2. 40 years of Chinese economic reform and development and the challenge of 50

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On 22 December 1978, the eleventh Central Committee of the Communist Party of China (CPC) completed its third plenary meeting.

There was no contemporary recognition in the West of its significance. The twentieth, thirtieth and now fortieth anniversaries have received far more attention. In the intervening years, China and its relations with the international community have been transformed.

We published the first of this series of books about the Chinese reforms and economy on the twentieth anniversary, 20 years ago. China’s economy had expanded by five times over the intervening two decades, and its foreign trade by 12 times. Consumption levels had greatly increased for nearly half of the world’s people in poverty. From being an isolated, autarchic economy, China through the 1990s absorbed about half of the foreign direct investment (FDI) flows to developing economies. From having no trade or investment ties with Taiwan and South Korea, by the 1990s, China was the first or second largest export destination of one and the third largest of the other.

Even greater had been the transformation of the Chinese mind. Tens of millions of Chinese were by then part of an international community of ideas and information. With the expanded role of the market had come a substantial widening in the sphere of personal freedom—to travel and to communicate with others.

Changes of this dimension and at this extraordinary speed are unsettling and potentially destabilising. Yet for all the disruption of change, and the many new problems it had generated, most Chinese welcomed the transformation over the first two decades. Certainly, the large increase in living standards was appreciated enough to provide a base for continuity in political leadership and institutions despite the immense stress and dislocation.

The pace of change has been maintained over the second 20 years of the reform period. The economy in 2017 was 5.3 times larger than in 1998, and international trade 12.6 times. The information networks in which ordinary citizens participate within and beyond China have expanded beyond the wildest imagination of 20 years ago. This is partly the march of global technology and partly the movement
of Chinese people to the global frontiers of knowledge and technology—somewhat constrained by the authorities’ restrictions on the use of those new technologies. More than 140 million Chinese now have passports for travel abroad and 751 million communicate with each other and outsiders through the internet.

The tensions over growing income and wealth inequality at the first and second decadal anniversaries have continued, and have been joined by concerns about deteriorating environmental conditions affecting the health of many people across the country. The abuse of office for personal enrichment has been a continuing and increasing source of resentment, eventually growing into a threat to the stability of Communist Party rule. The correction of growing inequality, environmental deterioration and corruption has become a central policy objective. The elimination of poverty is now a policy goal. Rapidly rising living standards for ordinary people as labour became scarce and state policy focused on distributional issues provided a salve to social tensions from the later years of the third decade of reform.

Now, approaching the fortieth anniversary, China has become such a large economy that changes in the rate or character of its growth affect people everywhere, generating tensions in China’s external relations and feeding back into domestic political and economic realities in complex ways. China is now large enough to be consequential to the developed countries’ ways of relating to each other and the developing world, and to ideas and norms relating to domestic political organisation everywhere.

**Ideas and policy in the first 20 years**

When Deng Xiaoping and his supporters took decisive control of the Central Committee of the CPC 40 years ago, they brought to an end what Deng himself once described to former Australian prime minister Bob Hawke in my presence as two years of indecisive economic strategy and policy after the death of Mao Zedong in 1976. During those two years, policies embodying pragmatic acceptance of a large role for domestic and international market exchange were in contest with Maoist commitments to local and national autarchy, central planning, state-owned enterprises (SOEs) in the cities and people’s communes in the countryside.

Deng and his supporters were victims of the Cultural Revolution. The reaction against the anarchy of that decade was their political launching pad. They had been the managers of the early periods of Communist Party success, in the 1950s before the ‘Great Leap Forward’ and in the brief interlude between the recognition of failure of that first lethal experiment in unworldly application of Maoist theory and the anarchy of the second. They harked back to earlier success, when markets had been allowed to play substantial roles at least in the countryside, within a system in which central planning was supported by a firm administrative order.
The reformist leaders of December 1978 were aware that the world had changed from the earlier days of partial success. They were aware of China's military vulnerability, as an economically weak and technologically backward society. They were deeply conscious that China shared the world's longest border with an apparently economically successful, technologically advanced and politically expansionist authoritarian state, the world's second military superpower. Some of them were aware as well that their rivals from the Chinese civil war across the Taiwan Strait, their compatriots in colonial Hong Kong and their Cold War enemies in South Korea were enjoying sustained economic success that raised deeply challenging questions about China's own continuing backwardness.

It was China's strategic vulnerability that had caused and allowed premier Zhou Enlai to champion the modernisation of industry, agriculture, science and technology and national defence in the early 1970s, after the armed clashes along the border with Russia in Heilongjiang. The intensification of the Sino–Soviet conflict and China's 'four modernisations' provided the context for diplomatic rapprochement with the United States and for Deng Xiaoping's temporary rehabilitation as vice-premier in the early 1970s. China's national policy lurched dangerously as competing ideas and political forces struggled to take control of the tiller of state. The ultimate directions were strongly influenced by the arrest by the People's Liberation Army (PLA) of the 'Gang of Four' after the death of Mao.

Important steps were taken to create a base for future growth in this period of indecisive policy. The awesome denial of formal education during the Cultural Revolution ended, with the return of competitive entry into the great universities in 1977. China's state enterprises experimented with the purchase of productive new technologies from abroad, but there were crosscurrents and countercurrents, continued ideological contests over high policy and uncertainty as subordinate leaders watched for the emergence of a clear national direction.

Since December 1978 there has been no turning back.

