GETTING CHINA RIGHT

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China's spectacular economic growth has been one of the most significant events of the past two decades.

In a single generation the nation has vaulted from impoverished backwater to the world's second-biggest economy and biggest trading nation. Its growth has lifted hundreds of millions of people out of poverty, transformed global supply chains, and created great wealth. But the introduction of China's enormous working population into the world labor force has also helped depress wages in developed countries, and its huge capital flows have brought a new and potentially destabilizing force into the world's financial markets.

For all these reasons and more, it's crucial to get China right. We need to understand how China works (and how it doesn't), why it works the way it does, where it might be headed in the coming years, and what this means for the rest of the world.

Getting China right is no easy task.

For one thing, China is an unusually large and complex country. This means that virtually any generalization you can make about it is true to some extent, and can find support in some evidence. The problem is figuring out the balance: which descriptions are more true than others, and which of the thousands of contending forces are most important.

For another, China's political-economic system is unique, and defies many conventional views. It's a dynamic, mainly capitalist economy governed by a secretive, authoritarian Communist Party. Since the 1980s critics inside and outside China have argued that this strange combination cannot possibly last; but so far, China's system has outlasted its critics.

Because it's so big and so difficult to understand, China tends to attract extreme opinions, which offer relief from the hard work of sifting evidence and forming careful judgments. These fall into two main types: "China Will Collapse Tomorrow," and "China Will Take Over The World Next Week." In order to figure out the right way to understand China, we first need to know why these popular narratives are the wrong way to understand China.

Bad Idea #1: No, China Won't Take Over The World

For much of the past decade, the favored story was "China Will Take Over the World Next Week." Thanks to low labor costs and the authoritarian government's ability to conjure up infrastructure in the blink of an eye, China was quickly taking over one industry after another and destroying the manufacturing bases of other nations. Its firms were climbing the technology ladder, and seemed poised to push aside their American, European, and Japanese rivals.

Growing at 10% a year, its economy would soon overtake the United States to become the world's largest. Media headlines trumpeted the "inexorable shift of power from West to East" and interpreted each step in China's economic and political rise as proof that the country was destined for global dominance.

For readers of a certain age, these tropes have a familiar ring: they sound a lot like the stories about Japan in the 1980s. At that time, Japan's economic rise seemed unstoppable. Yet in a matter of a few years, the world changed, Japan changed, and its rise stopped. At the very least, this lesson should remind us of the perils of drawing straight-line extrapolations from established trends.

The more specific lesson is that economic growth is not one thing: different kinds of growth are needed at different stages of development. Countries that enjoy great success at one stage may stumble at the next, precisely because their success in the old way of doing things makes it hard for them to adapt to new conditions.

Great Leap Forward: From Resource Mobilization To Resource Efficiency

In China's case, the key point is that the country developed an exceptionally good system for mobilizing resources; it excelled at the job of building up the capital stock required for a modern nation. In the past quarter-century it created world-class mining, steel, and petrochemicals industries; installed six of the world's ten biggest container ports; built an interstate highway system half again as long as that of the United States; laid down the world's biggest network of high-speed passenger rail; and constructed new housing for over 300 million people.

These are impressive feats. But that job is now almost done: China now has the roads, railroads, ports, basic industries, and housing that form the foundation of a modern industrial nation.

The next job is completely different: instead of simply building up its capital, China must make sure that this capital delivers the highest possible return. In short, rather than getting growth from mobilizing resources, it must get it by maximizing the efficiency of resource use.

In this new era, the command-and-control capacities of the state that were such an asset during the resource mobilization phase become an obstacle to progress. This is because efficient resource use is best achieved by markets, and markets function best when the state retreats from direct participation in the economy to a regulatory role.

In short, the China-will-take-over-the-world school assumes that the power of the Chinese state will be as beneficial to the economy in the future as it has been in the past; and this is a very questionable assumption. In similar fashion, the prophets of Japanese dominance in the 1980s assumed that Japan's industrial expertise guaranteed its permanent success. They failed to foresee that the country's finely-tuned industrial systems were poorly suited to the emerging post-industrial economy focused on services, software, open networks and flexibility.

Chinese Companies: A Long Way To Go

Today's champions of China make an even more elementary mistake: they overrate the capacities of Chinese firms. For all the talk of China's technological leadership and innovative capacity, concrete evidence of either is hard to find. The country has plenty of good companies skilled at meeting the fast-moving demands of Chinese consumers. It has hardly any that have proved themselves in the world arena, under rules not set by the Chinese government. Compare this to Japan, which by the early 1970s had a host of firms like Toyota, Sony, Canon and Panasonic that were already assuming global leadership positions.

