# The Political Consequences of Economic Challenges


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China faces a growth slowdown with broad policy implications that are intertwined with the pending leadership succession. Central leaders are resigned to a growth slowdown, but do not have a clear strategy to deal with it. This provides an opening to reformers who argue that only substantial new market-oriented reforms can address the problems. There is a strong sense that Wen Jiabao's era as an economic policy-maker is over, and that he has left many difficult problems in his wake. Resolving those problems would require willpower on the part of the new leaders, who are as yet an unknown factor. If rumored changes in the structure of the Politburo Standing Committee take place—in the number of members and the way their responsibilities are apportioned—it will indicate that leaders are preparing to tackle the economic issues.


In the previous issue of *CLM* I discussed the basic economic challenges that confront China's policy-makers today. A growth slowdown is inevitable, but there is enormous uncertainty: How much will long-run growth rates decline? How sharp and disruptive will the short-run drop in growth be? There are no simple answers to these questions. However, the change in conditions and the uncertainty of the future have already begun to affect Chinese politics. In this issue, I describe some of the most immediate policy and institutional consequences of these economic conditions.

## Broad Consensus in Beijing

There is a general consensus in the central government that growth will slow down. Moreover, the transformation of the growth model that Hu Jintao and Wen Jiabao have been advocating for more than five years is inextricably linked to the need to manage a transition to a new era of slower growth. Consider this quote from Liu Shijin, the vice-head of the State Council Development Research Center:

> From the Party Center down to the individual scholar, a consensus has already formed that a growth slowdown following a transformation in the economic development model is definitely not a bad thing. To transition from high-speed growth to medium-speed growth is to shift from one stage in which growth was driven by cheap production factors to a new stage in which innovation is the driver.[1]

This understanding means that there is very little support in Beijing for a massive stimulus along the lines of the 2008–2009 response to the global financial crisis (often called the "four trillion" stimulus). In fact, since the economy began showing signs of rapid deterioration in April, central policy-makers have been remarkably consistent in declaring that there will not be a massive stimulus response. For example, the official *People's Daily,* in a June 15 article entitled, "We absolutely cannot do another 4 trillion [stimulus package]," quoted He Keng, the vice-head of the Finance and Economic Committee of the National People's Congress, as follows:

> Under current conditions, the most important thing is not to act hastily. Theoretical workers have said that we absolutely should not do another 4 trillion investment [stimulus], and everyone's understanding on this is united to an unprecedented extent. This is really good. . . . We should carry out structural tax reductions to give enterprises more profit; lead and supervise the banks to better serve the real economy; transform the growth model and not just look at GDP growth; and put the people's livelihood at the center of everything.[2]

Of course, it would be naïve to believe that there is a consensus in Beijing just because the official press claims there is a consensus. But in fact this seems to actually be the case, as we can see in the government response. Premier Wen Jiabao articulated policy most clearly during a visit to Jiangsu at the beginning of July, accompanied by Ma Kai, Secretary-General of the State Council. Wen emphasized "stabilizing investment" as the key to a policy that would maintain growth, while also adopting more differentiated policies to stimulate consumption.[3] "Stabilizing investment" is a key concept: it means that steps can be taken to prevent investment from dropping rapidly (if investors' expectations of the future deteriorate), but that investment would not be increased to offset weaker demand for exports or domestic consumption. This provides leeway to speed up the approval of some investment projects, and ease restrictions on some kinds of financing, but it rules out a large-scale stimulus program.

> The last stimulus program left us with excess capacity in 21 industrial sectors; a build-up of stockpiles; a reduction in investment efficiency; increased environmental costs; worse inflation; a build-up of local government debt; plus an asset bubble. For the past two years we've been trying to deal with these problems, so I completely agree that we can't use massive investment to stimulate the economy. That would just be like taking drugs, or worse, drinking poison to quench our thirst.[4]

This approach also rules out a thorough relaxation of the housing control policies, which in addition are closely associated personally with Wen Jiabao. The need to maintain those policies has been repeatedly stated by Wen and other central government officials. A Politburo meeting on July 31, 2012, maintained the policy and reiterated previous statements.[5]

## Outside the Consensus: Local Governments

Local government interests are very different from those of the central government. Any individual locality can still improve its local economy by attracting more investment.

