China's Economic Transformation: A Threat to the Liberal Global Order?

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In the forty years since Deng Xiaoping launched his "Reform and Opening" program of economic development in December 1978, China has transformed itself from a closed-off backwater into a vibrant, prosperous country and a major global economic power. Per capita income has risen about 30-fold, from less than US$300 (one-twentieth the global average) in 1978 to US$8,200 (three-quarters of the global average) in 2017. The number of people living in absolute poverty, by the World Bank's standard of average daily expenditure, has fallen from over 750 million in 1990 to about 10 million today. The number of people enjoying "middle class" spending power (again by the World Bank definition) rose from essentially zero to over 200 million. No other country has ever achieved such a great improvement in welfare for so many people in such a short period of time.

As with most other countries that enjoyed sustained income growth through rapid, broad-based industrialization, these gains came at a substantial cost in environmental degradation, higher income inequality, and social tensions. China's problems in this regard are not unique: they are extreme versions of problems encountered by every successful developing country. And in general the government has shown strong capacity to identify and respond to these problems, although in many cases the implementation of environmental and social policies remains imperfect.

The rise in China's global impact is no less impressive. It is now the world's second largest economy, largest trading nation, biggest producer of manufactured goods, largest oil importer, largest source of international tourist travelers, and second largest source of cross-border direct investment capital. It is the biggest trading partner for at least 40 countries; by contrast, the United States is the top trade partner for less than 30 nations. On the darker side, it is also by a wide margin the largest emitter of the carbon dioxide that is the primary driver of global climate change. In 2017 it accounted for 27% of world CO_2 emissions, and it contributed nearly 60% of the total increase in world emissions in the two decades from 1997 to 2017.

In stark contrast to 1978, when it was diplomatically isolated and cut off from most world institutions, China today is a member of virtually all important global bodies, and an increasingly active participant in many of them. It is also trying to augment global economic governance through new institutions and initiatives, notably two multilateral development banks (the Asian Infrastructure Investment Bank and the New Development Bank); the Belt and Road Initiative, an effort to ramp up infrastructure investment in Central and Southeast Asia; and the Forum on China-Africa Cooperation, a program of lending and development assistance to Africa totaling about $20 billion a year.

China's place among the world's great economies is now an established fact, and despite various challenges such as an aging population and slowing productivity growth there is little doubt that China will continue to increase its wealth and global influence in the coming decades. Yet rather than being a cause for celebration, this prospect has aroused great anxiety in the capitals of the established industrial powers in the US, Europe and East Asia. Why?

The main reason is that in the context of the global economic order developed under US leadership after World War II, China's rise is anomalous in ways that now seem systemically challenging. China is:

a) a durably successful economy with a far higher degree of state ownership and intervention than any other major country;

b) an authoritarian, illiberal non-democratic state that is becoming more authoritarian and illiberal rather than less;

c) an independent geopolitical actor with no alliance or security partnership with the United States; and

d) an economy large enough to eventually displace the US as the world's biggest.

In the phrase of Council on Foreign Relations scholar Elizabeth Economy, "China is an illiberal state seeking leadership in a liberal world order."[1] This is an unpleasant fact for analysts and policy makers who believed for years that China's general trajectory under "reform and opening" was towards a less statist economy and a more liberal state whose values and interests were increasingly consistent with those of the global economic system.

The central question today therefore is whether, as it gains global influence, China will be generally supportive of the existing global economic system, cause that system to change in significant ways, or result in a dissolution of the present order and its replacement by something else. The answer to this question depends to a great degree on the time frame one uses to describe China's trajectory. Here we will consider three: the 40 years since the launch of Reform and Opening in 1978, the

[1] Elizabeth C. Economy, *The Third Revolution: Xi Jinping and the New Chinese State*, Oxford University Press (2018), p. 17.

two decades since the Asian financial crisis of 1997-98, and the decade since the American financial crisis of 2008.

China's development: the 40-year view

Taking the 40-year view, the key development has been China's shift from being a poor, isolated country with revisionist geopolitical aims to a relatively prosperous nation firmly embedded in global institutions and production networks and therefore a supporter of the international status quo. The country is richer, poverty has been vastly diminished, the fruits of growth have been broadly distributed (even if not with perfect equity), the realm of personal freedom for most people has been broadly expanded, and China has moved from being an obstructive or obstreperous actor in the international arena to a broadly constructive force, participating in most international agreements and forums, and playing an increasing role in international development.

