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China’s Reform and Opening: 40 Years and Counting

How far is the Chinese government willing to go in letting go of economic control?

By **Seung-Youn Oh**

This year marks the 40th anniversary of China’s Reform and Opening (*gaige kaifang*), initiated by Deng Xiaoping at the Third Plenum of the Eleventh Central Committee in 1978. These economic changes were so far-reaching that Deng described them as part of China’s “second revolution.” Since then, China has become an economic juggernaut with the world’s largest foreign reserves ($3.12 trillion), second-largest GDP ($11 trillion), and third-highest levels of foreign direct investment ($170 billion). Its share of the world economy grew from a mere 1.8 percent in 1978 to a staggering 18.2 percent in 2017. China is not just an emerging economy but has surely returned to its status as a major world economic power, which accounted for nearly 30 percent of the world economy in the 15th and 16th centuries.

Forty years after Deng's momentous policy shift, the world is now witnessing another strong Chinese leader, Xi Jinping, who aspires to increase the country's economic might. In Xi's case, the goal is to convert the world's second-largest economy into a global leader and manufacturing superpower. Not only has Xi put forth various domestic initiatives to usher in a new era of the "China Dream" (i.e., rejuvenating China through economic growth and modernization), he has also signaled a consistent commitment to continuing Deng's legacy of economic reform and opening on the global stage (including at the G20 Summit in 2016, the Davos Forum in 2017, and the Boao Forum earlier this year).

While these developments have elicited both excitement and expectations regarding Beijing's commitment to further liberalization, there are signs that China's economic opening cannot be considered a foregone conclusion. The forces that account for the economic success of the Chinese model have also created tensions between a political system characterized by Leninist single party-led authoritarianism and an economy and society characterized by vibrant market forces. How much of China's super-charged economic growth can be attributed to state-led planning and how much comes from entrepreneurship and market forces? With Xi holding all the levers of political power, how much is the Chinese leadership willing to let go of economic control?

Deng and China's First Transformation

China's rise is not just a story of late development in the post-World War II era, but also that of a transition from a planned to a market economy. Among many countries that followed similar paths, China became the poster-child of successful transitions with its gradual approach to economic change, as opposed to the disruptive "shock therapy" experienced by Russia. This gradualism involved reforming the existing domestic economic system to unleash market forces at the local level through fiscal reform and the proactive opening of Chinese borders to foreign investors through the establishment of "special economic zones" in the country's southern coastal provinces. Deng Xiaoping wanted to facilitate a dramatic change from the uniform levels of poverty and underdevelopment across China in the communist socialist era to geographically unbalanced development by "letting some people and areas get rich first." That "unbalanced" approach is how Deng pulled off the tough task of renouncing the Soviet economic model, undoing most of what Mao had done, and spearheading economic modernization while labeling it "Socialism with Chinese Characteristics." Deng was not just a great reformer but an *unbalanced* one, as Yukon Huang notes in his new book *Cracking the China Conundrum: Why Conventional Economic Wisdom Is Wrong*.

Deng's reforms initiated a socioeconomic transformation unmatched in human history. China's GDP has grown by 3,230 percent from 1978 to 2016, lifting 700 million people out of poverty and creating 385 million members of a new middle class. China's foreign trade in goods has grown by 17,500 percent, making China the world's leader in foreign trade since 2015. China now trades more in two days than it did during the entire year of 1978.

China's rapid socioeconomic change was bolstered by Deng's firm commitment to restoring the collective leadership system of the Chinese Communist Party (CCP). After surviving several rounds of demotion and purges in the 1960s and 1970s, Deng became wary of Mao-style dictatorship and pushed strongly for a system of limited tenure in office and orderly succession by handpicking four successors, which included future Chinese presidents Jiang Zemin and Hu Jintao. With regard to international relations, Deng's principles of "keeping a low profile" and "hiding one's talents and binding time" allowed China to focus on domestic economic development.

As radical as his reforms were, Deng was also a great stabilizer, according to Ezra Vogel's biography of the Chinese leader. China's transition not only secured economic prosperity for the Chinese people but kept the CCP in power through four decades of dramatic economic growth and market liberalization. In this sense, China's performance under Deng runs counter to the tenets of modernization – the belief that economic liberalization will lead to political liberalization.

Xi and China's Second Transformation

In place of Deng Xiaoping's oft-quoted two-cat theory – "It does not matter if a cat is black or white as long as it catches mice" – Xi Jinping has proposed creating a Chinese version of industrial development with his "two-bird theory." In his speech during the 12th National People's Congress in 2014, Xi highlighted the importance of lifting the birdcage and replacing "old birds" (low-value added industries) with "new birds" (high-value added industries*)*. Through this process, China will achieve a "nirvana of the phoenix" *(fenghuang niepan)* fueled by indigenous technology and environmentally conscious development.