The fact that the economy *as a whole* cannot rely on such an approach is largely irrelevant to the calculations of an individual locality. As a result, central government declarations ruling out massive stimulus have coincided over the past six months with a series of local government announcements of massive investment programs. These announcements should be treated with caution: often these are multi-year investment programs that may be little more than wish-lists. Occasionally, cities that are exceptionally favored by current national policies—such as Tianjin, Wuhan, Changsha—will announce bold programs that actually have some financial backing. In general, though, there can be big differences between the scale of local government ambitions and the reality of what they can actually find funding for.

To some extent, central government officials are trying a balancing act. Officials at the National Development and Reform Commission (NDRC) are trying to speed up project approvals, in order to keep investment from dropping too fast. For example, railroad investment, virtually halted during 2011, has now been reinstated.[6] On May 24, one of NDRC's most questionable judgments generated one of the year's most memorable news photos, in which the mayor of Zhanjiang City, Wang Zhongbing, is seen kissing the NDRC approval document that will enable him to finally start construction on a large integrated steel mill, after waiting for 34 years.[7] The decision is questionable because in the first half of 2012, China's steel industry as a whole lost money, so the need for additional capacity is rather weak.

This kind of jousting between locality and center is also prominent in the housing market. Not surprisingly, local governments have seized on signs of economic slowdown to introduce policies that selectively relax restrictions on housing purchase in their areas, seeking to revive the housing market as a spur to local growth, and as a revived source of local budgetary revenues. Many of these have been introduced, but so far the central government has shot down most of them, causing one article to liken Wen Jiabao to a player in a video game, repeatedly killing the various opponents who pop up one after another.[8] While the overall effect has certainly been *some* relaxation in housing policy controls, there has not been a wholesale abandonment of the policy, as some pundits expected.

## Consensus on the Challenges Does Not Imply Agreement on Future Policy

While everyone can agree on the inevitably of a growth slowdown, and the need for a new growth model, it is far more difficult to actually craft workable policies to facilitate the transition. In fact, there is a shortage of practical, workable proposals, and certainly an absence of consensus on what exactly should be done. There is only an agreement not to panic, and to gracefully accept some aging and slowing down of the economy.[9]

In fact, a quick look at two of the pillars of the new policies reveals some of the difficulties. Future growth should rely more on domestic consumption, and it should be driven by innovation. Yet Chinese consumers today would tell you that their consumption options are quite limited as they move into the middle class: there are restrictions on buying (and using) automobiles; there are restrictions on housing purchases; many of the high-level services that become more important as incomes rise are low quality and dominated by state providers (e.g., insurance). Consumer durables are cheap, but the market is near saturation. Just how will the government stimulate consumption? Similarly, fostering innovation is easier said than done. The Chinese government has been pouring billions of RMB into the "strategic emerging industries," in the belief that these are inherently innovative. Yet the result has been over-investment and excess capacity in sectors that have been favored by the government. The most striking example right now is the photovoltaic industry, where the leading firms have been bleeding red ink and face serious bankruptcy threats.[10] It is much easier to talk about innovation than it is to actually create an institutional environment that rewards innovators and entrepreneurs who genuinely take risks.

## The Opportunity for Reformers

These challenges have created a rich new opportunity for China's frustrated market reformers. Reformers have been sidelined for years, especially since the muscular response of the Chinese government to the global financial crisis in 2008–2009. Now their fortunes have changed. The consensus described in the first section shows that the ideas of the reformers have already been accepted, at least with respect to the costs of the 2009 stimulus program and the challenges and dangers of the current situation. Reformers were not against emergency stimulus at the end of 2008, but they began to warn early in 2009 that conditions had gotten badly out of hand. Now, their views have been vindicated.