On the domestic front, there has been a dramatic shift from a command economy to one that is substantially more market driven in virtually all dimensions. Private enterprises, which scarcely existed in 1978 and even until the 1990s were fairly insignificant, now account for about half of exports, over 60% of industrial output and fixed asset investment, and more than 80% of urban employment.[2] Virtually all state controls on goods and services prices were gone by the year 2000, and

[2] Figures from Arthur R. Kroeber, *China's Economy, What Everyone Needs to Know*, Oxford University Press (2016), p. 107.

controls on key factor inputs such as energy and land have been gradually relaxed and are now modest. Most controls on domestic interest rates were phased out during the 2010s. The renminbi exchange rate, long tightly managed against the US dollar, was substantially liberalized with the adoption of a flexible trade-weighted target basket (similar to Singapore's) in 2015.

Domestic governance is also far more open and institutionalized than it was in the late 1970s. As it emerged from the Maoist period, China had virtually no laws or courts, no regulatory bodies, and virtually none of the normal apparatus of a modern state. Over the next four decades China developed a large body of law and regulation to govern most commercial and social activities. Implementation remains deeply imperfect, but the general trend has been towards more consistent and predictable enforcement of the rules, by agencies whose responsibilities are clearly defined and whose staff continues to improve in technical competence. Local governments have more formal authority to set policy priorities in line with local needs and in recent years have gained more predictable sources of finance through the ability to issue both general revenue bonds and special bonds tied to infrastructure projects. These bonds are gradually replacing a chaotic system of off-budget financing heavily dependent on land sales.

Internationally, China under Deng Xiaoping (1978-93) abandoned its previous stance of supporting revolutionary Communist insurgencies around the world and instead focused on developing constructive ties with most countries, resolving many of its territorial disputes, joining international institutions and aligning its practices more with international standards. The biggest achievement of these efforts was of course China's entry into the World Trade Organization (WTO) in December 2001, after 15 years of negotiation.

Moves towards greater integration have continued since. China has played an active role in the G-20, the group of major economies that coordinated global responses to the American financial crisis of 2008, and in the UN-organized talks on climate change that led to an important initial agreement in 2014. Since 2013 it has been negotiating a regional free trade agreement, the Regional Comprehensive Economic Partnership, with the southeast Asian countries of ASEAN. Chinese companies have become more active in helping create international technology standards—for instance, the emerging standard for 5G mobile telephone networks.

The 20-year view

A somewhat different set of patterns if we examine China's development over the past two decades—that is, following the Asian Financial Crisis of 1997-98. That crisis turned out to be a pivotal moment for China's development. Domestically, it provided impetus for far-reaching structural economic reforms that unleashed a decade of spectacular productivity growth. This productivity surge transformed China from a fast-growing but volatile and unstable developing economy into a true industrial powerhouse. Internationally, the Asian crisis—which ravaged other countries in the region but left China looking like a rock of stability—cemented

China's position as the most desirable destination for foreign investment. As a result of its effective crisis response—on top of its long-running efforts to build modern infrastructure and mobilize its vast labor supply—China became an indispensable hub for globalized production chains.

On this 20-year view, two themes stand out. First, in a short space of time China transformed a peripheral country into one of the world's two central economic powers, along with the United States. Second, it adopted a style of economic governance that delivered much more stable growth than in the first 20 years of reform and opening, in part through a more centralized and effective role for the state.

During the first two decades of reform and opening, China underwent breakneck economy growth and wrenching social change. Yet the impact of these changes was mainly contained within China's borders. In the grand scheme of the global economy, China was not that much more important or influential in 1998 than it was in 1978. After the Asian crisis, however, China's growth spilled out mightily into the rest of the world. The breadth and depth of this impact is illustrated the table below, which shows the change in China's global share of various indicators, and its contribution to global growth during the period:

MEASURING THE CHINA SHOCK			
China % share of global total of various indicators, 1997 and 2017			
	1997	**2017**	**China share of global increase, 1997-2017**
Population	21.3%	18.7%	**9%**
Urban population	*15.4%*	*19.9%*	***28%***
GDP	3.1%	15.4%	**23%**
Investment	4.2%	26.5%	**41%**
Manufacturing value added	5.5%	26.7%	**40%**
Exports	3.2%	13.1%	**18%**
Manufactured exports	*3.9%*	*17.9%*	***26%***
Imports	2.5%	9.8%	**14%**
Official military expenditures	2.2%	12.9%	**21%**
Primary energy consumption	10.5%	23.0%	**49%**
Oil imports	3.0%	14.1%	**34%**
Electricity production	8.1%	24.8%	**47%**
CO2 emissions	13.7%	27.3%	**57%**
Foreign exchange reserves	9.0%	27.9%	**31%**
Stock market capitalization*	0.8%	12.0%	**15%**
* Includes Chinese companies listed in all global stock markets			