With regard to the question of who will lead China's second transformation, CCP leaders seem to believe that only the party (and not any other political or economic actors) can implement this vision. At the National People's Congress in March, China abolished presidential term limits and officially ushered in a new era of "Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era." Gone is Deng's style of collective leadership through a rotating committee. Power has been further consolidated at the top through the CCP's creation of small groups such as the "Leading Small Group for the Comprehensive Deepening of Reform and for National Security Committee." By appointing himself as the chairman of most leading small groups, Xi has become the ultimate arbiter for the most important policy issues and can oversee every Politburo member's policy portfolio.

The CCP is also regaining its primacy in the daily lives of the Chinese people by establishing a tighter grip on markets and society. Xi is clamping down on state enterprises; for example, Party cells are being dispatched into state-owned companies to track overall management. Foreign companies, meanwhile, face growing pressures to involve internal Party committees in strategic decision-making process. During Xi's reign, China has witnessed growing pressure on nongovernmental organizations and an increasing number of arrests of human rights activists. China's plan to launch a "social credit score system" of rating citizens is often likened to the *Black Mirror* episode "Nosedive" where everyone has a personal score based on ratings given to them by the rest of the population.

Many China experts initially believed Xi would be a liberal-minded princeling in the vein of his father, Xi Zhongxun, who served as governor of Guangdong province in 1978 and championed Deng's economic opening project. Soon after assuming the party leadership, Xi Jinping embarked on his own version of Deng's 1992 "Southern Tour." In early December 2012, President Xi made his first official domestic trip to Shenzhen in Guangdong province to show his commitment to continuing on the path of economic reform. Yet in the past five years, Xi's consolidation of political control has dampened entrepreneurial spirits and aggravated social discontent.

How is Xi planning to manage the seemingly inevitable clash between economic reforms and political rigidity? Xi's ambition of making China a powerhouse of innovation and the linchpin of the Eurasian continent through the Belt and Road Initiative are daunting tasks for the "visible hand" of the planned economy to manage on its own. The Communist Party is facing serious domestic problems related to the country's economic slowdown, increasing inequality, shifting demographics, and widespread environmental degradation. Many of these problems are the direct result of China's economic reform policies and their uneven impact across the country's provinces.

Limits of Liberalization

In dealing with these social problems, China's leaders have chosen to establish more centralized control, but this strategy could create an existential threat to the party if it undermines the entrepreneurial experimentation that became possible during the past four decades when local governments, private-owned companies, and foreign investors had more autonomy.

First, one of the main institutional underpinnings of China's gradual reform was the so-called "market-preserving federalism." While the central government provided the macroeconomic framework for growth, empowered local bureaucrats played an entrepreneurial role by engaging in competition with bureaucrats from other cities and provinces. In recent years, however, these local bureaucrats have exercised more caution in making economic decisions due to concerns that they could become targets of China's newly expanded anti-corruption campaign, which can investigate anyone in a position of power without a clear judicial process.

Second, state-owned enterprises (SOEs) still dominate key portions of China's industrial economy and send the lion's share of foreign investment out of China. Compared to previous Chinese leaders, Xi has placed more of an emphasis on public-private partnerships since 2014 as a way to increase private investment and the transfer of technological expertise. Yet, they are in reality *public-public* partnerships since these partnerships involve enterprises that are state-owned. The original intention of relieving some of local governments' debt levels across China has been distorted and some of these SOEs have moved from being "too big to fail" to "too big to bail out," endangering Chinese financial and industrial health in the process. This dominance of state-led and financially unsustainable economic development in China's approach to the world does little to encourage the participation of private or foreign firms.

The debt concerns are especially significant since these public-private partnerships are tied to the Belt and Road Initiative, an infrastructure and trade network connecting Asia with Europe and Africa along ancient trade routes. The Belt and Road Initiative has recently stirred up concerns about the issues of debt sustainability, transparency, credit systems, and governance. For example, Sri Lanka was unable to repay its debts to China and formally handed over its southern port of Hambantota to China on a 99-year lease.

Djibouti, Pakistan, and Kyrgyzstan are also on the list of potential debt defaulters.

While China is going out into the developing world and building infrastructure, Chinese companies are also going out into the developed world and buying up companies and real estate. In 2016, Chinese outbound investment to the United States tripled (to reach almost $200 billion) and also doubled in Europe. Yet, some of these outbound merger and acquisition (M&A) sprees are raising concerns over moral hazard, unfair commercial practices, and lack of investment reciprocity between China and other countries. In this context, the Committee on Foreign Investment in the United States (CFIUS) has discussed broadening its definition of national security risks. In China, meanwhile, the government has placed new restrictions on outbound foreign investment in an effort to curb capital outflows that are exerting downward pressure on the Chinese renminbi's value and draining foreign exchange reserves.

