resurgence. Reformers have important positions in the new government and in the country's most influential business media. At their core, these reformers have only one argument, but it is a powerful one: that the current economic situation and policy trajectory are simply not sustainable. Economic conditions are changing rapidly, and the current way of doing business risks serious crisis. The most dangerous course of action is therefore not to reform, in effect remaining on the current course. If policy-makers do not preempt the changes that are coming, then change will be disruptive and potentially devastating. But there is still time to act.

The unsustainability argument has four key components. First, the failure to substantially improve the quality of China's economic institutions will begin to gradually erode the pace of productivity improvement. China's total factor productivity has increased dramatically during the reform era, and grew strongly through most of the first decade of the century. This productivity improvement has been diffuse and attributable to multiple causes, including the learning and adoption of new technologies, as well as improved institutions. A key link has been the will-

ingness to let underperforming entities fail, concentrating production in the most competitive and productive firms. However, the strength of this competitive mechanism seems to have waned in recent years, and without a new wave of reform, productivity growth will continue to slow. Productivity is not simple to measure; there are time lags both in the appearance of productivity effects and in our ability to measure them. So by the time economists have formed an academically rigorous judgment, it is quite late to do anything about it. But in the interim, policymakers will look at growth rates compared to investment rates. There are many reasons why growth should slow, but as long as investment rates stay high, policymakers will take declining growth rates as evidence that something is wrong with their system's productivity, and will be motivated to push harder for reforms.

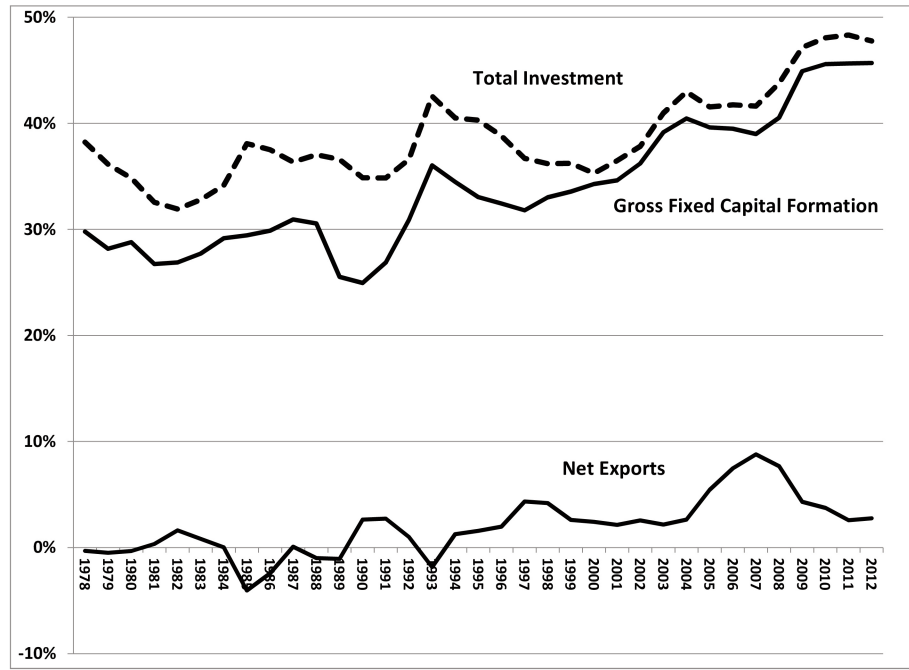
Second, the limits to investment-driven growth are appearing. China was able to sidestep the worst of the global financial crisis by increasing domestic investment. GDP growth scarcely dropped because the increase in domestic investment almost completely offset the drop in net exports. But this success was achieved at substantial cost. Because the stimulus program was so rushed, some unknown proportion of new investment was doubtless wasted on useless projects, although we have no way of knowing how large that proportion is. More fundamental, as Figure 2 shows, the investment surge of 2009 was not a one-off stimulus. Instead, China's investment rate moved more or less permanently to a higher level. Since 2009, China has been investing a remarkable 48 percent of GDP. An investment effort of this magnitude is completely unprecedented for a large economy. Japan, Korea, Malaysia, and Thailand all drove growth with investment, but none of them ran investment rates that exceeded 40 percent

for more than a couple of years. In 2007, Premier Wen Jiabao described China's economy as "unstable, unbalanced, uncoordinated, and unsustainable," and since that time, the unprecedented dependency on state investment has only further unbalanced the economy.

