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# The Problematic Politics of China's Economic Reform Plans

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Joseph Schumpeter, the Austro-American economist, once said that economics was all about "politics, politics, politics". Nowhere is that truer than in China, where politics both explains the urgency of the wide-ranging economic reform plans unveiled by the government last November and holds the key to their success or failure.

The importance of the reforms to China's ruling Communist Party is manifest. Xi Jinping, China's president – and, more important, secretary general of the Party – signalled as much by choosing to announce the 60-point programme personally at the end of the Party's leadership plenum in November. In addition, implementation of the reforms will be overseen by a special committee of the Party, not the government, and chaired by Mr Xi. Both moves are unprecedented and clearly intended to emphasize the seriousness of the leadership's commitment to change.

That commitment is rooted in the most powerful political imperative of all: the survival instinct. Though China's leaders are not accountable at the ballot box, they display a hair-trigger sensitivity to trends in the public mood that may affect their grip on power. For 35 years, they have maintained that grip by means of "performance-based legitimacy": that is, garnering popular support by delivering rapid and sustained improvements in incomes and living standards. Until recently, that has meant achieving double-digit levels of annual growth.

The increasing difficulty of sustaining such heady expansion, along with the severe environmental costs

## SUMMARY

China is in a race against time to re-engineer its faltering economic model, famously described by Wen Jiabao, its last prime minister, as "unsustainable, uncoordinated, unbalanced, and unstable". Against a background of soaring debt levels, proliferating asset bubbles and chronic excess capacity in many sectors, Xi Jinping, China's President, has announced a programme of sweeping, market-oriented, structural reforms intended to "re-balance" its economy and lay the foundations for the country's future growth.

Since taking office in 2012, Mr Xi has rapidly accumulated massive personal power and tightened his grip on the ruling Communist Party, while instituting one of the most ferocious crackdowns on corruption in China's history. By establishing an unchallenged hold over the Party's machinery and national decision-making, he has put himself in an exceptionally strong position to ram through much-needed changes in policy and bulldoze obstacles to the planned reforms.

However, as Guy de Jonquières argues in this policy brief, tightening political control while seeking simultaneously to free up the economy by expanding the role of markets has created a fundamental paradox. To be effective, many of China's reform proposals will entail less – not more – state intervention and reduced politicisation of the legal system and other economically important institutions. Yet the core purpose, indeed, the raison d'être, of the Communist Party is the right to exercise unfettered power over every aspect of Chinese society – and that right is unlikely to be surrendered willingly. How the paradox will be resolved is still far from clear.

and strains on resources that it has imposed, has spurred a lively political debate in China about re-engineering its economic model for several years. Starting in 2007, Wen Jiabao, China's last prime minister, famously warned his fellow citizens at regular intervals that its economy was "unsustainable, uncoordinated, unbalanced, and unstable".

However, neither Mr Wen nor former President Hu Jintao did much to turn those doom-laden words into action: indeed, it is common today to describe their time in office as a "lost decade", when difficult decisions were ducked or deferred. In retrospect, China's ability to keep growing after the 2008 financial crisis, the vulnerabilities that the crisis exposed in the west and the surge of national pride generated by the Beijing Olympic Games all appear to have bred a dangerous mood of hubris and complacency that deflected political attention in Beijing from the country's own pressing economic problems.

Those problems have now become too glaring and too serious to be ignored any longer. Three developments, in particular, have conspired to catapult reform to the top of the political agenda since Mr Xi succeeded Mr Hu last year.

First, weak global demand in the wake of the 2008 financial crisis has depressed many of China's biggest export markets, possibly permanently. Contrary to widespread belief, China's economy is not export-driven: exports matter, rather, because they support millions of producers and jobs by providing a vital outlet for disposal of goods that are produced in volumes far too large to be consumed entirely at home. From Beijing's perspective, exports have been at least as important as a contributor to maintaining social peace and stability – overriding priorities for China's leaders –as engines of national wealth.

Second, the efficiency of investment, which has long been China's principal growth generator and is largely financed by debt, has sharply declined, with ever larger amounts needed to produce the same incremental unit of GDP. It has been estimated that the increase in GDP generated by \$1 of credit has fallen from 83 cents in 2007 to barely 10 cents today.