One result is simply that reformers can get a hearing, and find outlets for their views. One maverick free-market economist, frozen out of the official press since 2008, found himself invited to a consultation with the premier, along with three other economists. We don't know that precise topic of discussion, but we know that this economist, like many reformers, struck a note of doom and gloom: without major reforms, there would be big trouble ahead. This is a common refrain of today's reformers, and it follows directly from the conditions described earlier in this article. Major action is required, but the policies of the past won't work anymore. Other important reformers make similar arguments. Qin Xiao, an important reformist voice, argues that the only way to handle the simultaneous transformation of growth strategy and short-run macroeconomic pressures is for the government's visible hand to withdraw from microeconomic coordination, and for a new pro-market consensus to be formed.[11] Guo Shuqing, the new head of the China Securities Regulatory Commission and a dynamic policy-maker with growing influence in the financial sector, made a similar point more subtly in his speech to the Lujiazui Forum this year.[12] Only dramatic changes in the structure of China's financial markets—rapid movement away from bank-dominated financing and toward indirect financing (corporate bonds plus various kinds of investment, private equity and venture capital funds) will provide the flexibility necessitated by the dramatic shifts in the Chinese growth environment. Guo even repeatedly uses the U.S. financial system as a positive role model. He argues that American capital markets were the reason for U.S. success in fostering technological innovation and growing high-technology industries beginning in the 1980s, and that since the global financial crisis, U.S. growth has been healthier than that in Europe, again because of more flexible U.S. capital markets.[13] It was once common for the U.S. system to be used as a model by Chinese economists, but it has been extremely rare in Chinese official rhetoric since the global financial crisis for the U.S. system to play this role in the argument over China's future.

Reformists describe looming dangers that threaten stability sometime between the next six months and the next three years. At the same time, they have launched a series of small but cumulatively significant initiatives. Eswar Prasad nicely described the current situation when he said: "Reform-minded officials are . . . using a megaphone to draw attention to the problems and introducing small but tangible changes."[14] These changes are perhaps most evident in the financial sector, where market-oriented officials have the most sway, and include a concerted effort to chip away at the monopoly of state-owned banks, creating a more diversified and flexible financial system.[15] Trial "financial reform regions" have been introduced in Wenzhou (in the wake of problems there last year) and in the Pearl River Delta, designed to give free rein to small-scale private financial institutions, under careful supervision. Guo Shuqing has pushed for expansion of approvals for corporate bonds, and for liberalization of procedures on the stock market. Many small changes have been introduced that, cumulatively, may have an important impact. However, it will take time for those effects to be evident.

Reformers, particularly those in the finance sector, are trying to create a new reality on the ground. This is in part because they believe that a large web of interlocking institutional changes will have to be made, and therefore that a start must be made today. But another motivation is surely that they are preparing the ground for the new leadership. They wish to short-cut the natural tendency of a new administration to come in and launch a big study of everything that needs to be done. That was what happened in the beginning of the Wen Jiabao administration, and culminated in the declaration on continued reforms of the Third Plenum of the 16th Party Congress that took place in late 2004. It was a lovely document, and nothing ever came of it. Big studies to devise overall reform programs sound important, but in the end, they only work if there is dynamism on the ground. Achieving some momentum today is likely to be essential in convincing the new administration to go forward with important market-oriented reforms.

## Old and New Leaders

Wen Jiabao will be replaced as premier in the spring of 2013, but he is already a lame duck. It is important to recognize that the consensus described in the early part of this article is in some respects a consensus judgment on Wen Jiabao. The policies that were tried and which have now left so many difficult problems were Wen Jiabao's policies. The policies that will not work today are Wen Jiabao's policies. There is a pervasive sense of disillusionment and frustration with Wen Jiabao.