What's wrong with this investment-driven, unbalanced growth? After all, investment-led growth has served the Chinese economy well over the past two decades. One of the great paradoxes of the Chinese economy is that although household consumption is an unusually low share of total GDP (35 percent), household consumption has also grown extremely rapidly over the past decade, only not as fast as overall GDP. And if you can have both more consumption *and* more investment, why not have it all? Well, because it is probably just not possible. Economists do not have any logical limit to how high a country's investment rate can be, or for how long. But all previous high-growth economies have eventually come to a point where investment rates subside, and usually at levels well below the current Chinese level. In the past, with unlimited supplies of labor, investment was the key growth driver. All that was needed to bring that labor out of the countryside was new industrial plant and infrastructure. Moreover, as a follower economy, planners and businesses could focus on transplanting business models, technologies, and infrastructure layouts from developed countries. The system delivered investment, and investment delivered growth. That equation is no longer so simple. Matching the right investment to the evolving needs of the economy is becoming much more difficult. The fundamental infrastructure framework China's planners copied from more advanced economies is nearing completion. Meanwhile, excess capacity has emerged in many industrial sectors as the economy has slowed.

China's Economy: Complacency, Crisis & the Challenge of Reform

Figure 2
Investment and Net Exports (Share of GDP), 1978 – 2012



Source: Chinese official data, updated most recently with the National Bureau of Statistics, *Zhongguo Tongji Zhaiyao* 2013 [*China Statistical Abstract* 2013] (Beijing: Zhongguo Tongji, 2013).

These suggest that China may be approaching the limits of this development strategy. Moreover, investment has an inherent tendency toward instability, since it is driven by investors' expectations of the future. While consumption is relatively stable, investment is subject to the "animal spirits" of those making decisions. In China, the government's willingness to serve as the reliable investor of last resort has also kept the investment propensity of private businesses high. The two have been in a productive symbiosis that thus far has served the economy well. As the momentum of the economy slows and existing opportunities close off, the danger

rises that investment from the private sector will drop.

Third, past investment excesses have already created financial fragility. The huge quantity of new fixed assets the Chinese economy has created over the past five years is just now coming onstream. Many of these assets are housed in corporate structures that have no good business model. The extreme example is China's gleaming new high-speed rail network. The system has a current debt load equivalent to \$429 billion. Whether or not a massive high-speed rail is worth building is one question – about which opinions differ – but whether there is a revenue

model to service this enormous debt is another question altogether. Outside of a few high-capacity lines like Beijing-Shanghai, most observers doubt it. The challenge is mirrored by literally thousands of local government projects and “funding platforms” around the country. Encouraged to invest following the global financial crisis, these local governments now face debts they cannot service with the income streams they can plausibly generate through user fees and sales revenues. In the aggregate, this debt amounts to more than \$1.6 trillion, by official estimates. Put together, these two debt loads amount to 25 percent of China’s GDP.

Chinese regulators and financial sector officials are well aware of these problems. They have been pushing China’s state banks to increase bad loan provisions and raise capital; they will certainly not be caught by surprise. Nonetheless, the hard work of actually restructuring these corporations has barely begun. Indeed, it can hardly proceed in the current inherited environment: credit is still flowing freely; shambolic state-backed corporations have easy access not just to bank loans but also to nascent bond markets; and governments turn to short-term financial markets to fund long-term debts. Some kind of credit squeeze will be necessary to drive forward financial restructuring, and both the squeeze and the restructuring will be painful. Yet the longer financial restructuring is delayed, the longer resources will flow into low-productivity or no-productivity projects and corporations. The creation of a vast sector of “zombie firms,” neither dead nor alive, would ultimately create a far larger and more dangerous risk of financial panic and collapse. The relevant comparison is with Japan in the 1990s, when the delay of financial restructuring kept numerous zombie firms alive, and kept the economy from recovering for an entire “lost decade.”