And while venture capitalists like to tout South China as the next Silicon Valley, the fact is that China's big technology firms owe much of their success to the protection offered by the "Great Firewall" of censorship and internet control, which prevents American internet firms like Google, Facebook and Amazon from freely operating in China. No Chinese technology firm has a significant presence in any international market, and none has invented an idea, technology, or business process that firms in other countries strive to emulate.

Bad Idea #2: No, China Won't Collapse

So are we to conclude that China's economic strength is just a mirage? That is what the "China Will Collapse Tomorrow" school would like you to think. This point of view has gained a lot of ground in the last year or two, as China's growth slowed to a 25-year low, a short-lived stock market bubble popped, and the Chinese currency, the renminbi, weakened.

Some of the wilder claims are based on shoddy research or cherry-picking of evidence, and can safely be ignored: you can't believe China's economic statistics (except the ones telling us that things are bad); the country doesn't really run a trade surplus; its foreign exchange reserves are overstated, and so on.

But the central idea behind the China collapse school is a strong one: the authoritarian, tightly controlled political system is at odds with the dynamic, increasingly capitalist economy. Virtually all of the world's rich industrial countries are democracies, and this is no accident.

Only democratic countries have proved consistently able to satisfy the varied and shifting demands of citizens once their basic needs for food, shelter, and secure livelihood have been met. And democratic societies have shown the greatest ability to continuously adapt their economic systems to new realities. When creativity, innovation, and flexibility are your main needs, a democracy will in the long run beat an authoritarian state every time. As we noted above, China is nearing the end of the era in which its Communist political system was an economic asset, and entering a phase where it will be a liability.

Before we jump on the collapse bandwagon, though, it's worth bearing in mind Adam Smith's retort to an acquaintance who thought that Britain's defeat at the Battle of Saratoga spelled doom for the empire: "Be assured young friend," Smith said, "that there is a great deal of ruin in a nation." Smith was right: a century and a half elapsed between the loss of the American colonies and Britain's eclipse as the world's leading power.

Similarly, it is a gigantic leap of logic to conclude that because China today faces an unprecedented challenge, it will certainly fail to meet that challenge. (The same can be said for pessimists who seize on every moment of American fallibility to proclaim the imminent decline of the United States. Over the past few decades, the numerous predictions of American decline and Chinese collapse share one key feature: they have always been wrong.)

In fact, China has a strong track record of adapting to change. Remember that when Deng Xiaoping launched economic reforms in 1979, China was a rigid Communist state in which the government controlled all production and all prices, and per capita income was the same as in many African countries. It felt much like North Korea today. Over the ensuing decades Deng and his successors used a process of trial and error—which they called “crossing the river by feeling the stones”—to gradually transform the economy and engineer prosperity.

Along with the economic shifts came changes in governance. Party and government officials were promoted more for competence and less for ideological correctness; age limits and rotation rules were put in place to prevent administrative sclerosis; and a degree of media freedom was permitted, in part to enable central government officials to learn about problems and abuses that local bosses would prefer to cover up.

Of course, these changes fall far short of democracy. But they are significant, and belie the notion that the Chinese state is a static monolith, unable to keep up with the times.

The Communist Party is well aware of the fate that awaits it if it fails to adapt. Twice in the last 20 years (once in the 1990s and again when Xi Jinping took office in 2012), China's leaders commissioned studies on the fall of the Soviet Union. Both concluded that the USSR broke up because its centralized, insulated leadership fell out of touch with grass-roots concerns, and because it allowed the economy to stagnate.

Thanks to these findings, Beijing spends a lot of time and money on research studies and public-opinion surveys that help it understand the problems of society, on developing policies to address those problems, and on trying to keep the economy vibrant. For all its flaws—and they are legion—the Party understands that it must adapt or die.

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Getting China Right: Three Transitions

So China will not take over the world, nor is it likely to collapse. What then is the right way to think about China, its challenges and its future? The starting point is to recognize that whatever its successes of the past may have been, China must now make three tricky transitions:

1 | **From a resource-mobilization to a resource-efficiency economy.** Economists sometimes call this the shift from an investment-led to a consumer-led economy. Basically, this means less government command-and-control, and more private entrepreneurship and markets.