Wen Jiabao's ultimate legacy will be complex. The incoming leaders, however, are likely to focus in the short run on one aspect of Wen's economic legacy: nearly all Wen's policy choices tie up resources and tie the hands of his successors. Wen has presided over the channeling of many billions of RMB into favored sectors such as the Strategic Emerging Industries. Those industries have not yet emerged, but the commitment of money is ongoing. Wen has committed billions to the expansion of health insurance, but hospitals are still underfunded and the mechanism is still shaky. Wen's housing policy requires constant jousting with local officials that hardly seems sustainable for the long term. At the same time, Wen's administration has *not* built up the institutional capital needed for the next round of reforms: the regulatory agencies and the institutionalized fiscal system that would provide the foundation for a new round of marketization are still very weak.

This means that it will be hard for the new leaders to restructure Wen's policies, but relatively easy for them to repudiate Wen's overall policy framework. New leaders need new slogans and policies to differentiate themselves from their predecessors in any case. Hu Jintao and Wen Jiabao moved with surprising speed in 2002–04 to chart a new policy course differentiating themselves from Jiang Zemin and Zhu Rongji. We should expect the same in 2012–14. It is true that Li Keqiang seems to be extremely closely tied to Wen Jiabao's policies, many of which he has participated in implementing. In spite of this, however, he is likely to surprise us.

There is no doubt that Xi Jinping is a very different personality from Hu Jintao, and his approach to governing is likely to be very different from that of Hu Jintao. While Xi's ideological orientation and policy preferences do not seem particularly distinct, he seems more accepting of the complexities of economic and political realities, less focused on controlling the agenda, and more likely to bless changes already in progress as long as they don't threaten any core interest of his. If reformers can create momentum, they hope, Xi Jinping will take ownership of dramatic new market reforms.

## The Structure of the Politburo Standing Committee

The policies that emerge from the next administration will depend significantly on the choices that the new top leaders make. However, an additional important factors will be the way in which institutions are shaped to represent interests and produce good economic advice. Over the past administration, economic policy-making has been highly concentrated in the formal government apparatus, with virtually all important decisions passed up through bureaucratic agencies for a final determination by Wen Jiabao. Wen's decision must then be ratified by the Politburo Standing Committee, which tends to ratify Wen's judgment. This system concentrates far too much authority in the hands of a single individual, who after all faces limits on his time, attention, and capability. A big question for the 18th Party Congress is therefore whether to alter power structures in order to provide broader channels to process economic input. This question is intertwined with the size and structure of the Politburo Standing Committee.

The economic challenges create an urgent need for a restructuring of the Politburo Standing Committee (PBSC). As the process of government transition has become more institutionalized, the division of labor among Standing Committee members increasingly stands out as a point that should be subject to discussion. As Alice Miller has pointed out in these pages, the PBSC corresponds to a rational and increasingly institutionalized division of responsibility.[16] Each PBSC member has (apparently) one voice in PBSC decisions, and each PBSC member presides over at least one institutional domain and its associated policy arenas. Thus, Wen Jiabao presides over the State Council, Wu Bangguo over the National People's Congress (NPC), and Jia Qinglin the China People's Political Consultative Congress (CPPCC).