It is not that Deng and his colleagues obtained endorsement for an elaborate, comprehensive new economic policy or plan. There was no blueprint for China's economic reform and internationalisation—even less than there had been in Taiwan and South Korea at the beginning of their sustained, rapid growth 15 years earlier.

But after the 1978 plenum, there was acceptance in China that domestic and international exchange through markets was a necessary and acceptable component of a national development strategy. There was pragmatic acceptance that institutions and policies that raised national economic output had a valid place in China—summed up in Deng's rehabilitation of an early Maoist exhortation to 'seek truth from facts'.

The new political environment after 1978 saw foreign trade, FDI and the utilisation of external technological cooperation and capital in all forms become acceptable elements of national policy. Local experiments with new forms of organisation of agricultural production were allowed, leading, within a few years, to the virtually complete replacement of the people’s communes with the immensely more productive household responsibility system (HRS). Markets became important for exchange for the rapidly expanding agricultural output.

The strands were drawn together in the 1987 CPC congress’s acceptance of general secretary Zhao Ziyang’s characterisation of China as a backward country in the ‘primary stage of socialism’, in which the first national objective had to be the strengthening of the national economy.

The absence of a comprehensive reform strategy, the eclecticism of economic policy and the gradualism of change were heavily criticised by foreign observers through the first two decades—and sometimes still are today. But the absence of a blueprint was an inevitable consequence of China’s circumstances, and in practice a virtue.

This was because there was no conceptual basis for a market-oriented economy. A few leaders, and a few intellectuals around the edges of policy, had absorbed some understanding of internationally oriented growth in Japan, South Korea, Taiwan, Hong Kong and Singapore. But the main understanding grew out of experience with the new patterns of economic development themselves, through observations of the operation of markets within China and increasing contact with foreign experience and ideas.

Nor was there an ideological basis in the early years for articulation of a model of development based on the operation of markets, deeply integrated into the international economy. Deng Xiaoping’s political control of the CPC and the PLA was strong but not unconditional. It was built partly on others’ confidence that he stood firmly for continued Communist Party political dominance and commitment to some undefined minimum core of socialist principles and objectives.

The absence of a blueprint was a virtue because any theoretical model of reform of the centrally planned economy in China would have been deeply flawed. The rapid unwinding of a centrally planned economy, dominated by SOEs in the cities and communes in the countryside, is fraught with risk of massive dislocation—a reality that was imperfectly understood before the unhappy later experience of Eastern Europe and the former Soviet Union. Some of the great strengths of the Chinese economy in the era of reform came as a surprise to Chinese and foreign observers alike and would have been given an inadequate place in a development blueprint built on the received theory and experience of others. First among the surprises was the extraordinary dynamism of industrial production in the township and village enterprises (TVEs) that grew from the remnants of the disintegrating people’s communes.
Deng used to describe economic reform in China as ‘crossing the river by feeling the stones’ at each step. Hu Yaobang described reform in a letter to Bob Hawke as an experiment without precedent. In the uncertain months following the dismissal of Hu from the office of general secretary of the CPC in January 1987, Deng alluded uncharacteristically to the Chinese classics in a conversation with the secretary general of Japan’s Liberal Democratic Party, Noboru Takeshita. He compared the path of reform with the mission of Guan Yu, who had to cross five passes and cut down six generals to achieve his noble objective.¹

These metaphors contain important insights. Chinese reform required transformations in ideology, in ideas about economic development and policy, in law and regulatory systems and in economic institutions. Above all, it required the accumulation of new knowledge and wisdom in a billion Chinese minds, as people learned to do new things in an economic and social world that was fundamentally changed.

These transformations in ideology, ideas, policy, law, institutions, knowledge and experience occurred concurrently, reinforcing each other, and each created problems for others when it ran into trouble.

It took great courage and faith in some abstract and thinly formed ideas for the Chinese collective leadership to wade into the river of reform—and a clear understanding that the maintenance of the status quo in centrally planned China in the aftermath of the Cultural Revolution meant continued backwardness, vulnerability and eventually instability in a rapidly developing East Asia and changing world.

On establishing his preeminence in the exercise of political power, Deng identified two effective agents for reform: Hu as general secretary, for reform of the CPC, and Zhao as premier, for reform of state institutions and policy. As general secretary, Hu led the task of replacing the huge cadre of beneficiaries of the Cultural Revolution with people able to lead and support reform. Zhao was the leader of the practical business of policy reform. Each made extraordinary contributions of leadership and intellect, managing change on a scale and at a pace that were unique in human experience. Each was informed by experience to the view that successful economic reform and development would require a widening of the scope for open discussion of policy, for dissent within the limits set by the imperatives of continued undisputed Communist Party rule and for reform of the political system to make policy somewhat more open to pressures from the rapidly changing society beyond the central leadership. Deng eventually came to doubt the will and the capacity

¹ When Takeshita visited The Australian National University in November 1998, I reminded him of the 1987 conversation, which was reported at the time in the Chinese press. He remembered it more for Deng Xiaoping’s imprecision in the numbers and details of economic policy than for his classical allusion!
of each to secure and enforce the authority of the CPC, causing the dismissal of Hu in January 1987 after student demonstrations in Shanghai and of Zhao, then CPC general secretary, in the crisis over the management of unrest in Beijing in May 1989.

