Breaking Point: the Future of China's Economy

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Beijing is on a slippery slope. Since the country's watershed of 1979, where Deng Xiaoping initiated massive reformations that opened the country economically, there has been a transitional period from a Party controlled state towards experimental capitalism; the objective being not only to modernize, but to create a fruitful environment for its citizens. Three decades later, the limelight has revealed astonishing economic growth, incredible feats of engineering, and the uplifting of hundreds of millions out of poverty. Whether these reforms have enabled the goal of collective prosperity is inconclusive. Development of a state and society though is not merely about economic growth, but the welfare of the public. "Perhaps of the most relevance to the state is that when compatible policy reforms and institutional strategies fail to keep pace with rapid socioeconomic change, social development will be far from balanced."[1]. Following the tradition of stability, China has been unable to adequately address the fluxing social changes occurring due to massive sustained economic growth. Instead Beijing continues to feed state owned enterprises, pours billions into investment, and eases restrictions on the free-market, believing that society, and thus the Communist Party of China, will remain static as long as wallets are filled and economic growth continues. While not imminent, it will be argued that the continuation of such policies will eventually create social resentment which will shake the fundamental base of the CCP, forcing it to change or be replaced.

A stronger economy leads to a stronger society. This concept – that economic development will lead directly to beneficial political and social change – is at the heart of the Modernization Theory [2]. Stemming from the Age of Enlightening in the 18th century, it states that if certain variables are stimulated, (e.g. industrialization, higher education, urbanization, high GNP per capita), 'traditional' countries can mirror already developed countries towards a more democratic stance. It begins with industrialization.[3]The rural population, wishing to rid itself of poverty from the countryside, migrates towards urban areas. Employment in industry creates a collective consciousness for this new class of workers, causing them to unionize. Additionally, the urban environment is not only more hospitable to education, but handicaps those who fall behind. Playing a critical role in the creation of this industrialized wealth, as well as now being educated and united, these prior migrants will demand a higher share of the state's resources. Conversely, due to the higher economic growth created by the working class, the government / elites are willing to bargain and share the newly developed wealth and provide political participation.

Modernization theory suggests that China's economic development, conjoined with capitalist ventures, is paramount for an eventual democratization of the country[4]. First, capitalism allows for the creation of an entrepreneur class who do not have to depend upon the state's coercive power to survive. Secondly, capitalism swells the bourgeois class, allowing for greater social pressure to be placed on the government to undertake a democratic shift to quench political turmoil, at least in theory. In China, this is not the case. The big private entrepreneurs in China benefit from a coupled relationship with Chinese officials[5] and thus are consequently unlikely to encourage democratic progress. Additionally, the middle class, in charge of the small private entrepreneurs, are equally unconvinced that democratic change will offer them much capital gain. In fact, the culture value of 'stability' is actually at odds with the "chaotic nature of a democratic transition."[6] As long as the newly created bourgeois class in China is content, then so is the Party. Reforms have thus been implemented to perpetuate the current economic cycle.

Before highlighting the obstacles to this decision though, it is important to acknowledge the prosperity that China has been able to create. In terms of GDP, China is 90 times larger than it was in 1978 when market based reforms were implemented in place the CCP centralized planning.[7] In August 2010, it passed Japan as the second largest economy after the US with $1.33 trillion in the second quarter compared to Japan's $1.28 trillion. With a monstrous growth rate between 8-10 percent, investors are already predicting when China will overcome the US economy of $14 trillion. The economic boom has enabled hundreds of millions to rise above extreme poverty. Additionally, this revenue has allowed China to invest massively into it's future through the education of it's youth. As noted by Robert Fogel in *Foreign Affars*,

"Over the next four years, enrollment in higher education increased 165 percent, and the number of Chinese studying abroad rose 152 percent. Between 2000 and 2004, university enrollment continued to rise steeply, by about 50 percent. I forecast that China will be able to increase its high school enrollment rate to the neighborhood of 100 percent and the college rate to about 50 percent over the next generation, which would by itself add more than 6 percentage points to the country's annual economic growth rate."[8]

Economic reforms which diverged from centralized planning, giving more freedom and incentives, were the primary ingredient for this opportunity. Before the 1979 market reformation, prices, production and resources were controlled throughout most of the economy. In the 1950's, under Mao, individual farms were collectivized into communes. By the 1970's, decades of rapid industrialization and central planning resulted in nearly three-fourths of industrial production being controlled by SOEs (State Owned Enterprises)[9] , and foreign investment and privatized enterprises were nil. The initial goal was to create a China that was essentially self-sufficient. What occurred though was an economy which was stagnant and inefficient. Few profit incentives, price regulations, and no competition between firms led to a skewed economy. Consequently, living conditions were drastically lower than in other developing states. The 1979 Economic Reforms, though, allowed for local and provincial governments in four specialized zones to operate under free market ideals. The purpose was to experiment in capitalism. Gradually, the Party relaxed state controlled prices, and has since created an environment which entices foreign investment and stimulates exports. The results of these reforms have led to a remarkable increase in GDP.