Those rapidly diminishing returns are to a large extent a result of the third factor, China's massive, credit-fuelled 2009 stimulus package. Widely applauded at the time as a master stroke that averted a sharp economic slowdown in the wake of the Lehman crisis, it has bequeathed a toxic legacy: asset bubbles, chronic excess industrial capacity, oversupply of property in many cities, feverish speculative activity and rising bad debts, the true size of which is almost certainly far greater than shown in the carefully massaged official figures.

Though the government has been striving to bring things under control, total social financing, the main official measure of debt, is still growing twice as fast as GDP, while China's overall debt level has soared in five years from 130 per cent to around 220 per cent of GDP. Some unofficial estimates put the level higher still.

But while the debt explosion has made reforms more urgent, the precarious economic conditions it has bequeathed have also made them harder to put into effect. China has dealt with big run-ups in bad debt before by rolling it over, in the confident expectation that continued high growth in the future would take care of the problem. That fix worked in the past and may still work for a little longer. However, trying to keep growth going indefinitely by pumping ever more credit into investments that is growing steadily less productive is a zero-sum game. Ultimately it piles up still bigger problems down the road and risks destroying, instead of generating, national wealth.

On the other hand, while China's leadership appears prepared – indeed, is obliged - to tolerate a moderate slowdown in growth in order to stabilize the economy, it cannot afford to let growth collapse. If that happened, it could swiftly turn China's debt hangover into a crisis, severely damaging the Party's popular standing and fomenting the social unrest that China's rulers so dread.

That, in summary, is China's dilemma today. Of all the factors that will determine the country's chances of breaking out of it, none is more important than politics – a point that Mr Xi has been quick to grasp.

## RETURN OF THE STRONGMAN LEADER

He has lost no time stamping his authority on the country and the Party since he took over last year, accumulating more power faster than any Chinese leader since Deng Xiaoping and assiduously cultivating a "strongman" image. In so doing, he has confounded the wisdom of those foreign pundits who, not long ago, were proclaiming that China's governance had evolved irreversibly from a system dominated by one individual into a more amorphous, consensus-based, style of collective leadership.

Mr Xi's first priority has been to tighten his grip on the Party, imposing strict disciplines and meting out tough penalties on those who flout them. Self-criticism sessions, loyalty oaths and rhetoric intended to evoke the Mao era have all made a comeback, both in government and in state-owned enterprises. Those measures have been powerfully reinforced by one of the most ferocious crackdowns on corruption in recent Chinese history, involving the arrest, trial and predictable conviction of officials at almost every level. By one estimate, some 180,000 people have been apprehended so far, and rumours swirl constantly in Beijing about whose heads will be next to fall.

Anti-corruption campaigns have long been favoured by China's rulers as a method of eliminating political enemies or rivals. Given the prevalence of corruption among Party officials, not to mention the political malleability of the judicial system, it is not difficult to come up with charges against almost anyone in a position of authority that can be made to stick.

In addition, the current crackdown appears to have at least two other motives. One is to try win back popular support by attacking a prime source of public resentment and disenchantment with the Party – though at the risk of inadvertently encouraging the belief that every senior official is lining his or her pockets at the country's expense. The other objective is to break down political and economic "vested interests" in government and industry that oppose reforms because they profit so handsomely from the status quo. The drive appears to have been particularly effective in bringing to heel the powerful energy SOEs, which have long been used to doing as they pleased and have been more important than the government in shaping energy policy – always to their own advantage, of course.

Meanwhile, the Party has clipped the wings of the National Development and Reform Commission, architect of China's legendary five-year plans and a once-powerful voice in the making of many kinds of economic policy. The central government's regulatory business approvals process is being streamlined and rules for starting new businesses simplified. Plans are also afoot to sell minority stakes in some non-bank SOEs, though these are likely for the foreseeable future to remain ultimately under firm political control.

Some commentators detect signs of an embryonic personality cult in the energetic promotion and projection of Mr Xi's image. There are also suggestions of grumblings by party elders, including former President Jiang Zemin, still an influential figure behind the scenes. Mr Jiang, a number of whose own followers have been targeted by the anti-corruption campaign, is reported to have urged Mr Xi to rein it in, arguing that it risked tearing the Party apart.