General secretary Jiang Zemin and other successors to Hu and Zhao after the leadership crisis of 1987–89—selected by Deng and, until his death in 1997, sustained by him—placed a higher premium on stability. They defined and narrowed the boundaries of discussion of political system change—in the end, without diminishing commitment to internationally oriented market reform. Deng’s legacy of both internationally oriented economic reform and strong state political control has persisted and gathered stronger support under other leaders in the two decades since his death—the latter most decisively under General Secretary Xi Jinping since 2012.

In the early years of reform, courage and faith, and a clear view of the futility of standing still, were required in the leadership of all state institutions. In the great universities, ageing professors—some with pre-revolutionary experience of academic institutions in the West—were called back from the disgrace of the Cultural Revolution to the massive and depressing replacement of half a generation lost to disciplined education. Some leaders of pre-revolutionary business who had opted to make their lives in the mainland, and who had mostly been rewarded by humiliation in the years before reform, accepted invitations to lead market-oriented new state businesses as examples for the huge and cumbersome enterprises that had grown within the framework of central planning.

In one of the boldest of early reform decisions, in the first decade, many tens of thousands of young people were sent or allowed to go abroad as students—to America, Australia, Japan, Europe and Hong Kong. They became channels for information and agents of change when they returned to live and work or, more commonly, when they returned to visit or simply kept in touch with home. They were later overwhelmed numerically by private students going abroad. Student exchanges have educated large numbers of Chinese and foreigners about their shared and differentiated human experience.

The conceptual gap that had to be bridged in the course of reform was immense, extending into every corner of economic policy.

To take one corner, the idea that a country can maximise the value of its production and incomes through open trade, relying on imports for goods and services in which the economy has comparative disadvantage, is not intuitively obvious to Chinese any more than to anyone else. Even where policymakers accept the logic of comparative advantage, its full reflection in policy is resisted by vested interests which expect to be damaged by it. In China, the usual resistance to specialisation according
to comparative advantage was reinforced by the heavy emphasis on autarchy in communist central planning, by the special Maoist exhortation to ‘self-reliance’ and by the overlay of security concerns about dependence on foreign trade. Inside and outside China there were doubts about the capacity and willingness of the rest of the world to adjust to much higher levels of Chinese exports.

The acceptance of the idea that there are gains in specialisation according to comparative advantage came slowly, and each major sector of the economy became a battleground over acceptance. The idea gained enough ground for policy change to allow the beginnings of rapid expansion of exports of labour-intensive manufactures alongside rapid growth in imports of a range of capital-intensive and technologically sophisticated manufactured goods and of industrial raw materials. The gains from trade then made their own eloquent case for going further. An important milestone was Zhao Ziyang’s articulation of a coastal economic strategy in early 1988, under which coastal China would expand its export-oriented manufacturing base, building on its relative abundance of labour and drawing raw materials from international markets.

The understanding of comparative advantage and the gains from trade was assimilated into Chinese development policy so thoroughly that official and academic China at the fourth decadal anniversary of reform have become sources of education on Ricardian theory and practice. As US President Donald Trump denies the advantages of international specialisation according to comparative advantage, President Xi, at Davos in early 2017 and at Boao in early 2018, explains the shared interest in open trade. Professor Lin Yifu’s Center for New Structural Economics at Peking University has become a source of knowledge on comparative advantage, influencing development planning to good effect in some African countries (Lin and Wang 2017).

Reform in the first decade was constrained by the legacy of CPC ideology—specifically, the elements of ideology associated variously with Marx, Lenin, Stalin and Mao. The ideological legacy of Mao turned out to be the least constraining for economic reform, once the CPC had delivered its verdict that Mao was 70 per cent right and 30 per cent wrong. On the legacy of Marx, the theoretical distance of classical Marxism from the practical decisions of state, and its denial of the possibility of socialism in a backward country, weakened the constraint it placed on reform. Some intellectual gymnastics were required in the mid-1980s to render the operation of a labour market consistent with the labour theory of value. What then remained was a commitment to avoid the extremes of income inequality that the Chinese leadership associated with capitalist developing countries, and a view that the state should continue to own the largest enterprises in key economic sectors and guide development elsewhere to some extent. The Leninist legacy of firm Communist Party control through ‘democratic centralism’ remained a cardinal
principle of Deng’s. It has never been successfully challenged. It remains a premise of the leadership at the fortieth anniversary. The Stalinist legacy of central planning had little continuing ideological resonance after the early 1990s.

Beyond ideology and policy, there were immense problems of a highly practical kind, especially in reforming the system of central planning. The practical challenge was how to build the regulatory system, the institutions and the human knowledge and skills to implement reform policy and to make the partially reformed system work. Among the most difficult tasks was the building of an institutional framework to implement monetary policy and therefore macroeconomic stabilisation indirectly, as is necessary in a market economy. Through the first 15 years of reform, weaknesses in this area had generated a cycle of growth, inflation and balance of payments pressure that seemed to be widening over time (Garnaut and Ma 1993). The apparent ‘soft landing’ after the inflationary boom of 1993–95 was suggestive of progress that has since been sustained—with the large role of costly direct controls on investment during that episode a feature of subsequent stabilisation crisis management as well.

By the mid-1990s, it was clear to the Chinese Government that sustained, stable growth required fundamental reform of SOEs. Partial success in this allowed stronger enforcement of hard budget constraints after the Asian Financial Crisis.

The decadal crises

Reform in China has not and could never have been a smooth process. There have been challenges at every step, some bumps in the road, detours and dead ends. Through an accident of numbers, the challenges reached a climax at the first three decadal anniversaries. While the fortieth anniversary approaches with apparent relative stability in domestic economic and political conditions, the growing challenge of China’s relations with the developed countries, especially the United States, may make these times the most difficult of all.