"Economists generally attribute much of China's rapid economic growth to two main factors: large-scale capital investment (financed by large domestic savings and foreign investment) and rapid productivity growth."[10] The double edged sword here is *investment*. China has developed since the 1970s into an export-led industrial nation which is fueled by a weak currency. This has resulted in high household savings rates (41%) and corporate savings rate, as well as a dependance upon net exports and fixed investment. "When net exports collapsed in 2008-2009 from 11% of GDP to 5%, China's leaders reacted by further increasing the fixed-investment share of GDP from 42% to 47%." [11] Looking at the GPD equation is helpful to see how an economies expenditures (Investment, Consumption, Government, and Net Exports) are broken down.

$$Y = I + C + G + X\text{-}M$$

In China, the majority of GDP depends on Investments (I). Chinese trade-market reforms, as well as very low interests rates has led to an outpouring of Foreign Direct Investment (FDI) into the country. By 2002, China had surpassed the United States as the world's largest recipient of FDI [12] This foreign investment has enabled it to promote the exportation of it's goods. The United States, in contrast, relies primarily upon Consumption Expenditure (70%), while only 35% of Chinese GDP originates from Consumption. This is due, amongst other things, to (1) lack of social safety nets, (2) underdevelopment of consumer finance, and (3) a weak currency which lowers potential 'purchasing power.'

"Low interest rates on deposits and low lending rates for firms and developers mean that the household sector's massive savings receive negative rates of return, while the real cost of borrowing for SOEs is also negative. This creates a powerful incentive to over-invest."[13]

During the recession of 2008-2009, instead of risking civilian discontent and passing policy to address the lack of consumer Consumption, Chinese policy pushed for an increase in investment (I), instead, to compensate for GDP loss. This allowed them to temporarily avoid the severity of the recession, but this precedent has now increased fixed-investments to nearly 50% of GDP. The following chart [14] demonstrates how fixed investments have increased by an astonishing 186 times increase since 1982, while GDP has remained steadfast.

The current Twelfth 'Five-Year Plan' for 2011-2015 aims to increase consumption in GDP, improve social safety nets, social infrastructure and essentially rebalance the economy[15] The elephant in the room though is that the plan primarily continues to focus upon investment to carry the burden of economic growth, rather then creating an agenda which privatizes / taxes SOEs, and eases household registration and financial repression.

Emphasis on Investment is dangerous. First it is wasteful. To efficiently spend 50% of GDP in investments would be an incredible feat. Instead, China is littered with empty airports, bridges to nowhere, make-work programs and ghost cities. As Patrick Chovanec, a business professor at Tsingghua University explains, "Who wants to be the mayor who reports that he didn't get eight percent GDP growth this year? Nobody wants to come forward with that. So the incentives in the system are to build. And if that's the easiest way to achieve growth, then you build."[16]

Secondly, in the short run, this massive influx of investment spending will indeed increase GDP, but as the Phillips Curve demonstrates, as the output gap of GDP increase, inflation will inevitably follow. During the 1990s, excessive expenditures in investment led to a financial crisis in East Asia. Paul Krugman in 1994 argued that the economic expansion in East Asia was caused by excessive investment and increased labor force participation, and that actual total factor productivity had not increased.[17] Although there are key differences, China could abruptly run head-on into the same hurdle. Academics have suggested that pressures from inflation due to Zhao Ziyangs market reforms in 1988 were at the root of vehement criticism of the CCP[18]

The manifestation of this is occurring now. As reported by the BBC, April 17, 2011, to combat rising inflation:

> "China's central bank has increased the money Lenders must hold in reserve, for the fourth time this year. This comes after inflation hit a nearly three-year high, and many now fear the world's second biggest economy is over-heating. By raising the required reserve ratio to 20.5%, the Chinese central bank hopes to lock up about $54bn (£33bn) of loanable cash, restricting the amount of money that can be borrowed."[19]