2 | **From a young to an old society.** During its past 35 years of high-speed growth, China has been a young society: today it has more than five workers for every retiree, double the figure for the United States. But China is growing older at a rapid clip: a generation from now, its worker/retiree ratio will be down to two—the same as Japan today. In 2025, its population will start to fall. As Japan has shown, it's hard to sustain growth and creativity when the population is shrinking and aging.

3 | **From a politics of getting things done to a politics of inclusion.** China's political system must adapt to meet the needs of a richer citizenry, a consumer-led economy, and an aging society. This doesn't necessarily mean democracy. But it does mean government must

spend less time telling citizens what to think and do (in the interests of getting things done as fast as possible), and start including them in decision-making, in order to unlock their creativity.

These are daunting challenges, but the Chinese system is resilient and adaptable. What are the chances it will overcome these challenges, fully or in part?

Getting China Right: Three Scenarios

Putting it all together, we can sketch out three plausible scenarios for China in the next decade or so.

Scenario 1 | **Singapore On Steroids.** Xi Jinping and his colleagues move aggressively to clean up the mounting problems in China's economy. They restructure and privatize inefficient state-owned firms, deregulate protected industrial and service sectors to allow more private competition, fix the finances of cash-strapped local governments, and end the relentless rise of debt. China's growth rate stabilizes at about 5%, or about twice the expected rate for the United States.

The Party retains tight control of the political system, but permits limited expansions of free expression and legal rights. As in Singapore, the people put up with less room for political expression than is normal in the United States and Europe, because they are satisfied with the Party's ability to deliver material progress and social stability.

Implications: China does not supplant the United States as the world's major power, but it does create challenges for United States foreign policy in Asia. A strong and prosperous China will seek to create a sphere of influence in its neighborhood, and to gradually erode the United States presence. On the positive side, a vibrant, consumer-led Chinese economy would provide a much needed demand boost for the world, and create many business opportunities for multi-national companies.

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Scenario 2 | **Retreat To Nationalism.** A second, darker possibility is that Xi and his colleagues decide that thoroughgoing economic reform would be too destabilizing, and that rather than relying on economic growth for legitimacy as in the past, the Party should stress nationalism and an assertive foreign policy. This would turn China into something much closer to Vladimir Putin's Russia. The economy would be driven by state enterprises and favored crony capitalists, and its course might become more erratic.

Implications: In the long run, this course could be very destabilizing, and could eventually lead to the crumbling of the Communist Party regime that pessimists have predicted. But given the state's strength and coercive power, that collapse could be a long time coming. In the meantime, China might become a more truculent force in Asia, and more hostile to the foreign investors it has long courted.

Scenario 3 | **Japan 2.0.** Like Japan in the 1990s, China faces slowing growth and a rising debt burden. Under this scenario, the Party tries to restructure its economy, but fails to overcome fierce opposition by state enterprises and other interest groups that benefited from the old growth model. As a result, China falls into the same low-growth, high-debt trap that drove Japan from incipient superpower to also-ran. But at the same time, the Party's obsession with stability and strong pragmatic streak discourage it from foreign adventurism. Instead, its focus turns inward, and it piles up more and more debt to provide a social safety net that the Party maintains popular support even as the economy stagnates.

Implications: This would be a long, slow transition, and China's influence on the world economy would continue to be strong for years. It would continue to generate large cash flows that would sustain ever increased outward investment, and the sheer size of its domestic economy would continue to generate opportunities for MNCs. But by 2030 all talk of China challenging the United States for economic or political supremacy will have faded.

Reality, of course, never proves as neat as the imagination of scenario planners. China's future is likely to include elements of all three scenarios. For what it's worth, my money is on some variant of Japan 2.0. Although China can continue to muddle through the next several years with incremental reforms and reliance on debt to fuel growth, ultimately the Communist Party must substantially reduce its reliance on command-and-control techniques, and allow enough political openness to enable creativity to flourish. **So far there is little evidence that the Party is willing to make those tradeoffs—and in fact at the moment it is heading in exactly the opposite direction. A significant change of policy course is required if China is to continue its impressive progress towards the front ranks of world economies.**

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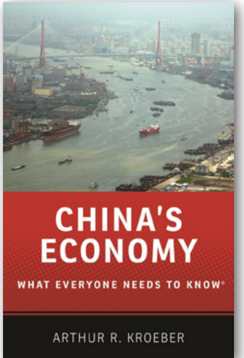

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