Yet the six other members of the Politburo Standing Committee, the Party's supreme decision-making body, appear willingly to have endorsed the glorification of Mr Xi. One reason may be that many of them will be required to step down in 2017 on grounds of age, so presumably harbour few unfulfilled ambitions for career advancement. Another is that they have come to accept that only a leader perceived to be an unstoppable human bulldozer is capable of driving through change and sweeping away entrenched obstacles to reform.

## WHAT KIND OF REFORMS?

But can Mr Xi actually deliver? And what, precisely, will he be delivering?

By any standards, he appears to be taking a giant gamble. If it pays off, he – and China - will reap rich rewards. But if it fails, there will be no obvious fall-guys onto whom to shift the blame, since all the most likely candidates have been nudged into the sidelines, including Li Keqiang, the prime minister, who is nominally responsible for overall supervision of economic policy. And the agenda to be tackled looks daunting.

The programme endorsed by the Plenum calls for a broad swathe of policy measures. They include opening to market forces sectors long dominated by SOE monopolies, such as telecommunications, water, energy and transport; changing the laws on rural land ownership and accelerating liberalization of the financial system and achieving capital account convertibility. Apparently in an effort to make structural changes more palatable to the public, there are also plans to reform some deeply unpopular policies by loosening the one-child policy and the hukou household registration system and by abolishing correctional labour camps.

Though steps are being taken to implement some of these proposals, at this stage much of the reform programme is still a work in progress, not a done deal. Some proposals will unavoidably require a long time to be put into effect: for instance, because land sales provide a growing source of funds for cash-strapped local governments, new systems of local government financing will need to be put in place before the planned rural land reforms take effect. However, there are other reasons for being cautious about how far and how fast China's rulers are prepared to go in implementing the programme.

First of all, the reforms are being imposed top-down by an iron-fisted leadership that seems even more determined than its predecessor to suppress public debate and expressions of dissent. Yet history, in China and elsewhere, tells us that effective market-based reforms usually are often propelled by strong and direct pressure from the bottom up - and/or a manifest crisis of some kind. Since China's leaders will go to great lengths to avoid both developments, much is likely to depend on whether Mr Xi and his colleagues can generate the necessary momentum for change through the exercise of sheer political will.

Second, the Plenum identified giving a "decisive" role to the market as a centrepiece of the planned reforms. But if that pledge is genuinely to be fulfilled, two conditions must be met. One is that the state, or the Party, must scale back the extensive intervention and micro-management long practised in many sectors of the economy. The other is that China needs to develop the sound institutional frameworks, clear rules and effective supervision and regulation that markets require in order to function efficiently.

However, in China today, property rights are still ill-defined; the rule of law is applied unevenly; the courts are subject to political control; market regulation is haphazard and subject to political manipulation; and, crucially, every institution is constitutionally subordinated to the will of the Party, whose decision-making is opaque, unaccountable and often unpredictable. Even if Beijing is committed to changing all those things – itself a highly questionable assumption – they will not be changed quickly.

Third, successful implementation of the reforms will rely heavily on enlisting the co-operation and commitment of authorities at provincial, municipal and local level, which Beijing has not always been able to secure in the past. In recent years, its efforts to moderate the rate of growth and curb debt and inflation have often been frustrated by lower-level officials in different parts of the country who have not only seen themselves as in competition to maximise economic expansion but in many cases have profited personally from it. In post-imperial China, the old adage that "the mountain is high and the emperor is far away" remains as relevant as ever.

The leadership appears to be counting heavily on the anti-corruption drive and mooted reforms of local government financing to bring lower levels of the Party into line. But much more may be needed: in particular, the creation of a structure of incentives that encourages officials to behave differently – in other words, a change in the political and institutional culture. As anyone who has ever attempted that knows, it is not easy to achieve.

Fourth, structural reforms on the scale that China needs and its leaders appear to envisage are bound to create job losses and other social upheavals and dislocations, at least temporarily. In the 1990s, when Zhu Rongji, then prime minister, rammed through China's last big round of structural reforms, he presided over the mass closure of inefficient and uncompetitive state-owned enterprises, throwing an estimated 40 million people out of work and devastating the social welfare support that state industries provided.

