

## Prospects for China's transition

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»» After 30 years of fast development, China has become an important part of the global economy. Now, the Chinese economy is highly dependent on international markets and resources, as well as technology and human capital. China's economic success is the story of globalisation. Over the next ten years, China's transition will also be a story of globalisation. Whether successful or not, it will have a significant impact worldwide.

China's transition will be determined by domestic political, economic and social factors. Beijing faces multiple simultaneous challenges, including opening more space for market forces, industrialisation, urbanisation, information technology, internationalisation and democratisation. In this context, China will have to shift from an external demand-driven growth model to one more reliant on domestic demand and innovation. Beijing will also have to undergo a political transition toward a more inclusive governance system that can meet public expectations regarding increased participation in policy-making and a transparent and efficient government.

### **POLITICAL TRANSITION: BALANCING REFORM AND STABILITY**

After decades of rapid economic growth, Chinese politics has experienced a great transformation, with improving levels of social and political freedom. While the constitutional status of the

### **Highlights**

- Demand for public participation in decision-making and a more transparent government is growing in China.
- China will have to shift from an export-driven growth model to one more reliant on domestic demand and innovation.
- A stable geopolitical environment will be critical in shaping the trajectory of China's transition.



Communist Party of China (CPC) remains unchanged, the political ideology and system has in fact undergone considerable reforms, including opening up to the international community, granting Chinese society more freedom of choice, and narrowing the ideological gap with the world's mainstream.

In the next ten years, the current establishment will have to adapt to the growing demand for public participation in decision-making. Thanks to the development of information technology and social media in particular, Chinese citizens are increasingly more sensitive toward corruption and the abuse of power by some government officials. More aware of other countries' democratisation, the Chinese public hopes that China's political system can evolve at the same pace as the country's economic progress. Chinese politics will come to a critical crossroads in the next few years, but many factors remain uncertain. The country needs to strike a sustainable balance between introducing political reforms and maintaining political and social stability. Various scenarios can be envisaged over the next decade:

The first scenario foresees significant progress in terms of political reform and China undergoing a smooth transition towards democratisation with Chinese characteristics, including the strengthening of democracy within the Party and the empowerment of the National People's Congress with power to supervise government. There could be an increased institutionalised representation of different interests in the decision-making process and a more effective regime of checks and balances could be introduced. Democratic elections at different levels could take place,

paving the way for a more accountable and transparent government. The CPC's ruling status, however, would not be touched.

Under the second scenario, political reform would not deliver much change, with the state investing large amounts of resources to maintain the status quo. This is mainly because deep-rooted interest groups do not want change, as it would end their monopoly over resources and power. Relations between the state and society would remain tense and the state power apparatus would be preoccupied with keeping stability, as it was the case over the last decade.

The third scenario envisages China suffering from large-scale social and political unrest due to protracted global economic downturn and misguided internal policies. The declining pace of economic growth could trigger a spike in unemployment rates, complaints about environmental degradation and corruption and, as a result, anti-government movements. The political transition would plunge into a state of disorder.

An analysis of the current situation indicates that China is likely to follow a tentative path between the first and second scenarios, with a mix of cautious reform and status quo preservation. The last 30 years of reform and opening up have helped the Communist Party to build a very strong governance capacity and have shown that it is able to adapt to the changing expectations of the

**China's transition is likely to follow a mix of cautious reform and status quo preservation**



population and to deal with a complicated environment at home and abroad. Given their powerful mobilisation skills, the Chinese leadership could probably overcome potential economic and social unrest to maintain stability while at the same time pushing forward – though limited – political reform.

The third scenario is very unlikely. After the Cultural Revolution, most Chinese people are still afraid of the turmoil caused by dramatic political changes to the state and society. The majority of the population supports the general idea of ‘no more hassle (over ideology at the expense of all else)’ proposed by President Hu Jintao and gradual reform is likely to continue to be the main strategy of China’s political transition.

### **ECONOMIC TRANSITION: SHIFTING GROWTH PATTERNS**

China is likely to maintain a sustained growth rate in the range of 7-8 per cent a year for the foreseeable future, higher than most world economies. China’s market demand will continue to expand, because of the country’s relatively low GDP per capita, combined with rapid urbanisation and industrialisation over the next decade. By 2015, China is projected to become the second largest consumer market in the world, with enough purchasing power to buy 14 per cent of the world’s products. According to McKinsey, by 2020 private consumption would rise to 43 per cent of GDP, while investment would drop to 38 per cent.

With an increment of 2.7 per cent annually, between 2000 and 2010 China urbanised at an unprecedented pace and scale, adding approximately 205 million new urban residents. Today, about 50 per cent of households are registered as urban residents. By 2025, two-thirds of China’s population (an estimated 64 per cent) will live in cities. China will further narrow the gap in terms of total economic output with the United States in the next decade. According to the most optimistic estimates, China’s GDP will catch up with that of the US by 2020, calculated according to the renminbi-dollar exchange rate.