To encourage private companies to begin to take a greater role in the Chinese economy and decrease Beijing's reliance on state-owned enterprises, Xi's "Made in China 2025" plan encourages a collaborative approach with market actors to spur innovation and highlights the prominent role of social capital. The plan allows companies to determine their own technology standards and helps them better participate in international standards setting, instead of focusing on top-down and unique domestic technical standards. However, when priority is given to investments that comply with national economic and strategic objectives, such as deals in high-tech sectors, private firms risk losing out to SOEs. Xi's industrial policy measures fall short of reversing the recent trend of *guojin mintui* ("the state moving in and private sector retreating"), thereby casting doubts on Beijing's ability to deliver sustainable and long-term growth by enabling market actors.

What about foreign investment? Xi's team wants to attract more foreign investment in newly established development zones and free trade zones, especially in high-value added sectors such as information technology, clean energy, and advanced machinery. According to the American Chamber of Commerce in China's 2018 China Business Climate Survey, 46 percent of respondents are confident that the Chinese government will open the country's markets to further foreign investment within the next three years. However, most foreign enterprises seem less confident about their fate in the Chinese market. Seventy-five percent of member companies in the American Chamber of Commerce in China continued to feel less welcome than before Xi Jinping came to power. Under Xi, foreign businesses are often investigated by Chinese officials. Thus, close to half of the chamber's members voiced concerns over unequal enforcement of regulations and preferential treatment that favors domestic companies. Nearly a quarter of the firms report that they have moved or plan to move business out of China.

International organizations such as the World Trade Organization (WTO) have their own limitations on how far they can push China toward further liberalization. Since China's entry into the WTO in 2001, the central government has lifted more than 7,000 trade barriers and reduced average tariffs to 10 percent since 2011. Still, Beijing can game the system by skillfully navigating through the WTO's long dispute-resolution process and taking advantage of the fact that WTO rulings are prospective rather than retrospective – that is, they only cover losses commencing *after* the ruling and not before. Under this WTO system, it is in China's interest to adopt industrial policy measures first, achieve their intended purposes during the dispute process, and then withdraw these policies after a WTO dispute ruling. Global supply chain dynamics certainly complicate the issue of initiating trade disputes with China. Multinational companies implicitly or explicitly support protectionist measures in China either because they fear retribution from Chinese government officials or because they benefit from gaining even small pieces of the ever-enlarging pie of Chinese trade.

What Lies Ahead

Much has changed in China since 1978, yet one thing is indisputable: promoting reform and development through openness is the only path toward sustainable development and continuous prosperity. China's leaders know that only market forces can generate the long-term growth that can sustain the CCP's political survival, yet they want to ensure that the state controls the wealth that markets generate.

It is worth noting that further liberalization does not mean removing all forms of regulation. Reform requires opening up, and opening up also requires further domestic reform to improve the country's macro-control capabilities, and promoting the modernization of the country's administrative and corporate governance system. The success of the "China model" is in large part due to *how* the country opened up to the outside world along with domestic adjustment.

The current problem of China's economy is that its reform and opening are inadequate, rather than excessive. China's degree of openness is still restricted and is incompatible with the country's status as a power that wields global influence. It has yet to match the purchasing power and consumption habits of China's booming middle class. With more Chinese people going abroad for vacations and educational opportunities, more of its people have had direct experiences with the rest of the world and now want more choices at home.

The Chinese people have come a long way in the ups and downs of their country's developmental path over the last four decades. Mao Zedong's original social contract of constructing a communist utopia through people's communes and the Cultural Revolution degenerated into widespread famine and bloodshed. Deng's version of the social contract promised happiness and prosperity as long as the country remained focused on economic rather than political reform and the Chinese Communist Party maintained its political monopoly. Yet Deng's preference to avoid or postpone questions of political control may no longer be sustainable in today's China.

One way to address this political question is to ensure that the power consolidation occurring at the top of the Chinese government right now serves as a temporary means to an end rather than an end in and of itself. Attempts to establish a permanent form of total CCP political control might eventually weaken the effectiveness and competitiveness of China's economic model, as well the party's ability to address economic and social crises.

Within the party leadership, there is the recognition that China needs a new social contract and thus more assertive efforts at reform. China's consolidated political power structure should help facilitate these reforms if the political will exists to make them. Some worry that Xi's abolition of presidential term limits could mean that various policy challenges will go unaddressed in the future. But one could be cautiously optimistic that Xi will use his unipolar status at the apex of the CCP power structure to hammer out Xi Jinping Thought on a "Social Contract with Chinese Characteristics" for a New Era. This would not only position him as a reformist leader on par with Deng Xiaoping, but also open another door to the "great rejuvenation of the Chinese nation" for both its own benefit and for the benefit of the world.

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