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40 Years Since Deng Xiaoping's Reforms: The Chinese Economy's Challenges and Prospects

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After four decades of gradually opening the Chinese economy to the world and at the beginning of the Xi Jinping's second term in office, China's authorities are announcing deep reforms, including increasing market access for foreign entities. Despite strengthening Xi's power, one should expect a further, selective opening of the market depending on the strength of Chinese enterprises in specific industries and their development needs. The announcements of the reforms provide an opportunity for the EU to put pressure on improving the situation of companies from Union countries operating in China.

The initiation of market reforms in China by Deng Xiaoping in 1978 put the country on the path of dynamic economic growth: from 1979 to 2016, the average annual GDP growth amounted to 9.6% while GDP per capita in purchasing power parity (PPP) increased by 55 times, from $300 in 1980 to $16,600 in 2017. China has become the second-largest economy in the world (the first in terms of GDP PPP) and a key actor in international relations. Currently, China's authorities aim to achieve the status of a "moderately affluent society" by 2021 (by the 100th anniversary of the establishment of the Chinese Communist Party, or CCP), which would mean doubling the GDP per capita of 2010, and then a "modern socialist state" by 2049 (by the 100th anniversary of the creation of the People's Republic of China).

Challenges Facing the Economy. Since Xi Jinping took leadership of the CCP in 2012, there has been a visible change in the thinking about the economy, instead of maintaining a high rate of growth, the authorities now focus on "quality", that is, more balanced and inclusive development (the so-called "new normal"). The thinking goes that China's economic model should be changed from one focused on exports and investments to one based on internal consumption and innovation. This change of approach is partly the result of imbalances in the Chinese economy (including overproduction) and the effects of the 2008 financial crisis. This is reflected in the statistics: In 2011, the GDP growth rate in China was 9.5%, but by 2017, it was 6.9%, and the government's target for 2018 was set at 6.5% (the lowest in almost 30 years).

However, changing the economic model requires facing the structural challenges. An ineffective banking system burdened with bad debt caused by such things as financing politically motivated investments or the use of "shadow banking", operating outside the regulations and offering loans to people with low incomes. This is connected with a national debt problem, both households and private and state-owned enterprises (SOEs), which is estimated to total more than 250% of GDP, as well as the existence of a real-estate bubble. China is struggling with overproduction, especially in heavy industry, which means that the costs incurred by Chinese factories outweigh their profits. The long-term potential of the Chinese economy may be significantly weakened by demographic issues due to the aging society. It is estimated that by 2040, almost a quarter of Chinese will be 65 or older.

Plans for Reform. On the 40th anniversary of the commencement of the economic transformation and at the beginning of Xi's second term in office, the Chinese authorities are announcing deeper reforms. However, changes in limitations on the role of SOEs or the financial sector already were put forward by Xi in 2013 at the 3rd Plenum of the Central Committee of the CCP. The Chinese economy was to be based on "market forces" and limited interference by the authorities. So far, however, there has been little progress on such reforms, and the role of the state in the economy is still crucial. Among the reasons for this situation were the resistance of party activists associated with SOEs and the fear of socio-economic destabilisation in the country (including rising unemployment).

The net effect of the authorities' actions so far is that the proposed reforms are less credible. It is assumed that the debt of companies and private borrowers will be reduced, for example, by limiting loans from state-owned banks. In the short term, though, this may negatively affect the level of consumption and investment. However, the reduction in credit should reduce speculative bubbles, including in real estate. At the same time, the government promises to increase control over "shadow banking". In response to the issue of overproduction, unprofitable enterprises, including steel mills, are being closed. This also aims to improve the quality of the environment, degraded in recent decades by industrial activity.[1] The Belt and Road Initiative (BRI), through which Chinese companies can use their excess capacity to expand infrastructure connections between Asia, Europe, and Africa, also aims to solve the problem of overproduction.

A novelty in the authorities' plans is to increase access to the Chinese market by enhancing the threshold for the participation of foreign investors in joint ventures (JV) created with Chinese companies, including obtaining a majority stake in, for example, the automotive or aviation sectors. The Chinese authorities also have announced increased access to the financial sector, including banking, payment, and insurance services. The duties on selected products, such as cars, are also to be reduced. Stronger competition on the local market may have a positive impact on the productivity of Chinese companies, the flow of know-how, and the growth of innovation. At the same time, China is to introduce tighter control over compliance with intellectual property rights (IPR). Doing so would meet the expectations of its economic partners and protect innovative Chinese companies that have achieved a strong position in industries such as telecommunications or the automotive sector.

Conclusions and Perspectives. The reforms introduced and announced by the Chinese authorities are aimed at curbing the threats to China's long-term development, including the level of debt and the unprofitability of many SOEs. Currently, Xi may have more possibilities than he did a few years ago, in part because of the effects of the anti-corruption campaign. It serves, among others, to eliminate from public life opponents of the Chinese leader who may lose, for example, because of changes to SOEs with which they were associated. However, despite Xi's increased power, economic policy will continue to be subordinated to maintaining the country's stability and the credibility of the CCP, which can slow the market reforms if they threaten those objectives.

Increasing the accessibility of the Chinese market for foreign companies will continue to be gradual and diverse in terms of individual industries. Greater opening can be expected in sectors in which Chinese enterprises have already gained a strong position and will be able to effectively compete with foreign entities, such as banking, automotive (including electromobility), and environmental technology. Selective approval for the admission of companies to the Chinese market may also be an element of pressure in political relations with individual countries. China's "Made in China 2025" strategy, focused on the development of its high-tech industry, means the requirement to transfer technologies to China within the framework of JVs with local entities probably will be maintained. The concerns of foreign companies about infringement of IPR are to be limited by more effective enforcement of regulations in this area, already announced. These plans lend credibility to the fact that they will also be beneficial for innovative Chinese companies. It should be noted that many industries, including media, energy, and telecommunications, key to maintaining the CCP's power, will remain under state control.

The announcement of a further opening of the Chinese market and China's opposition to protectionism, expressed internationally, should also constitute an argument in trade disputes with the U.S. and build the image of China as a country conducive to globalisation.[2] This creates an opportunity for the EU to put pressure on improving the situation of exporters and investors from Member States present on the Chinese market, which would test the credibility of China's plans. Pressure to open the Chinese market can also be a converging point of EU and U.S. interests, which could have a positive

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1 M. Przychodniak, "China's Environmental Disaster: Social Problem and Business Opportunity," PISM Bulletin, No. 37 (1108), 28 February 2018.

2 J. Szczudlik, D. Wnukowski, "China as an 'Engine' of Globalisation: More Words than Deeds," PISM Policy Paper, No. 5 (158), 5 September 2017.