The Chinese economy is facing the challenge of a shift in growth patterns. China’s economic transition should be carried out at three main levels. First, Beijing should move from an external demand-driven economic growth model to a domestic demand-driven one. Second, growth should rely less on fixed assets expansion and more on innovation. Third, the focus is likely to shift from efficiency and output maximisation (while tolerating large disparities between rich and poor) to paying more attention to ‘inclusive growth’, wealth redistribution and social welfare. Such a transition is needed not only for rebalancing the global economy, but also to achieve a more balanced social and economic development within China.

However, several factors could negatively affect the course of the economic transition. First, for the past three decades China’s economic development has been characterised by decentralisation of economic power from the government towards the market, with enterprises playing a larger role and



the government ensuring the provision of infrastructure and public services. However, in recent years, state-owned enterprises (SOEs) have overgrown or crowded out private and foreign firms. This has caused numerous concerns. If this trend is not corrected, it will probably be more difficult to meet the targets in innovation, job creation and income growth. In relation to this, it is also important to address the expansion of investments in fixed assets and the subsequent overstretching of SOEs and local governments. Fixed assets investment has reached more than 50 per cent of China's GDP, which is considered unsustainable. The good news is that the new-generation Chinese leadership has expressed the political will to allow the market to play a larger role in resource allocation.

Second, in the next ten years, China will undergo increased industrialisation. The ensuing larger overlap in the exports structure between China and advanced economies is likely to intensify competition. Trade frictions will test China's negotiating capacity and determination to maintain the global trading system open. On the other hand, China's economic growth will open more opportunities for market access. Expectations that China will become the largest global importer will definitely increase its market power.

Third, given current trends on urbanisation and population aging, it will be vital for the Chinese government to manage the large numbers of rural migrants, creating high-quality jobs and establishing a better social welfare system. Taking into account the accelerated aging of the population and the decreased demographic dividend, China could risk 'getting old before getting

rich' and the social welfare system could be overburdened in the next decade. According to UN estimates, the number of people with 65 or more years of age is expected to surpass 14 per cent of the Chinese population by 2025. By then, China's GDP per capita may still be less than \$10,000 (at market exchange rates). Other economies including Japan, South Korea, Singapore and Chinese Hong Kong featured a per capita income of \$20,000-30,000 when they reached a similar demographic structure.

Fourth, since the start of the global financial crisis in 2008, the pace of financial liberalisation and innovation in China has stagnated. Partly driven by the government-led economic stimulus plan (\$600 billion), state-owned banks have grown increasingly dependent on their near-monopoly position to extract profits. As a result, the lack of financial innovation is still a big weakness, which works to the disadvantage of China's economic transition. Current experimental measures aimed at promoting the liberalisation and innovation of the banking and financial system should be expanded to let the market determine interest rates, create more space for private banks and make more loans available to small and medium enterprises.

Fifth, China's economic transition needs more investment in education, human resources, science and technology. Future growth will have to come from high-level human capital and services, which requires a more efficient investment in education, human resources and R&D. The State Council has set the objective of increasing the annual investment in education to 4 per cent of GDP, but this target has not been matched yet. There are



also concerns regarding the efficiency of investments in the education system.

## CHINA, EUROPE AND THE US

As China enters a new transition phase, its relations with Europe will change accordingly. But China and Europe will continue to be both strategic partners and competitors.

From a Chinese perspective, Europe occupies a special position in the country's foreign relations. It is widely believed in China that the US's top policy priority is to maintain its global hegemony. There is a perception in the country that the US sees China as a challenger and seeks to contain Chinese development and influence. Europe, on the other hand, is perceived as a group of countries that pursue integration and self-strengthening through non-military means. Unlike the US, European influence is mainly reflected in international rules and norms. Therefore, in the eyes of China's leaders, China and Europe do not have a real conflict of interests and there is considerable scope for cooperation.

Looking forward, strategic competition between China and the United States might intensify in China's neighbourhood and other parts of the world. Stimulated by the so-called 'rebalancing' policy of the US, China's diplomatic and economic strategies could tilt towards cultivating deeper ties with Europe, Russia and emerging economies.

Nevertheless, a number of complicating factors will probably continue to affect relations between the European Union (EU) and China. For example, the parties might

continue to disagree over human rights and the Tibet issue. China's relationship with the EU will depend mostly on the direction of China's political transition. A successful Chinese-style transition towards a more democratic system would facilitate a closer partnership between China and the EU. However, if the process stagnates, or worse still, turns into chaos, bilateral relations risk being impaired. Under any scenario, the EU should not hold too high expectations on the nature of political changes in China but be prepared to deal with China's own path to reform.

## CONCLUSION

Successful transition in China will depend on the establishment's capacity to adapt to the needs of economic development as well as the population's expectations for a more transparent government, wider public participation and more inclusive development. Europe and the international community have a big stake in encouraging positive changes in China and creating good international conditions for a successful transition.

Of course, China's transition faces no small risks. The main challenges lie in the ruling party's capacity and determination to deepen institutional reform, including striking a better balance between the public and the private sectors in the economy by enhancing market-oriented reforms and through the promotion of a more equitable distribution of wealth.

China's transition over the next decade is not immune to world developments and domestic



progress will be exposed to international risks. The ongoing opening up of the global trade system and a stable geopolitical environment based on international cooperation can help to ensure that China will continue its success story of the past 30 years. In turn, a smooth and successful transition will help China make a growing contribution to a more peaceful and prosperous world.

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