At the tenth anniversary, acute problems of managing demand in the partially reformed economy and the inefficiencies and arbitrage opportunities of dual pricing manifested as elite and popular anxiety about inflation, corruption and the directions of economic reform. Bob Hawke and Chinese premier Li Peng met in Canberra late in 1988. I was one of a few people present at a small dinner at Hawke’s residence. The two leaders discussed the itinerary for a reciprocal visit in the new year. Hawke, seeking ground for cordial interpersonal communication, expressed his pleasure in anticipation of playing tennis with former vice-premier Wan Li and golf with general secretary Zhao. ‘Why would you want to spend time with them?’ Premier Li responded, alerting us to the high political temperature.
The political cauldron boiled over as huge numbers of students and others poured into Tiananmen Square in Beijing to express their grief at the death of former general secretary Hu Yaobang in April 1989, lingered in increasing numbers and attracted others to their weakly bounded discussion of China’s political landscape. The upper echelons of the CPC divided over the appropriate response. Division was resolved by Deng reaching from outside the formal structures to secure military action.

The unrest within the community and division within the party leadership had economic consequences as well as economic origins. Economic growth in 1989 and 1990 was by far the slowest in the reform era, contributing to a Western Pacific recession in 1990 and 1991. As Chinese rates of growth soared from 1991, the effect on others’ recovery from recession was emphatic.

The two years after the political crisis of 1989 saw profound uncertainty over the direction of reform—the only time in 40 years in which it was possible that the increasing use of markets and deepening integration into the international economy might be reversed. Uncertainty was brought to an end by Deng’s tour of southern China in 1992 and his exhortation to deepen reform and interaction with global markets.

The next half-dozen years saw rapid expansion of the role of the nonstate and especially the private sectors (Garnaut et al. 2001), massive increases in foreign trade and investment and the establishment of mechanisms for monetary and fiscal management that, with deft application, moderated what had been dangerous cyclical variations in demand and economic activity.

It is a sign of the greatly expanded role of international trade and payments that crises at the twentieth and thirtieth anniversaries mainly involved China’s interaction with the external economy rather than domestic tensions.

The twentieth anniversary saw China grappling with the consequences of the Asian Financial Crisis. The crisis began in July 1997 with immense speculative capital outflow from, and then currency depreciation in, Thailand. It quickly spread into deep recession and currency depreciation across all of South-East Asia and South Korea, with a slump in activity and large yen depreciation in Japan (McLeod and Garnaut 1998).

China experienced a sharp downturn in exports and speculation that it would join its neighbours in currency depreciation. Its response had two parts. One was to defy the regional trend and fix the renminbi exchange rate against the US dollar. The second was to offset the downward pressure on domestic employment and incomes with the largest Keynesian fiscal and monetary expansion the world had ever known. The response was motivated mainly by imperatives of domestic stability but was also seen at home and abroad as being helpful to stabilisation of activity and exchange rates elsewhere in East Asia. It was a risky strategy: net exports fell sharply,
the trade and current accounts went into deficit and there was speculation against the renminbi and Hong Kong dollar. The fiscal expansion, fixed exchange rate and consequent increase in the current account deficit could not have been sustained indefinitely. In the event, the strategy was validated before it had reached its time limit by recovery in the rest of the East Asian economy, to which Chinese strategy made a substantial contribution.

The Chinese macroeconomic response to the Asian Financial Crisis was brilliantly successful, but it left a deeply problematic legacy of structural change. Monetary and fiscal expansion was administered through public institutions—SOEs and national, provincial and municipal governments. This cut across the rapid expansion of the relative role of private enterprise and, more generally, the increase in market-directed relative to state-directed activity, which had accumulated great momentum through the 1990s.

The restoration of a larger state role was one of two sculptors of a new pattern of growth through the first decade of the twenty-first century. The other was Chinese membership of the World Trade Organization (WTO). The long and sometimes tortuous path to Chinese membership had commenced in 1986 with a request for Australian technical support for the Ministry of Foreign Trade and Technical Cooperation. Momentum was broken by international reaction to the political conflagration of 1989. Discussion of China’s WTO entry was mired in controversy through the 1990s as the developed countries felt their way through their own responses to China becoming a major player in the global economic system (Garnaut and Huang 2001).

The strands finally came together at the Asia-Pacific Economic Cooperation (APEC) leaders’ meeting in Shanghai that preceded the WTO ministerial meeting in Doha in late 2001. Asia-Pacific heads of government saw the admission to the WTO of what was soon to be the world’s second largest economy and the launching of a new round of multilateral trade negotiations as acts of international solidarity in the immediate aftermath of the 11 September 2001 terrorist attacks in the United States.

The entry of China was the most important development in the life of the newly formed WTO. Inside China, it locked in commitment to deep integration into the global trading system and the domestic institutional changes that were necessary to that end. Externally, it constrained the clamour for arbitrary protectionist responses to China’s emergence through the early twenty-first century as the world’s largest trading economy. The other product of late 2001 solidarity, the Doha Round, on the other hand, was bound in shallows and miseries.
The expanded role of the state and deeper integration into the international trading system framed a remarkable period of Chinese growth led by investment and exports. The investment share of economic activity—disproportionately and increasingly concentrated in infrastructure and heavy industry—rose to the highest ever, anywhere. Alongside infrastructure, much investment was concentrated in an increasingly diverse and sophisticated export sector. An even larger savings share supported high investment, so that the trade surplus rose to one-tenth of gross domestic product (GDP) in 2007.