This seems very reasonable and institutional, but of course the actual responsibilities of these organizations are far from equal. If we were to analogize this system to the United States, it would be as if Wen Jiabao presided over Treasury, Commerce, Energy, the Federal Reserve Board, Housing and Urban Development, and Health and Human Services, and also oversaw Bank of America, J.P. Morgan, and Goldman Sachs; while Wu Bangguo presided over the Senate; and Jia Qinglin . . . well, let's say he gave speeches to the Chamber of Commerce. Yet when these leaders come together in meetings of the Politburo Standing Committee, and must ratify important national decisions, each has, as it were, one vote. This is an unusual system, and it is unlikely to persist long term. Indeed, the PBSC in the past has generally had a second economics specialist besides the premier. Since the institutionalization of the PBSC began with the 13th Party Congress in 1987, that role has been played successively by Yao Yilin, Zhu Rongji (before he became premier), Li Lanqing, and Huang Ju, all of whom had primarily economics portfolios, without having any additional formal responsibility to preside over nominally high-ranking institutions such as the NPC or CPPC. However, when Huang Ju died in office during the 16th PBSC, he was not replaced. Instead, in the 17th PBSC, that "slot" was filled by Li Keqiang, the presumptive successor as premier. Li Keqiang is an economist in a sense, since he attended a post-graduate program for high officials at Peking University, and wrote a thesis that was accepted for an economics Ph.D. However, he is clearly in training to take over all of Wen Jiabao's broad portfolio, and no longer specializes in economics as such. Thus, the "economist's slot" has turned into the "successor's slot."

In practice, representation on the PBSC is intertwined with the fate of Wang Qishan. Wang is widely regarded as a capable and competent economist. He can only serve one term in the PBSC, due to age limits. The more pressing the economic challenges are, the more likely that Wang will be selected to serve that term—there is currently an urgent need for an additional economics specialist among the top leaders, and Wang Qishan is the obvious candidate for the job. But there is a problem: Which institutional hierarchy would he head? There is no institutional slot for him on the current PBSC. This is, however, an artificial problem, the legacy of incremental institutionalization without a deep underlying rationale. Thus, there needs to be a shakeup of the PBSC, and the more challenging the economic conditions, the more likely that shakeup. Rumors circulating in Beijing increasingly suggest that the PBSC will shrink to seven members at the 18th Party Congress. Wang Qishan is also currently rated a favorite to become a PBSC member, although this is not certain. The ideal outcome would be for the PBSC to shrink while simultaneously reinstating the "economist's slot." That would concentrate authoritative positions in areas requiring serious policy-making efforts.

## Conclusion

China's economic challenges require a major multi-stranded program of market-oriented institutional reforms. Remarkably, China's political system shows increasing signs of recognizing this truth, and there are increasingly vocal calls for a renewal of reform. These challenges are shaping the succession process. However, to achieve a positive outcome, China's new leaders must navigate successfully through a difficult redistribution of power and resources during the succession process and renew their commitment to economic reform. The outcome is far from certain.

## Notes

[1] Quoted in Dong Shanfeng and Chen Heng (董山峰 陈 恒), "Prospects for the New Year: Indigenous innovation in the 12th Five-Year Plan" (新年展望：看"十二五"自主创新), *Guangming Ribao* (光明日报), January 5, 2012. Accessed at http://www.mlr.gov.cn/wskt/hgjj/201201/t20120105_1055098.htm.

[2] "We absolutely cannot do another 4 trillion [stimulus package]; Tax policy should release some water to allow fish to grow" (绝对不能再搞四万亿 税收要放水养鱼), *People's Daily* 人民日报, June 15, 2012, accessed at http://news.xinhuanet.com/fortune/2012-06/15/c_123286565.htm.

[3] "Wen Jiabao in Jiangsu inspection [says]; stabilizing investment is the key to steady growth based on increased domestic demand" (温家宝在江苏调研:稳定投资是扩内需稳增长的关键), *China.com*, July 9, 2012. Accessed at http://www.china.com.cn/policy/txt/2012-07/09/content_25852438.htm.

[4] Cheng Siwei 成思危, "Using massive investment to stimulate the economy is like drinking poison to quench thirst" (用大量投资刺激经济是饮鸩止渴), July 10, 2012, CCTV, accessed at http://news.163.com/12/0710/02/86147IO60001124J_all.html.

[5] Wang Lei (汪蕾), ed., "Central Politburo reaffirms stable growth, real estate control policies will not waver" (中央政治局定调稳增长 地产调控不动摇), *Duowei News* (多维), August 1, 2012, accessed at http://economics.dwnews.com/news/2012-08-01/58794619.html.