But much has changed in China since then. Though it is still a long way from having an "entitlement culture", expectations of steady improvements in living standards and quality of life have become entrenched in the popular consciousness. Opinion polls suggest that, unlike many people in the west, China's citizens believe that, materially at least, they will be better off tomorrow than today. If their hopes are disappointed, popular disenchantment with the Party is likely to rise.

The growth of an educated, travelled and increasingly vocal urban middle class, able to express its demands and grievances through social media, increases pressure on the Party officials to deliver results that cannot be measured by crude economic statistics. That means providing such public goods as clean air and water, safe food and medicines, efficient and reliable healthcare services and a less corrupt education system. As one senior official recently admitted privately, the Party has yet to demonstrate that it is capable of responding to and managing such expectations effectively.

Furthermore, while rapid growth can no longer be counted on to generate the public support for the Party that it secured in Mr Deng's and Mr Zhu's day, nor can its continuation be guaranteed in the future – even, or especially – if the the reforms are implemented in full and succeed in the objective of "re-balancing" the economy. That is because the result will be to make demand much more reliant on domestic consumption and services, rather than on massive fixed asset investment and exports. Though that shift promises to raise household incomes – indeed, it will need to do so in order to support increased domestic consumption – it is not a formula for producing double-digit rates of headline GDP growth.

Fifth, the reforms are intended not just to free China from the constraints of an obsolete growth model but to lay the basis for a new one that will fulfil its ambitions to become an advanced high-income economy and a global technology leader. In order to do so, China needs to avoid falling into the "middle income trap". That is the no man's land in which developing economies often get stuck because they find it increasingly hard to compete with lower-cost competitors yet lack the capacity and resources needed to vault into the ranks of the rich ones.

Remarkably few developing countries have managed to extricate themselves from that morass. Indeed, the World Bank says that of 101 economies categorised as middle-income in 1960, only 13 had achieved high income status by 2008. Success depends on putting in place policies that stimulate innovation, productivity and a sustained move into higher value-added goods and services. The trick lies not only in choosing the right policies but in assembling them in the right combination. No reliable text books or road maps exist for how to do this.

## AN EXISTENTIAL CHALLENGE?

These are all essentially issues of practical implementation. Beyond them looms a much bigger and more fundamental question: one, indeed, that goes to the heart of China's governance and ultimately poses an existential challenge to the Communist Party and the system over which it has presided

The system's foundation is the Party's absolute right to rule over and dictate every aspect of the nation's life. Accountability in China has always been from the top down, never from the bottom up, and anyone or anything that dared to challenge the Party's pre-eminence has been either co-opted or, more often, sidelined or suppressed. Reduced to its purest essence, the Party is about the unfettered exercise of control and power.

Yet it is hard to see how the reforms can fully succeed unless the Party is prepared to loosen or even abandon entirely control over a wide swathe of the economy, ranging from the ownership and management of state-owned enterprises to the operations of the judiciary. Indeed, some observers, in China as well as abroad, argue that economic reforms will only work if they are accompanied by at least a measure of political reform. Yet, for reasons explained below, that is anathema to the current leadership.

All this amounts to a profound, possibly historic, paradox. As Mr Xi and his colleagues evidently recognise, pressing ahead with the reform and modernisation of the economy is indispensable to shoring up the basis of the Party's continuing legitimacy and monopoly on power. Yet the pursuit of those objectives poses a direct challenge not only to the party's traditional way of doing things but, potentially, to its essential purpose and reason for existence. After all, if the Party is not about control, what is it about?

That Party leaders are keenly aware of the tension between these two forces, and the risks that they pose to their own position, is apparent. Perhaps the clearest evidence is the intense attention they have devoted to studying the events leading up to the collapse of the Soviet Union. The lesson they appear to have drawn from it is that Mikhail Gorbachev's crucial mistake was to couple perestroika, economic restructuring, with glasnost, the opening of the machinery of power to public scrutiny and, by extension, accountability. To be tagged "China's Gorbachev" is a fate that every Chinese politician is desperate to avoid.