Sources: World Bank World Development Indicators; BP Statistical Review of World Energy 2017; World Trade Organization; IMF International Financial Statistics; UN World Population Prospects 2017; UNCTAD; WIND; author calculations

In 1997, China's global share of most indices of economic activity was far below its share of global population, but by 2017 its share was generally equal to, and in some cases far higher than, its population share. And its share in the 20-year global *increase* in many of these indices—especially those relating to physical goods production—was enormous. Over the two decades, China accounted for 40% or more of the global increase in manufacturing, investment spending, electricity production, total energy consumption, and carbon emissions. It also emerged as by far the most important importer of commodities, accounting for 34% of the increase in crude oil imports, and 50% or more of the increase in imports for industrial metals and ores such as iron ore and copper. By the end of the period China's US$12 trillion economy was second only to that of the United States, and more than twice as big as the next largest (Japan).

In a very short time, China went from being an economy that most people in most places could ignore to one whose ups and downs had major global impact, and which was central to all global economic decision-making. On net, this impact was economically positive, through the creation of a large new source of demand. But in many specific respects China's impact was disruptive: the entry of its low-cost labor force into the global market made it much harder for richer countries to sustain high-wage manufacturing employment, and businesses in many sectors found it hard to compete with low-cost Chinese competitors, which often benefited from explicit or implicit subsidies from the Chinese state.

The second important theme of this era was the transition from the chaotic and unstable growth pattern of the early reform-and-opening period to a more stable and resilient growth model. This model has two important features: a) a durable bargain between the Communist Party and the rising private business elite; and b) a much stronger coordination and control role for the central government than in any other major economy.

The early stages of the reform-and-opening era, from 1978 until the mid-1990s, were characterized by forceful and often messy efforts to break the power of the old Maoist central planning system. This required decentralization of economic decision-making down to local governments, which also captured most of the tax revenues generated by growth. There was much volatility and social stress. Investment booms and busts were violent, and inflation was a recurrent problem, running high through the 1980s and peaking at 25% in 1993. Between 1978 and 1995 the official renminbi exchange rate depreciated by nearly 80%, from 1.5 to the dollar to 8.5 to the dollar. Dissatisfaction over inflation, corruption and inequitable growth played a big role in the political disturbances leading to the Tiananmen Square massacre of June 1989.

Starting in the mid-1990s, the central government made coordinated efforts to increase its control over the economy and to craft a system that continued to deliver high growth, but with much more economic and political stability. These efforts included:

- fiscal reform in 1994 that returned control of the majority of tax revenues to the central government;
- recapitalization and restructuring of the state-owned banking system in 1998-2004;
- the initiation of centrally-managed national infrastructure projects, starting with the build-out of an expressway system from 1997, and continuing with the creation of national telecommunications and electricity grids, and the construction of the world's largest high-speed rail network in 2007-2017; and
- a massive restructuring of state-owned enterprises designed around the concept of 抓大放小 (*zhuada fangxiao* or "grasp the big and release the small").

The latter program was usually interpreted by outside analysts as a "market oriented reform", and so it was in part. But while "release the small" meant privatizing vast swathes of China's export-oriented light manufacturing industries, "grasp the big" was at least an equally important goal. It involved tightening the central government's grip on the economic "commanding heights," including most of heavy industry and the network operators (electricity, telecommunications, transportation and so on) that collectively can be thought of as the economy's nervous system.

Centralization gave Beijing greater ability to coordinate resource allocation and to manage macro-economic volatility than in the days when economic decision-making lay largely with dozens of provincial governments. But by itself it could not generate sustained rapid economic growth; this required a dynamic private sector to generate gains in productivity, innovation, employment and incomes. So an implicit bargain was struck: the Communist Party would give private entrepreneurs plenty of latitude to grow their businesses and personal wealth, and in exchange entrepreneurs would give their political fealty to the Party. In 2001 private business people were once again allowed to join the Party, after being shut out of it following the 1989 political disturbances. Subsequently, entrepreneurs were systematically co-opted by being encouraged to join government bodies such as the National People's Congress and the Chinese People's Political Consultative Conference.[3]