Double-digit economic growth was supported by large-scale migration of labour from the countryside and wages that grew more slowly than total economic output. Rapid economic growth and slower increases in wages raised the profit share of economic activity. This supported the increasing savings, which, in turn, underpinned extraordinary levels of investment.

This remarkable period of investment and export-led growth made China, by late in the twenty-first century’s first decade, the world’s largest exporter and trader, the second largest economy by any method of measurement and by far the world’s largest source of surplus savings for international investment. The flow of surplus Chinese savings into US Government securities supported imbalances of historic dimension in the US economy—massive budget, trade and current account deficits funded by capital inflow. They allowed the US Government to pursue for a while reductions in tax rates and increases in military expenditure without large increases in domestic interest rates. There is a sense in which the availability of Chinese savings to support US deficits enabled the persistence and increase in imbalances that helped to make the US vulnerable to financial crisis.

The strong growth of the early twenty-first century had its downside. Rapid increases in lending from and to SOEs led to deterioration in credit quality and manifold risks in the financial sector. Growing inequality within China sparked political disquiet. The unprecedentedly rapid expansion of coal-based heavy industry made China the consumer of half the world’s coal and overwhelmingly the largest global emitter of greenhouse gases driving climate change. There was growing awareness of the costs for Chinese health and longevity of deterioration of air and other environmental quality (Chen et al. 2013).

Rising Chinese exports and trade surpluses were accepted in the developed countries with adjustment costs and some pressures for restriction, but ultimately with relative ease through the debt-funded expansion to 2008. The political context changed with the economic conditions after the Global Financial Crisis (GFC) of 2008. Protectionist pressures strengthened and resistance weakened, most importantly in the United States.
The financial risks after the response to the Asian Financial Crisis attracted urgent attention. Refinancing of the banks—successfully and at considerable budgetary expense—was a strong focus of premier Zhu Rongji’s in the first years of the new century.

From early in the twenty-first century, there were calls from some economists for a new approach to economic growth. This was reflected in new official statements on development strategy, led by president Hu Jintao and premier Wen Jiabao. The new approach would be built on higher growth in consumption and lower growth in savings and investment, an expanded role for services in expenditure and output, greater reliance on domestic relative to export demand, reduced inequality in incomes and wealth and reduced pressure on the domestic and global environment. An early expression of the new goals was the introduction of a broadly based expansion of social security, education and health programs to raise living standards for rural and low-income urban residents (see Wong, this volume).

About the same time, a historic turning point in the real economy began to exert immense pressure in many of the directions required for the suggested new approach to development. In 2005, there were signs in some coastal cities that easy availability of surplus labour from the countryside at low wages was coming to an end (Garnaut and Huang 2006). The 2006 book in this series was entitled The Turning Point in China’s Economic Development (Garnaut and Song 2006). It made the call that China was approaching a Lewisian turning point, in which continued strong growth in the modern sector of the economy would lead to rapidly rising real wages in both the towns and the countryside. This was followed by productive research into the implications of the end of surplus labour at the Chinese Academy of Social Sciences and Peking University (Cai and Huang 2013), and gradual incorporation of understanding of the importance of these labour market developments into a new model of growth. Growth in wages and the labour share of income during and beyond the turning period would contribute to reduced income inequality, higher consumption relative to savings and investment, lower export growth and trade surpluses and a lower rate of growth of polluting emissions. Discussion of and innovations in policy emphasised changes in taxation and government expenditure to support reduced inequality. There was also focus on upgrading of skills and innovation to build a more sophisticated economy as labour-intensive activities became less competitive. There was discussion of market and direct interventions to reduce the negative impact of Chinese growth on domestic and international environmental amenity.

The thirtieth anniversary of reform came as the world grappled with the GFC in 2008. In the months that followed the collapse of Lehman Brothers in the United States in September 2008, Chinese manufactured exports to North America and Europe fell sharply. Twenty million migrant workers in coastal cities were sent back
to the countryside well in advance of the normal exodus for the Chinese Spring Festival. China was again vulnerable to a downward spiral in economic activity and exports (Garnaut with Llewellyn-Smith 2009: 109–10).

The G20 heads of government meeting in Washington, DC, in November 2008 agreed on concerted implementation of expansionary policies. The Chinese response to the onset of the GFC had been immediate and immense, and was extended after the G20 summit. Keynesian monetary and fiscal expansion was implemented on a much larger scale than during the Asian Financial Crisis a decade earlier. By late 2009, the downward spiral in activity at home had been reversed and rapid growth in Chinese imports was supporting recovery in the rest of the world.

As in the aftermath of the Asian Financial Crisis, the macroeconomic response to external financial crisis was prompt, large and brilliantly successful. For a few years from 2009, investment and output increased as rapidly on average as in the early twenty-first century. The return of strong economic growth restored labour scarcity and pressure for increased wages. Again, there was another side—similar to that of the stimulus in response to the Asian Financial Crisis a decade before. Again, the manner of implementing monetary and fiscal expansion reinforced the roles of state institutions and put on hold policy innovation to build a new model of growth.

By 2011, confidence in restored growth allowed resumption of focus on structural change. The party and the state returned to implementation of the new model of economic growth that had been forming in economists’ and leaders’ minds in the years before the GFC. The new leadership around Xi Jinping that took office in 2012 declared commitment to greater equity in income and wealth distribution, domestic and international environmental amenity and a more flexible and market-oriented economic system.