That Mr Xi and his colleagues are simultaneously tightening their political grip while embracing, at least rhetorically, the objective of economic reform suggests that they are optimistic that the tension can be managed. Whether they are right and whether this high-wire act can be sustained is still far from clear. But it will certainly be made no easier by another set of conflicting impulses with which policy must contend.

These centre on the speed with which to proceed with reform. On the one hand, China's leaders are acutely sensitive to the danger that pressing ahead too rapidly could produce destabilizing upheavals that, at worst, would cause them to lose control. Those dangers are especially great at a time when growth is slowing and the authorities are struggling to rein in the credit explosion without provoking a property market crash that would depress growth still further.

Politically, there are two risks to rushing reforms which will necessarily involve inflicting short-term pain in the name of benefits that will only materialise over a much longer time span and which cannot be guaranteed in advance. Mr Li, the Prime Minister, has acknowledged as much, by comparing reforms to the act of cutting off one's own hand.

One risk is that the pain will prove unacceptable to public opinion, deepening the Party's unpopularity. The other is that, conversely, liberation of market forces might fuel popular pressure and demands for parallel political liberalization. Both possibilities argue in favour of advancing carefully one step at a time by, in line with Deng Xiaoping's much-quoted approach, "crossing the river by feeling the stones".

Yet that option involves other potential problems. There is a natural tendency, when implementing reforms, to seek to make them politically acceptable by tackling the easiest ones first. However, in the over-used terminology of international trade negotiators, there is a finite quantity of such "low-hanging fruit" to be harvested. Once it has all been picked, if the process is to continue, tough and difficult decisions become unavoidable. Delaying them risks derailing the endeavour and allowing more time for "vested interests" to mobilize opposition to reform.

There are also technical risks. These are most conspicuous in the financial area and, in particular, in the challenge of correctly sequencing domestic reforms on the one hand and the opening of China's closed capital account and the achievement of currency convertibility on the other. Though in theory the two operations could be undertaken separately, in practice they are closely linked.

Lifting China's tight capital controls would be recklessly imprudent until its fragile domestic banking system and primitive financial markets have been strengthened and modernised. Though a number of steps have been taken in that direction, much remains to be done. Unless the process is managed successfully, premature external liberalization could unleash a tsunami of destabilizing capital flows, both in and out of the country, with severe adverse systemic consequences – for China and for the rest of the world.

However, if external liberalization is delayed until after domestic liberalization is completed, there is a risk that momentum will be lost and the latter enterprise will run out of steam. Without external pressure, there will be less incentive to adapt. Indeed, attempts to ratchet up that pressure, notably by pushing for "internationalization" of the renminbi, are one of the most powerful psychological instruments that reformers in the politically otherwise weak People's Bank of China possess.

These conflicts and contradictions go some way to explain the sometimes puzzling hesitations and oscillations that have characterized recent Chinese macro-economic policy. One week, credit is tightened, in an effort to curb speculative excess and expunge moral hazard. The next week, it is relaxed again, apparently out of fear of precipitating financial collapses and a steep, and politically unacceptable, further slowdown in growth.

Meanwhile, there is a continuing steady trickle of piecemeal financial "reforms", each pointing in a generally liberal direction but individually modest and collectively lacking the obvious hallmarks of a coherent master plan. The overall impression is of a scattergun array of semi-experimental shots fired into the air, rather than of an orderly and carefully planned sequence of measures leading up to a pre-determined conclusion.

For how much longer can this state of affairs continue? Flawed as China's economic model undoubtedly is, it may well be possible to eke a few more years of growth out of it. But the costs of doing so, in terms of growing capital misallocation, squandered resources and a rising debt burden, are likely to be large. And the longer things continue that way, the bigger the eventual bill will become.

Sooner or later, the pressures to bite the bullet and take difficult and painful measures will become too great to withstand. Unless, of course, China's leaders resolve before then to pre-empt that risk by acting boldly and decisively to move beyond talking about tough reforms to implementing and enforcing them vigorously.

It would be fruitless, at this stage, to speculate about which direction China's leadership will follow, even more so about the precise destination to which it will lead. Events have too often conspired to show that the main function of predictions about how the country will or will not develop has been to confound those making them. The one thing that can be said with some confidence is that rarely, if ever, have its leaders been forced to confront so many formidable challenges at once.

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