

ISSUE BRIEF

No. 3574 | APRIL 23, 2012

Chinese Economic Reform: How the U.S. Should Prepare

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The U.S. government suffers from understandable but harmful confusion concerning Chinese economic reform. It is correctly understood that market reforms have been most often implemented gradually. However, that slowness is misperceived to be moderation. In fact, when market reforms have occurred, they have been clear and powerful.

This confusion has mattered little in the past nine years because the current Chinese government is hostile toward the market. The political transition that starts in the fall, however, might change things. The natural expectation after an extended period of statism is for any market reforms to be mild. However, if reforms do occur, both history and the existing policy mix suggest that they are likely to be dramatic. The branches of the U.S. government that deal with the People's Republic

of China (PRC) should prepare for this possibility by pushing Beijing for detailed plans of reforms that would actually matter.

Reform Chatter. It is no accident that, after years of stagnation,¹ early 2012 has seen a rush of Chinese economic reform proposals. The pro-state government led by Hu Jintao and Wen Jiabao is on its way out, to be replaced starting in the fall by unknown quantities like Xi Jinping. The reform camp, led typically by the People's Bank, correctly sees an opportunity.

The person doing the most talking is Premier Wen himself, in particular calling for an end to state monopolization of key sectors such as banking. However, the premier lacks credibility. It was his predecessor, Zhu Rongji, who tried to shrink the state sector, while the state giants that Wen now criticizes re-emerged and prospered under his ostensible leadership.²

Elsewhere, the People's Bank has been inching forward with external financial changes, including widening the yuan's formal trading band against the dollar and more uses of the yuan in investment. The central bank is selling the nationalist line that a global power must have a global currency while minimizing the fact that a truly global currency

requires money to move freely in and out of the PRC—i.e., an open capital account. This would diminish the government's control of interest rates, a dramatic shift.

Perhaps most important, Wen's likely successor as premier, Li Keqiang, linked himself to a document co-authored by the World Bank and the Development Research Center, an arm of China's cabinet,³ that calls for resurrecting multiple, fundamental reforms that have fallen by the wayside. It would be far too ambitious if the current government were staying in power, but it may not be if the incoming government is less statist.

Reform Pattern. Skepticism concerning the prospects for true market reform is entirely justified. The principal beneficiaries of a decade of statism have been large national firms and elite Communist Party cadres and their families, known as princelings. They constitute a daunting hurdle to introducing more competition and encourage a sense that, if reform occurs, it will be very modest. While sensible, this view cuts against both the pattern of Chinese policy changes and current conditions.

The economic pattern over the past 30-plus years shows

This paper, in its entirety, can be found at <http://report.heritage.org/ib3574>

Produced by the Asian Studies Center

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fundamental shifts, positive and negative. The granting of limited property rights to farmers in the late 1970s was a revolutionary change. The Tiananmen-driven economic recentralization was brief but stark. Deng Xiaoping's famous southern tour in 1992 was neither modest nor cautious. Deng's death and the ascent of Zhu to the premiership in 1997–1998 triggered an attack on the state sector and a much more serious approach to World Trade Organization (WTO) accession.

When the current government took office, concessions made to win WTO membership were still being implemented, but all new policy moved sharply away from the market. The idea of state firms as national champions was fully embraced, lending by state banks moved considerably higher in sustained fashion, and—crucially—an imbalance between investment and consumption appeared.⁴ Market reform has been almost completely absent since. History argues for all or nothing: substantial market reform or primacy of the state.

Current conditions argue the same. The various ills plaguing the economy have become too entrenched to be addressed by half-measures. Income inequality could be addressed by severe populism—not market reform but nothing mild, either. Impressive talk will not curb

state monopoly power or liberalize interest rates; these require a decisive turn away from the state to the market.

Reform Response. The U.S. was blindsided by the shift, starting as early as 2002, from a Chinese government committed to market reform to one staunchly opposed. After years of fruitless dialogue, it now may be that the U.S. is unprepared for a positive change. Such a change would offer immense opportunities; once clearly underway, it would also call for incentives from the American side. These incentives could include presidential renunciation of sanctions based on exchange rates and an improved investment environment for Chinese firms in the U.S.

Lack of genuine competition is perhaps the most fundamental problem, so one measure to watch is the share of truly private investment in key sectors, such as energy and telecom. An indication of false reform would be if restructured but still state-controlled firms or state firms from outside sectors are portrayed as increasing competition and breaking monopolies.

What the US Should Do. The safe bet is that no Chinese change will materialize. But if one does materialize, it is unlikely to be subtle. The U.S. should prepare for possible sharp reform in the following fashion:

- **The U.S. Trade Representative and the Department of Commerce should request a specific calendar for the announced “de-monopolization” of major sectors.** They should demand details regarding timing, market shares, and eligible participants.

- **The Department of the Treasury should request timetables for interest rate and capital account liberalization.** Domestic financial liberalization is another major possibility and could take multiple forms. Interest rates could be directly liberalized, of course, but permitting foreign capital to participate fully in the interbank market or money to leave the country more freely would greatly enhance the influence of market forces, as well. Inauthentic financial reform would be allowing people to do more things with their money they have no interest in, such as holding RMB overseas.

Good American policy toward the PRC also requires the business community to contribute. There are other indicators that may turn out to be crucial, including ones that are quite obscure at present. Because any market reform will be plain, American companies and business

1. Derek Scissors, “Deng Undone,” *Foreign Affairs*, May/June 2009, <http://www.foreignaffairs.com/articles/64947/derek-scissors/deng-undone> (accessed April 20, 2012).

2. *CPC Encyclopedia*, “Giant State Firms Need Private Investment,” http://www.cpcchina.org/2012-02/13/content_14588499.htm (accessed April 19, 2012); and Derek Scissors, “Chinese State-Owned Enterprises and U.S.–China Economic Relations,” testimony before the U.S.–China Economic and Security Review Commission, April 1, 2011, <http://www.heritage.org/research/testimony/2011/04/chinese-state-owned-enterprises-and-us-china-economic-relations>.

3. Mu Xuequan, “China Vows Closer Co-op with WB for Global Economic Governance Reform,” Chinese Government’s Official Web Portal, February 28, 2012, http://english.gov.cn/2012-02/28/content_2077964.htm (accessed April 19, 2012).

4. “We Are the Champions,” *The Economist*, March 18, 2004, <http://www.economist.com/node/2495172> (accessed April 19, 2012); and National Bureau of Statistics, *China Monthly Statistics*, Vol. 12 (2002)–Vol. 12 (2004).

organizations do not need to read tea leaves. But the faster they recognize any authentic change and adjust their strategies accordingly, the better for both the U.S. and the bilateral relationship.

Prepare for the Worst—and the Best. The U.S. is all too ready to bang heads with another statist Chinese regime. History says that if there is reform, it will be powerful rather than modest. The Administration, Congress, and the business community should prepare for that possibility, too.

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