The results of this hybrid of top-down control and bottom-up entrepreneurial dynamism have been impressive. Annual economic growth averaged around 11% from 1998 through 2013, and 6.5% since then—still by a wide margin the fastest growth rate of any major economy. While this growth was more volatile than

[3] The mechanisms of entrepreneur co-optation are well described in Richard McGregor, *The Party: The Secret World of China's Communist Rulers* (Allen Lane, 2010), chapter 7, pp. 194-228.

depicted in official statistics, it was much less volatile than the growth in the preceding two decades. Inflation stayed firmly under control. The exchange rate stabilized and, after 2005, was allowed to appreciate, by around 36% against the dollar over the next decade. The private sector delivered the lion's share of productivity and employment growth, but it remained politically subservient to the Party.[4] And after a period of retrenchment, the economic role of state-owned enterprises stabilized, continuing to account for about a third of output and firmly controlling the "commanding heights" sectors.

The 10-year view

Looking at the decade since the American financial crisis of 2008 that quickly turned into the biggest global economic disruption since the Great Depression, two themes are crucial:

- China's increasing confidence in the value, durability and perhaps exportability of its state-led economic development model.
- A shift in emphasis from "opening inward" (that is, increasing market access for foreign firms in China) to "opening outward" (increasing China's business, economic and political influence in the rest of the world).

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[4] Documentation of the private sector's disproportionate contribution to China's economic growth since 1997 is in Nicholas Lardy, *Markets Over Mao: The Rise of Private Business in China* (Peterson Institute for International Economics, 2014).

These shifts have their origins in events, systemic changes, and personalities. The first pivotal event obviously was the financial crisis of 2008-09, which severely weakened the US and Europe and more importantly discredited the cause of market-oriented liberalization in China. Thanks to a massive economic stimulus program that depended heavily on state-led infrastructure spending, China recovered from the crisis far more quickly than any other country and sustained high economic growth rates without resort to the unorthodox monetary policies used by the US, Europe and Japan. Starting in 2013, the trend growth rate fell from its long-run average of over 10% to about 6.5%, but this was a natural development in a maturing economy and had been widely foreseen.

The second pivotal event was the political transition in 2012-2013 from the relatively cautious and politically fragmented Hu Jintao administration to the rule of Xi Jinping, a far stronger, more visionary and more determined leader. Xi launched a massive anti-corruption campaign, tightened central control over local governments and the control of the Communist Party over all aspects of society, and abandoned the "hide and bide" foreign policy stance laid down by Deng Xiaoping in favor of much more forceful assertion of China's international interests, including territorial claims in the South China Sea. He also promoted two major initiatives which, while ostensibly economic in nature, augured a far bigger geopolitical role for China.

The first, announced in 2013, was the Belt and Road Initiative (BRI). Though often portrayed as a set of infrastructure projects, BRI is really a foreign policy "grand strategy": an effort to increase China's geopolitical influence through fostering economic interdependence. The idea is that as China finances and builds useful infrastructure in neighboring countries, linking their markets more tightly with China's and (perhaps) creating positive spillovers in the local economy, those countries will have an increased incentive to align their interests with China's. The logic is similar to that of US grand strategy after World War II, which used liberal international economic arrangements such as the Marshall Plan, the Bretton Woods institutions, and the General Agreement on Tariffs and Trade to encourage countries to stay in the global security alliance against the Soviet Union.

The second, launched in 2015, is Made in China 2025, a comprehensive industrial policy that aims to boost China's technological capacities in ten major sectors including semiconductors, artificial intelligence, robotics and aerospace. The program includes specific market-share targets for Chinese firms, and so can be seen as a program of import substitution. The government has also set up myriad "government guidance funds" which aim to direct billions of dollars of investment to Chinese firms in the targeted sectors. Headline numbers almost certainly exaggerate the amount of money deployed by these funds. But in a few sectors, notably semiconductors, the impact of these "venture capital" subsidies is already clear. Today three memory-chip plants are under construction in central China, with most of the $35 billion in construction cost covered by a government-run integrated-circuit fund.

These policy shifts obviously owed much to Xi's leadership. But they also grew out of earlier trends. Belt and Road is the successor to the "Go Out" policy of Jiang Zemin in the early 2000s, and to a great extent merely codifies international activity by Chinese engineering companies that was already widespread. MIC2025 is the latest iteration of technology-focused industrial policies dating back to the 1980s.