The 2013 book in this series announced the arrival of a ‘new model for growth and development’ (Garnaut et al. 2013). Subsequent books have reviewed progress so far. The early scorecard shows much reorientation of demand from exports to domestic expenditure. It reveals some modest progress in shifting demand from investment to domestic consumption and reversing the increase in inequality. Net exports and the current account surplus fell quickly and by large amounts. The scorecard shows considerable progress on changing the relationship between economic growth and pressure on the global environment; since 2013, more than the whole of the increase in electricity use has come from generation with zero greenhouse gas emissions. There has been some progress in changing the relationship between economic growth and pressure on the domestic environment, especially in Beijing and the great cities of coastal China. Progress so far on institutional reform to support higher productivity through the transition from an upper–middle to a high-income country is harder to find.
China's progress with the new model of growth will be tested by international developments. The interaction of increasing trade tensions with the political and geostrategic consequences of China's rapid growth and concurrent weakness in the US political system could, in extreme circumstances, build mutually reinforcing pressures for withdrawal from open trade into a fourth decadal crisis. It is likely, and not an extreme circumstance, that rising geopolitical and geostrategic tensions will introduce potential for conflict to disrupt economic development over the fifth decade of reform.

The immediate risk is from protectionism in developed countries and China's and other countries' responses to it. The scale and speed of China's trade expansion inevitably places pressure on the economic structure in other countries. Chinese export growth forces contraction in directly competing industries abroad. This kind of adjustment pressure accounts for much of the growing contemporary negative commentary on China's participation in international trade.

Resistance to structural change can take the form of political demands for restrictions on trade with a large, rapidly growing partner. Political systems are especially vulnerable to such pressures in times of high unemployment or low income growth—the circumstances of the developed democracies since the GFC.

These demands in the developed countries for protection against growing Chinese exports have had to be managed alongside declining support for 'globalisation' more generally. This, too, is a response to stagnation in the incomes of ordinary citizens—apparent in the United States since the eclipse, from the 1970s and early 1980s, of the dominant and successful post-1932 New Deal social-democratic approach to economic policy. The stagnation of workers' incomes was exacerbated in the United States and extended through most of the developed world by the GFC.

The reaction against globalisation is not directed specifically against China, but provides fertile ground for protectionist reaction against Chinese trade expansion.

Here, the most important case is the United States since the election of Donald Trump to the presidency.

As Corden and Garnaut (forthcoming) have set out in a recent paper, the Trump administration has implemented two major initiatives in economic policy: expanding the budget deficit to pay for cuts in corporate and personal income tax and increasing (or threatening to increase) barriers against imports (with the threats greatest against countries with which the United States has bilateral trade deficits—first of all, China). These initiatives are meant to do two main things: to increase growth in the US economy as a whole, and especially to increase employment and the incomes of manufacturing workers in rust-belt states, which swung towards
Trump in the 2016 presidential elections; and to reduce US trade deficits with the world as a whole, and especially with countries, first of all China, with which the US has large bilateral deficits.

Trump’s policy changes come at a time of near full employment, after a long, slow but reasonably steady increase in US economic activity and employment after expansionary policies were adopted to offset the effects of the GFC.

The Trump policies are unlikely to achieve their objectives, and may have perverse effects. For good or ill, the economy operates within reasonably well understood laws that are not changed by forceful political assertion of a contrary reality.

The two policy initiatives together are likely to increase the US trade deficit in total and with each major trading partner. They are unlikely to increase total employment. They may (or may not) increase employment and incomes in industries specifically earmarked for increased protection. They are certain to reduce employment and incomes in other industries producing tradable goods and services—such as manufacturing beyond the industries receiving increases in protection.

It may be a dangerous time when the President sees the evidence of increase rather than reduction in the trade deficit, and the disappointing outcomes on employment in manufacturing and other export- and import-competing industries taken a whole.

Partner countries are adversely affected by an increase in American protection. Corden and Garnaut (forthcoming) have worked through the implications of their various possible responses. Foreign governments may choose not to react. They may choose to reduce their own trade barriers, either to persuade President Trump that he should now desist from his increases in protection or to increase gains from trade to offset losses from the change in US policy. They may retaliate by raising their own trade barriers, in the hope of forcing a reversal of American policy—or simply to persuade domestic political constituencies that they are ‘standing up’ to American pressure.

If other countries reduce their own protection, they will offset—perhaps more than offset—the losses from the increase in US protection. If their reactions persuade the Trump administration to desist, so much the better. This is the best response to the change in US policy from the point of view of economic welfare in China and other partner countries, and obviously for welfare in the United States and the world as a whole.

Doing nothing is second best. At least the costs of increased US protection will not be compounded by reduced gains from trade as a result of one’s own decisions.
The worst outcome for the partner countries, the United States and the world as a whole is retaliation that leads to an increase in protection. This compounds the loss from the American action—in the retaliating countries and in the United States and the world as a whole.

Whatever the response of other countries, the outcomes from President Trump’s policies may cause him to take the failed policies further. There is potential for large problems.

China handled the second and third decadal crises in ways that avoided long-term destabilisation of its development effort and helped to avoid unnecessary exacerbation of instability in the rest of the world. It has an opportunity to avoid destabilisation at the fourth decadal anniversary as well. The best way to minimise the chances of destabilisation is to avoid retaliation for any increase in US protection. China will do well if it gives substance to the rhetoric of President Xi at Davos in early 2017 and more explicitly at Boao in early 2018, and of Prime Minister Li Keqiang in Jakarta in May 2018, and takes this opportunity for accelerated liberalisation of trade at home and leadership of a new round of liberalisation in Asia.