Decreasing loanable money means that interests rates will have to increase. Acknowledging that both Investments and Exports are affected negatively by higher interests rates [R] in the following economic equations,

$$I = e - dR$$
$$X = g - mY - nR$$

it can be reasoned that the restriction of loanable money will decrease investments and exports, and thus China's GPD ($Y = I + C + G + X\text{-}M$) will have to fall. While deflation should increase the 'purchasing power' of individuals, any increase in consumption expenditure [C] would be countered by the fact that (1) Chinese consumers save 40% or more due to lack of social safety nets, and that (2) consumption currently constitutes less then 50% of GDP[20], meaning that financial consumer infrastructure simply isn't developed enough to compensate for the drastic drop in GDP from the loss in investments and exports. Additionally, higher interests will put greater strain upon the already fragile banking system. The Chinese Government has been using the banking system to keep money-losing SOEs alive for political means by pressuring state banks to provide low interest loans. With less money to loan though, these SOEs would inevitably go bankrupt. (In fact, bad loans are in such high quantity that, "three out of four state commercial banks are believed to be insolvent"[21]. The millions of employees from these SOEs would join their unemployed comrades who are not building infrastructure because the interest rates are too high to finance it.

John W. Lewis and Xue Litai stated in *Social Change and Political Reform in China: Meeting the Challenge of Success* that,

> "Underlying changes that accompanied dramatic economic growth created serious internal problems, and these problems in turn forced the leadership to undertake more open political reforms or face rising dissent, deepening corruption and an even greater loss of Party authority."[22]

This continues to hold true today. Rapid economic growth has created inequality and rising social polarization. Although those in the prominent coastal regions enjoy the luxuries of wealth, one can witness grave problems afflicting migrant workers and the poor. “The overall scenario is thus a society with a galloping economy (“rush-to” mod-ernisation) but fails at managing the social effects of economic change.”[23] “‘The original social strata are disintegrating, and new classes are taking shape and becoming stronger.’[24] As stated previously, the Chinese government forfeited the lower class in hopes to sustain economic growth by working with the new bourgeois class. “As a result, the Party has lost its original social base.”[25] Additionally, this cozy arrangement only works because the two parties trust each other to continue economic growth.

As the childhood story goes, ‘If you give a mouse a cookie, he’s going to ask for a glass of milk.’ CCP offered it’s citizens a cookie under the “Open Door” policy by opening free markets and capitalistic opportunities. Consequently, an influx of western ideas filtered through Chinese culture,

> “A national survey of Chinese political culture . . . reported that not only the highly educated and urbanized segment of the population but also party and communist youth league members adhered to Western ideas regarding assertion of individual choice . . . Even after the crackdown of the pro-democracy movement in 1989, a wide range of survey data intimated that many students still admired Western democracy and supported capitalism . . . There was also wide endorsement for free choice in religion, thinking, and life goals, with most believing that the state should not attempt to interfere with the private life of citizens.”[26]

When the Chinese economy finally hits the economic hurdle, and these entrepreneurs see their quasi-capitalist dreams threatened, their partnership with the government will dramatically change. “Essentially, what the middle classes seeks is an institutional justification of capitalism, in order to cement their business sustainability and capitalist way of life”[27]. Truly, “They are more vociferous than the bourgeoisie in their demands for legal-institutional apparatus to prevent the party-state from manipulating the market”[28]. As the middle class continues to grow in China and contributes more towards the wealth of the country, it is inevitable that they will want safeguards to protect their earnings and investments. While this has began with liberalizing capitalist reforms, it will transform into a substantial class block who will demand greater securities over their goods from the government.

Having cast their lot in with these entrepreneurs, the Party will have to respond by initiating more capitalist reforms. The privatization of SOEs, which represent a quarter of industrial production and employ almost two-thirds or urban laborers, would have to be implemented, or at least taxed more heavily, and their profits directed towards the household sector to increase Consumer expenditures to ensure a crisis would be softened. Of course, this would imply that the government would allow many of these politically powerful firms to go bankrupt, which is not likely. No doubt, a further increase in investment would be implemented to keep these expired firms afloat, which would only further create distrust between the government and the entrepreneur.

While this is not imminent, it is certainly on the Chinese horizon. Capitalistic reforms which continue to quench the thirst of workers and entrepreneurs alike, while decentralizing the role of government in economic affairs, are certainly on the table. As stated previously, the continuation of these reforms will accumulate and lift more Chinese into the middle class, and as more are lifted out of poverty they will become an increasingly powerful block which, in turn, will be able to put persistent pressure open the CCP to adapt and respond to growing economic challenges. In theory, this new civil society, created by capitalist reforms, could be a step towards a possible democratic transition. What is certain is that a failure to acknowledge and adequately compromise with the new class, putting emphasis simply on continued economic growth, will ultimately backfire in discontent. In the thriving economic world, where there is a fluxing socioeconomic structure, it would be reckless for the Chinese government to not act prudently to avoid this inevitable outcome.

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