Fourth, China is going through profound changes in its labor markets that point to substantially slower growth. For decades, employers had been able to hire at will new workers migrating from the countryside, offering a wage that changed little through the 1990s and early 2000s. But some time after the mid-2000s, competition for workers began to drive up unskilled wages. By 2012, real wages for migrant workers were two and a half times what they had been in 2003, increasing by 10.8 percent annually. This dramatic change in labor market conditions led many observers to proclaim “the end of cheap China.” The sudden change also revived interest in a so-called Lewis turning point, a structural shift that occurs when the reservoir of surplus labor in the countryside is finally depleted, and employers have to pay higher wages to draw people out of agricultural work.⁶ In past Asian growth “miracles,” the arrival of a Lewis turning point often signaled the end of the very-high-growth period. Rapid growth of unskilled wages tends to force the end of an early growth phase led by the export of labor-intensive manufactures. Economies start to lose comparative advantage in clothing, shoes, and toys, and export growth becomes a less important demand-side driver of growth. These forces are now operating in China, and since export demand from the European Union, Japan, and the United States is likely to be weak for the immediate future, exports will make a much smaller contribution to China’s future growth than they did during the past decade.

Just as rural labor surpluses were beginning to disappear, China reached another crucial turning point. In 2012, the population at working age began to decline. This is an entirely different type of demographic transition, accelerated by China’s draconian birth control policies. Previously, China had been experiencing

a “demographic dividend” in which the population at working age was growing more rapidly than the overall population. As a result, dependency ratios decreased and the work force became younger and better educated. However, as the essay by Deborah Davis in this issue details, China’s demographic dividend is now exhausted – as it eventually had to be – and China’s population has begun to age and experience a higher (elderly) dependency ratio. The working age population has reached a plateau, and will start to decline rapidly in absolute size by 2020. The fact that the Lewis turning point and the end of the demographic dividend are occurring at the same time means that the shift in labor force conditions will be unusually abrupt. For comparison, Japan’s labor force began to shrink about twenty-five years after the end of its high-growth era – when the country was already quite rich – and Korea’s labor force began to shrink about fifteen years after the end of its high-growth era. In China, these two changes are occurring simultaneously.

The structural changes in China’s labor force mean growth is bound to slow; but this does not have to be a bad thing. After all, higher wages mean that incomes are growing, that people are better off, and that there is an opportunity to shift the pattern of economic development so that it provides a greater share of output for household consumption. Moreover, China is a huge continental economy and does not have to tie its economic growth only to its export strategy. Chinese incomes overall are still relatively low and there is plenty of room for catch-up. So this structural change is a huge challenge, but not necessarily a looming disaster. This is a transition that must be managed carefully, but one that can lead to a much more productive and capable society overall. Here, though, the record of Asia’s earlier “miracle economies” advise caution. When

economies such as Japan, Korea, and Taiwan moved out of their very-high-growth phases, they each faced major challenges to their growth models. Japan’s growth rate dropped sharply in 1973, and then again in the 1990s. Never again did Japan come anywhere close to replicating the high growth rates of the 1950s and 1960s. Similarly, the end of the Korean high-growth phase in 1997 arrived with the Asian financial crisis, massive financial distress and restructuring, and a permanently lower growth rate. The evidence is clear that if China does *not* handle this transition well, it could have a substantial economic price to pay.

At this point, a broader argument about the nature of China’s economy and society comes into play. Typically, as forerunner economies have reached the end of their high-growth phases, they have upgraded into high technology and more sophisticated sectors. China clearly hopes to follow this lead. To prepare, China has invested massively in university education since 2001, and has also begun to pour government money into research and development in promising “emerging” industrial sectors. Last year, China invested just shy of 2 percent of its GDP into research and development, a sum much greater than that of other economies at comparable levels of GDP per capita. But ordinarily, forerunner economies have facilitated this upgrading process by transitioning into more of a “light touch” role for government support for development, and a broader liberalization of economic and social conditions. Thus, the government typically hands off more of the responsibility for development to the private sector, and relies on dispersed entrepreneurship to identify and exploit the promising new sectors. In China, the movement in recent years has *not* been in this direction. Government, flush with money, has stepped

up its own direct role in technology research and innovation. Entry barriers that have long since fallen away for ordinary manufacturing sectors are still in place for high value services such as finance and information (including Internet businesses). There is a very real danger that a top-down, state-directed program of innovation, combined with state control of large swathes of the economy, will end up retarding China's essential graduation toward an innovative, diverse, and resilient economy.