Where is growth going and when will it end?

The experience of East Asia since the middle of the twentieth century, of China in 40 years of reform and of other countries in the past few decades tells us that sustained, rapid economic growth is no ‘miracle’. Rather, it is a normal part of the human condition in a poor country that meets a number of conditions for growth. Rapid growth is easier to sustain in its early decades than to initiate, until successful development has taken a country into upper-middle incomes where China is now—the threshold of entry into high-income status. The period immediately after the turning point of economic development in a densely populated country—when labour becomes scarce and wages rise rapidly—is a harvest time of political support for outward-looking growth: rising incomes are more effective in allaying doubts and undermining resistance to change when they are a current reality rather than a hope and a promise. Continued growth in incomes becomes more challenging after upper-middle incomes have been reached, requiring greater sophistication in economic institutions including markets, and making stronger demands on high levels of education, information and innovation (Armstrong and Westland 2016).

Nevertheless, the new experiences of East Asia and the older experience of industrialisation in the West tell us that growth and modernisation do not proceed in logarithmic straight lines. However, there is a strong tendency for them to continue
until the world’s economic frontiers are approached. At any level of development, but especially from upper-middle incomes, growth momentum can be broken temporarily or permanently by adverse developments of several kinds.

Booms and manias, followed by economic collapse, are ever-present risks of market economies and sometimes result in major lurches in policy that block a return to growth. The risk of financial crisis following a boom and bust in asset prices in China grows with diversification of financial intermediation away from large state institutions and the expansion of new kinds of financial intermediation that may be imperfectly understood by the regulatory authorities.

Poor policy, resulting from weakness in economic analysis or political manifestations of resistance to change, can block the continual reallocation of resources to more productive uses.

A failure of economic and political institutions to adjust to the changing structure and aspirations of the community as incomes rise can undermine social and political cohesion around the objective of growth.

Noting these risks to the continuation of strong growth, I said in my contribution to the book that marked 20 years of reform that it was more likely than not that ideas about policy, policy itself, institutions and the knowledge of Chinese people would evolve with the experience of rapid growth in ways that would sustain it (Garnaut 1999). The rapid growth that was concentrated among a few hundred million people in the coastal provinces would spread inland as regulatory and infrastructural barriers to internal trade were removed. It was unlikely, I said, and at odds with the experience of others, that there would be no setback to rapid growth—no recessionary end to a market mania, no large misjudgement of macroeconomic policy, no failure of leadership nerve or judgement on continued market or necessary political reform.

But the experience of the reform period suggested, I wrote, that it is more likely than not that the average growth of the first two decades would be sustained for several decades more. Output would double and double again over the next two decades. By the fortieth anniversary, I said, the several hundred million people in the dynamic coastal provinces would enjoy living standards broadly at the level of Taiwan at the end of the twentieth century.

Economic growth in China would not end in global famine, as had been famously contended (Brown 2000). Global markets could handle the growing demand for food that rising incomes in China would generate.
It would not end in national environmental catastrophe. Rising incomes would bring both the will and the economic capacity to do something about the environmental degeneration that was associated with urbanisation and industrialisation in China. China's sustained, rapid growth raised larger, global environmental issues, but not just for China.

In two decades, I said 20 years ago, China would face a huge challenge of demographic transition, when the one-child family was entering middle age and the number of young workers was shrinking. This would be much on the minds of leaders in the nineteenth CPC congress in 2017, as a threat to the longer-term dynamism of Chinese society and the economy.

But, I wrote, 2018 would be an unlikely end point for the growth process that began with reform. The modernisation of the vast inland of China would be in its early years. It was more likely that Chinese society—aware as never before of the pain and costs of growth—would choose to push ahead. It would be a natural and in no way miraculous outcome if the growth of China’s first two decades of reform continued until most of China's people enjoyed living standards and productivity levels close to those in the world’s most advanced economies.

Now, at the fortieth anniversary, we can see that what seemed most likely 20 years ago has come to pass.

What is most likely for the next decade?

Economic growth cannot be taken for granted, but it seems to me that the conventional economic threats to growth are less daunting now than at any of the first three decadal anniversaries.

Protectionism in the developed countries is an immediate threat, but, as we have seen, the avoidance of the most damaging outcomes can be influenced, if not completely secured, by China’s choice.

The biggest risks for the decade ahead lie in the possibility of mismanagement by China and other major states of adjustment to China's emergence as the world's largest economy and, by many measures, its most powerful state.

We are not yet accustomed to China assuming the relative weight in the world economy that will emerge over the next decade or so.

The most recent data from the International Monetary Fund (IMF 2018) calculate China's share of global GDP measured in purchasing power at 18.7 per cent, compared with 15.1 per cent for the United States. The differential between Chinese and American growth has narrowed in recent years. A reasonable assessment might suggest a differential between Chinese and US growth rates averaging near 3 percentage points on average from now through the 2020s. The realisation of such
an outcome would take Chinese purchasing power to roughly double that of the United States by 2030. There are downside risks to both US and Chinese growth, which would widen or narrow the differential if realised for one but not the other.