[6] Eric Min, "China to increase railway investment," *21st Century Business Hearld Online*, July 31, 2012, accessed at http://www.morningwhistle.com/html/2012/Company_Industry_0731/213308.html.

[7] "The mayor of Zhanjiang City in Guangdong kisses the document because the project was approved" (广东湛江市长因项目获批亲吻文件), *Zhanjiang Daily* 湛江日报, May 28, 2012, accessed at http://news.sina.com.cn/c/p/2012-05-28/223724493737.shtml.

[8] Wang Xiaoqing and Li Xuena 王晓庆 李雪娜, "Who maintains the real estate control policies?" (谁在坚持地产调控), *Caixin New Century* 财新《新世纪, August 13, 2012, accessed at http://magazine.caixin.com/2012-08-14/100422352_all.html-page2.

[9] To be fair, it should be acknowledged that not everybody agrees the economy is already facing long-term slowdown. For example, Justin Yifu Lin, who has just completed his term as chief economist at the World Bank and returned to Peking University, believes that China can continue to grow at 8 percent for another 20 years. His argument is based on a straightforward, but perhaps overly simple, comparison. China's per capita GDP today is about 21 percent that of the United States', measured at purchasing power parities. This is the same position relative to the U.S. that Japan held in 1951, Korea in 1977, and Taiwan in 1975. In the subsequent 20 years, those economies grew at 9.2 percent, 7.6 percent, and 8.3 percent, respectively. Therefore, China can as well. This is an important argument, but relies heavily in on calculations using relatively weak purchasing power parity data; and it assumes that the duration of rapid growth phases is determined by relative position (gap behind the leading economy, in this case, the United States). Most analyses consider the structure of the domestic economy (rural vs. urban); demographic conditions (labor force growth and dependency); and investment rates to be more important, but these do not figure in Lin's argument. See Justin Yifu Lin, "China in the World Economy," Public Lecture, Vienna, August 10, 2012, Powerpoint document at http://www.oefse.at/Downloads/publikationen/documentation_china_10_08_2012.pdf.

[10] There has been extensive reporting on the troubles of this industry. For one recent example, see Ma Nan, "China Development Bank fell in Suntech's fraud case," *21st Century Business Herald Online*, August 1, 2012, accessed at http://www.morningwhistle.com/html/2012/FinanceMarkets_0801/213316.html.
[11]Qin Xiao 秦晓, " Kick off a new round of economic reforms in China—Problems, objectives and policy tools" (启动中国新一轮的经济改革—问题、目标与政策工具), outline of remarks presented at the *Financial Times*《金融时报》Qingdao Conference, June 20, 2012.
[12]Guo Shuqing 郭树清, "If China doesn't reform its financial structure, there is no way out" (中国不改金融结构，没出路). Speech at the Lujiazui Financial Forum, June 29, 2012. Posted on Phoenix Finance (凤凰财经), August 2, 2012, accessed at http://www.xj71.com/2012/0802/684665_2.shtml.
[13] Guo Shuqing 郭树清, *loc. cit.,* pp. 4–5.
[14] Eswar Pradad, "Reform by stealth is reason for optimism about China," *Financial Times* [London], August 6, 2012, page 9.
[15] Even Wen Jiabao joined in the criticism of the monopoly by state banks, although it is a little difficult to figure out what he intends by this, given that he has been premier for almost 10 years, during which time that monopoly was consolidated. "China's Wen Criticizes Big Banks' Monopoly," April 5, 2012, accessed at http://www.morningwhistle.com/html/2012/FinanceMarkets_0405/3.html.
[16] Miller, Alice (2010). "The 18th Central Committee Politburo: A Quixotic, Foolhardy, Rashly Speculative, But Nonetheless Ruthlessly Reasoned Projection," *China Leadership Monitor*, no. 33 (Summer). Accessed at http://media.hoover.org/sites/default/files/documents/CLM33AM.pdf.