Today's China clearly faces a set of challenges that are different from those in the past. China must upgrade the quality of its human resources; identify the sectors, products, and services where opportunities lie; and transition from a follower economy to a position at the global frontier in numerous sectors. Can it do those things without also further scaling back the power of the state, eliminating visible and invisible barriers to the growth of innovative businesses, and empowering households to make more of the fundamental economic decisions? It seems unlikely, which leads us back to the problem of economic reform.

The reform proponents' arguments about sustainability have a high degree of internal coherence, and also great immediacy. In the first place, the current changes in the external economic environment are obvious for all to see. Slowing labor force growth, soaring wages, and rapidly changing cost structures and competitiveness are part of daily life for all Chinese citizens. But these changes directly imply that the existing economic strategy has reached its limits. In fact, all four of the fundamental challenges described above are reaching a climax at the same time. Investment-led growth is running out of steam just as the productivity dividend from previous reforms risks reversal.

Structural changes in the growth potential are intersecting with financial fragilities linked closely to the post-2009 investment surge. Growth slowdown will force the hand of policy-makers. Otherwise, the danger that unaddressed problems will lead to a broader loss of confidence may grow, and threaten the system's ability to stably reproduce itself. The reformers argue that without further market-oriented reform, there is no way to resolve these challenges. In a sense, Xi and Li have inherited a situation that is the exact opposite of the one inherited by Hu and Wen ten years earlier. The Xi–Li economy looks good, but it comes with a legacy of deferred problems and unresolved issues. Xi and Li still have a chance to address these problems, to move China toward a path of sustainable, but slower, growth, but they have to do so promptly, before a host of bills comes due. The timing of this is not under the control of Chinese policy-makers.

By tradition, one year after the Communist Party Central Committee is first empanelled, each new Chinese administration convenes a Third Plenary Session in order to lay out its economic program. In the past – especially in 1978 and 1993 – this Third Plenum has marked a turning point, the initiation or revitalization of a major reform program. Xi Jinping and Li Keqiang convened their own Third Plenum from November 9 through November 12, 2013, and produced a strong reform document that addressed key economic issues while also expanding well beyond the strictly economic realm. The document that emerged is best characterized as part vision statement and part to-do list. The vision statement is an essential part of a document of this type, which emerges out of a long consensus-building process within the Communist Party leadership. This process tends to generate broad statements of principle, plus (at best) a few compelling slogans. To a certain extent, the 2013 Third

Barry
Naughton

Plenum resolution shares these features, but the content is surprising. It calls for a redefined role for government, with government playing a reduced role in micro-economic decision-making, the market playing a “decisive role” in resource allocation, and the development of new models of social governance. It does not shy away from key areas of financial and fiscal reforms, and it marks a clear effort to revitalize reform in the state-owned enterprise sector. This vision is surprising because it revives a rhetoric and vocabulary not much in evidence in China lately, and it charts a course that is very different from many of today’s policies. The to-do list, meanwhile, is extremely ambitious. Laid out in sixty articles and comprising well over three hundred policy measures, the to-do list commits the regime to an impressively broad array of actions, ranging from relaxing the single-child birth control policy to increasing the share of dividends that state-owned enterprises hand over to the government and its social welfare funds.

The Third Plenum resolution is best understood within the context of achievement, change, and credibility crisis described above. Xi Jinping and Li Keqiang – and their secretaries and advisers – clearly exerted a major effort to make the Third Plenum resolution a credible document that would generate momentum for the reform process. In the first instance, they did so by producing a plenum document that was simply *bigger* than many people expected: it was both broader and more detailed than most previous documents. Moreover, the overall approach of the document has the potential to create a coherent response to the multiple economic challenges that China faces. Financial reforms, fiscal reforms, and state-enterprise reforms are all cued up in the Third Plenum, and pricing reforms and a reduction in administrative barriers round

out the core economic elements of this initial reform package. It is striking that the framers of the document have provided a number of tangible commitments that will serve as benchmarks by which to judge whether or not the reforms are actually implemented. Further, Xi Jinping personally and publicly identified with the resolution in a remarkable account he published the week following the Third Plenum, stressing his chairmanship of the drafting committee and his deep engagement with the entire process. Xi, we would say, took personal ownership of the document. By crafting a document designed to impress, by including concrete and observable contents along with the more abstract goals, and by encouraging personal identification with the resolution, Xi Jinping is clearly signaling his intention to pursue this agenda.⁷