While purchasing power measures provide more realistic comparisons of the size of economies, for some purposes, especially related to influence in the international economy, conventional national accounts data converted at current exchange rates provide a more useful measure. This is a more volatile measure—for example, causing the size of the US economy to rise in the circumstances immediately ahead of us, with loose budgets, high interest rates and a strong US dollar. The size of the US economy by the national accounts measure would go into reverse in the period of dollar weakness that is likely to follow the debt-funded expansion.

By the national accounts measure, the World Bank (2017) estimates that the US economy was two-thirds larger than China’s in 2016. Mechanical application of the 3 percentage point differential in growth rates would see the Chinese economy reach the size of the United States’ around the fifth decadal anniversary.

This national accounts calculation does not consider one important additional factor. Purchasing power estimates of output systematically exceed national accounts calculations in developing countries for a good reason: wages are lower in the developing country, so the same nontradable goods and services are valued more highly in the developed country with higher wages. Once a developing country has passed the Lewisian turning point in economic development, labour incomes rise more rapidly than GDP. This leads to the reduction and eventually removal of the difference between comparisons based respectively on purchasing power and national accounts measurements. The national accounts measures of relative size converge over time towards the purchasing power estimates.

The result is that a developing country’s GDP measured by national accounts catches up with a developed country’s more rapidly than you would expect from mechanical application of a specified growth rate differential to current measures of relative size. China has passed the labour market turning point. Over the past 15 years, a substantial part of the difference between national accounts and purchasing power measures of GDP has disappeared. Purchasing power measures valued, on average, each unit of Chinese output five times higher than national accounts measures in the early 1990s. Today, purchasing power measures value each unit of Chinese output only two times higher. The difference between purchasing power and national accounts measures will continue to shrink as Chinese wages increase more rapidly than GDP. There will be convergence towards the purchasing power measures as Chinese incomes converge towards the levels of the developed countries. By the fifth decadal anniversary of reform, the continuation of the supposed differential between US and Chinese growth rates will see the Chinese economy about twice as large as the United States’ by purchasing power, and moving towards twice as large when differences are measured by national accounts data.
The rise of Chinese average incomes into the range of the developed countries takes us into unknown territory in relation to the capacity of established Chinese domestic political institutions to manage the stresses of structural change.

Virtually all of the one-seventh of humanity living in countries with high average incomes now live within representative and competitive democratic political systems. Is this because there are powerful social forces requiring democratic political systems for effective management of high-income societies? Or is it a product of a particular history of development, which leaves open the possibility of stable economic and political management by the government of a one-party state after the country has entered the ranks of high-income countries?

China’s average incomes are more likely than not to enter the range of the high-income countries by the standard definitions of the World Bank in the early 2020s. If there were no large change in the Chinese system of government, this would fundamentally change what had seemed to many to be an immutable association between high-income countries and competitive democratic political systems. A majority of the people living within high-income countries would then be governed by the Communist Party of China.

China’s social and economic change over the past four decades has led to many political changes, although not a fundamental change in the Leninist political superstructure. Going forward, the great relative size of China means there will inevitably be a new and different type of interaction and competition between the Chinese and other political systems. There will be argument about whether government for the people is possible without representative government by the people. There will be more searching questions asked about the quality of government delivered by established competitive democratic political systems.

There is a positive element to this: competition for hearts and minds can strengthen focus on governing for the people in competitive democracies and communist party systems alike. But, without careful structuring of the terms of competition, it is likely to lead to suspicion and disruption, causing a failure of international cooperation at a time when it is essential for global peace and development.

My own view is that domestic order, good government and sustained development in China and the competitive democracies alike require explicit understanding of the terms of competitive engagement. They require mutual acceptance of differences in political systems. They require acceptance in each country that others will seek to insulate their own political systems from external political influence across national borders. They require acceptance that the competition between political systems may lead to different structures across high-income countries. Disruption is likely unless there is broadly based acceptance that the outcomes from contests over political systems in each country are to be determined by domestic processes within each.
Success in China and in the high-income countries as China moves towards the fifth decadal anniversary requires an explicit or implicit twenty-first-century grand understanding of these issues.

The contemporary international system has been built around the reality that the United States has been overwhelmingly the dominant global power since World War II.

China's economic weight will not be so overwhelming that it can exercise hegemonic power over the whole of the rest of the world even if it is twice the economic size of the United States. There will be other great centres of economic, political and strategic influence—most obviously, the European Union and India. Members of another tier outside the big four will be important, eventually with Indonesia having large influence, and with Russia, Japan and the post-Brexit United Kingdom as older powers in decline but retaining influence for some time. The second tier of powers will have more leverage in the emerging multipolar world than in the bipolar world after World War II or the unipolar decade immediately after the collapse of the Soviet Union.

The emerging structure of power in the international system has large implications for the political culture of international cooperation. International cooperation will be difficult, so we will need to economise on its use. Decisions will be better located at the regional and national levels except where there are strong reasons for effective action to require global agreement. Providing reasons for countries to act in ways that are consistent with the international interest will become increasingly important for effective international cooperation. Defining and measuring shared interests and sharing knowledge of the compatibility of national and global interests will be crucial. Concerted unilateral action in support of shared goals will be an increasingly important means to global ends, including on trade, climate change, global macroeconomic stability and global development.

Explicit agreement among the great powers will continue to be crucial for peace.

Will Chinese economic growth continue through to and beyond the fiftieth anniversary of reform? That will be determined by the answer to two other questions. Will the Chinese political system change enough to provide effective domestic political management when its citizens have joined the world’s high-income people? Will the international community find ways to make the international system work cooperatively when China is overwhelmingly the world’s largest economy?
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