Conclusions

What do these varying perspectives tell us about the question we posed at the outset: will China's rise support the global economic order, force it to change in important ways, or cause it to fall apart? The 40-year view is the most optimistic: it tells us that, over the long run, China has steadily moved towards greater global integration, has benefited enormously from this integration, and so has a large vested interest in the perpetuation of the system that has enabled its rise. Repeated statements by Xi Jinping and other senior leaders over the past two years about the need to maintain an open trade and investment arrangements reflect this understanding.

The 20-year view is more sobering. It shows, first, that China's impact on the global economy has been unusually large and disruptive. More important, it suggests that the aim of China's economic strategies over that period has been to create a unique Chinese economic model, with several core characteristics—notably the key role of state-owned enterprises controlled by the Communist Party, and the use of the state-controlled financial system to massively subsidize favored industries—that diverge dramatically from the model assumed by global economic institutions, chiefly the WTO.

China's scale would be less of a problem if its economy were organized in ways more recognizable to (and therefore more susceptible to economic pressure by) the established powers. And its unusually statist economic model would be much less of a problem if China were not so big. The combination of unprecedented scale and a fiercely idiosyncratic (and successful) economic model means that both China and the global system must adjust substantially if their productive symbiosis is to continue.

The 10-year view can produce the most alarming prognosis—but only if one wants it to. The extreme interpretation is that the shock of the American financial crisis and the rise of Xi Jinping have pushed China into becoming a full-on "revisionist" power, bent on ultimately replacing the postwar global order with one of its own design. This view was adopted by the Trump Administration in its national security, defense and trade strategy documents,[5] and provides the rationale for its pressure campaign of trade tariffs and investment restrictions designed to hobble China's economic and technological development and to encourage US companies to scale back their investments there.

[5] Respectively available at https://www.whitehouse.gov/wp-content/uploads/2017/12/NSS-Final-12-18-2017-0905.pdf; https://dod.defense.gov/Portals/1/Documents/pubs/2018-National-Defense-Strategy-Summary.pdf; https://ustr.gov/about-us/policy-offices/press-office/reports-and-publications/2018/2018-trade-policy-agenda-and-2017

In my view, this interpretation greatly exaggerates the systemic risk posed by China and unhelpfully confuses questions of global economic governance with US geopolitical anxieties. A less extreme and more accurate interpretation of the last decade is that China has indeed become more confident in the value of its statist economic model, and more insistent on taking a greater role in regional and global affairs—on its own terms, not terms set by other countries. It asserts this role both by pushing for a greater say in existing global institutions, and by fostering new institutions. For instance, under Xi Jinping China both lobbied for greater voting rights in the IMF, and set up the new Asia Infrastructure Investment Bank. After much delay it gained more votes in the IMF (although its voting weight, 6.09%, is still less than half China's weight in the global economy). The AIIB is headquartered in Beijing and has China as its largest shareholder; but over 70% of the shares are held by 67 other member countries, and its governance structure is closely modeled on that of the World Bank and Asian Development Bank.

Moreover, China's assertiveness is tempered by its continued reliance on access to international markets and on flows of foreign investment. Foreign direct investment continues to enter China at an annual rate of over $100 billion, bringing with it much needed technology and management expertise. Portfolio investment inflows are minimal but will need to increase massively if China is ever to realize its hope to develop a fully modern financial system.

In short, China's economy is both profoundly different from other major economies and profoundly dependent on the global system. The liberal global economic system is seven decades in the making and its core, the 34 members of the OECD, account for a combined 57% of world GDP, far more than China's 16%. It has the financial, institutional and intellectual resources to figure out how to accommodate China's natural ambitions while enhancing the most important features of the global system, namely reciprocal market access, low barriers to trade and investment, and robust rules for fair competition. The capacity of the current order to defend itself is far greater than the capacity of China, which has no real allies, to create a new one.

An example of how this could be achieved is the Trans-Pacific Partnership (TPP), an agreement that would have established higher standards for intellectual property protection, trade in services, treatment of state-owned enterprises, environmental standard and labor rights. Had it come into effect—covering 12 countries with a combined GDP two and a half times that of China—China would be left with the choice of staying out and sacrificing large economic gains, or joining at the cost of modifying much of its domestic system to conform more to international norms. The prospects of TPP ever taking effect were dimmed by US withdrawal in January 2017. But the logic behind it remains sound. China will always seek to run its economy on lines quite different from those that prevail in the industrialized West. For its economy to keep growing at a rapid pace, however, it has little choice but to integrate more deeply with the rest of the world. It is an achievable—though by no means easy—task for the custodians of the liberal global system to enable China's integration while maintaining the fundamental principles on which that system is based.