Of course, actually implementing these ambitious goals is far more difficult than merely stating them. This, in turn, leads to our final question: can Chinese policymakers act preemptively, dismantling their own special privileges, *before* the arrival of a serious economic crisis? The question is not only whether reform proponents can overcome the entrenched power of vested interests, but also whether they can overcome such power in the absence of a full-blown crisis. If the chances for renewed market reforms were assessed solely on the basis of short-run economic and political conditions, it would be hard to be optimistic. In that sense, both the complacency and the crisis of confidence would be justified; it is difficult to make an argument for change based on a crisis that has not yet hit.

But at the end of the day, the reformers are right that only major institutional changes that make the economy more open, competitive, and rule-bound can avoid the serious problems looming overhead. Even these reforms will require

adept policy-maneuvering to avoid submerged obstacles. The reformers are right about impending changes and potential crises, and they are right about the type of economy and society that China must become in order to be technologically creative, institutionally flexible, and supportive of a high standard of living for a majority of its citizens. China must make

the transition to a lower growth rate, but in the context of a wealthier, better-off society. It absolutely has the capability to do so, but policy-makers must summon the will and determination, craft an effective proposal, and push for a renewed domestic and foreign opening of the economy.

Barry
Naughton

ENDNOTES

- ¹ National income, expenditure, and fiscal data in this paper, including those used in Figures 1 and 2, are Chinese official data, updated most recently with the National Bureau of Statistics, *Zhongguo Tongji Zhaiyao 2013* [*China Statistical Abstract 2013*] (Beijing: Zhongguo Tongji, 2013). GDP from the production and expenditure side, see p. 19, 33–35; fiscal data, see p. 72–73.
- ² Wu Jinglian, “Toward a Renewal of Reform,” in *Wu Jinglian: Voice of Reform in China*, ed. Barry Naughton (Cambridge, Mass.: MIT Press, 2013), 12. Wu is quoting his close friend Zhang Zhuoyuan.
- ³ Li Keqiang’s remarks reported in Du Yongtao, Fu Yingnan, Wei Xi, and Liu Yang, “Li Keqiang Emphasizes that the Biggest Dividend that China Enjoys is the Reform Dividend” (in Chinese), *People’s Daily Online*, November 22, 2012, <http://finance.people.com.cn/n/2012/1122/c1004-19667962.html>.
- ⁴ Chinese currency values have been converted to U.S. dollars at prevailing exchange rates, and deflated by the U.S. Consumer Price Index.
- ⁵ Daisuke Wakabayashi and Min-jeong Lee, “Samsung’s ‘Good’ Problem: A Growing Cash Pile,” *The Wall Street Journal*, May 8, 2013, <http://online.wsj.com/article/SB10001424127887323798104578454440307100754.html>.
- ⁶ Migrant wages from Feng Lu, “Consolidation or Stimulation? Remarks on China’s macro-economic situation and policy,” U.S.-China Economics Dialogue, Beijing, June 19, 2013. For a good collection of academic articles on the Lewis turning point, see the 2011 special issue of *China Economic Review*, especially the article by the leading proponents of this view, Cai Fang and Du Yang, “Wage Increases, Wage Convergence, and the Lewis Turning Point in China,” *China Economic Review* 22 (4) (2011): 601–610. The empirical evidence in favor of the Lewis theory in other developing economies is mixed, but China fits many of the Lewis model’s predictions. Moreover, China has unique institutions that make the basic Lewis assumption of surplus rural labor more plausible, including collective land ownership and institutional barriers that retard rural-to-urban migration.
- ⁷ Chinese Communist Party Central Committee, “Resolution on Several Important Issues on Comprehensively Deepening Reform” (in Chinese), November 12, 2013, http://news.xinhuanet.com/politics/2013-11/15/c_118164235.htm. Xi Jinping emphasizes his personal role in Xi Jinping, “An Explanation of the ‘Resolution on Several Important Issues on Comprehensively Deepening Reform’” (in Chinese), November 15, 2013, <http://politics.people.com.cn/n/2013/1115/c10001-23559327.html>. As of mid-December 2013, there is still no official English translation of the Third Plenum resolution.