Reform Agenda in Turmoil: Can Policy-makers Regain the Initiative?

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The stock market turmoil in China revealed a certain amount of disarray in the top-down economic policy process designed by the Third Plenum. In line with traditional division of responsibility, the State Council and Premier Li Keqiang have been playing a central role in coordinating day-to-day economic policy. This is evident with respect to both stock market policy and state enterprise reform. Competing policy entrepreneurs will drive the next step of the policy agenda.

July was a remarkable month in the Chinese economy, and it will take months for the fallout to become clear. The stock market fiasco certainly revealed a rich tapestry of buck-passing, blame-shifting, and sheer incompetence. After a train wreck of this proportion, particularly one that was easy to see coming, people have both the opportunity and the incentive to start inventing alibis and cover stories early. It's much harder to get to the bottom of things, particularly with so much money at stake. Moreover, no system has greater ability to bury a negative story than the Chinese system, or such rich experience in doing so. We should anticipate that the stock market story will quickly disappear, and the stock market left to sink back into near-term mediocrity.

But then again, who are we to judge? Nothing the Chinese could do to their stock market can come close to equaling the breathtaking mixture of greed, regulatory slackness, and policy missteps in New York and Washington that marked the Global Financial Crisis (2008–09). Only the European Union can come close to matching the U.S. in both the scale of the wealth destroyed, and the sheer complexity of the mechanisms that were used to destroy wealth. Therein, in fact, lies an important difference from the Chinese case. In both the U.S. and European cases, while it was not hard to discern specific risks and flaws, only a very few clear-eyed individuals were able to assemble in advance all the different parts of the Global Financial Crisis or the European Crisis into a coherent whole. Well-informed opinion held that the system was robust enough—that its complex interacting parts would provide checks and balances, outlets, safety—so that it could withstand a little bit of abuse and profiteering (whereas the reverse turned out to be true). In China, by contrast, this was an outcome that many people could see coming, and about which many people certainly did whisper in the ear of policy-makers, "hey, we should watch out for this." It was, in other words, a train wreck waiting to happen.

There's nothing like a breakdown to reveal how an engine works. In this case, the example should certainly have laid to rest one version of economic policy in China, namely, the one claiming that Xi Jinping is rationally seeking to impose discipline on the system so that he can put through some efficiency-enhancing reforms. Instead, it reveals a very different picture of policy-making in China. In this picture, an authoritarian leader attempts to control the entire policy agenda, which is impossible. As a result, actual policy-making initiative gets seized in apparently random, difficult-to-predict episodes by policy entrepreneurs.

In this short piece, I exemplify that idea by telling two stories: The first reflects one or two aspects of the stock market crash, while the second discusses the current status of state-owned enterprise reform. Neither is intended as anything like an exhaustive analysis of these complex issues. Rather, they are introduced as moral tales that help understand one aspect of how economic policy-making works in Xi's China. The final two sections make some observations about the observed pattern.

The True Story of the Chinese Stock Market . . . Or Is It?

The first thing to notice about the Chinese stock market story is that the most widely accepted version of the story in China does not appear in the official Chinese press at all. As is often the case in China, the official press is full of conspicuous absences, which the ordinary public reads around. The basic facts upon which the narrative is built are simple: the Chinese stock market, after an extraordinary, exuberant run-up (to a peak of 5166 on the Shanghai Index on June 12), wobbled and then crashed, amid something very near panic, to a low point (of 3507 on the Shanghai Index), on July 8. Massive intervention—combining truly enormous sums of money, suspension of many losing stocks, administrative controls, legal threats and standard monetary policy tools—eventually stabilized the market. There are a number of careful reconstructions of the events that led up to, and immediately followed, the panic and intervention.[1] I do not replicate these here, and there are far too many relevant details to cover in this short piece. However, note that the two crucial parts of the popular narrative are carefully avoided in the official accounts.

First, everybody in China believes that the political leadership encouraged the stock market boom (or "bubble"). There are many different versions of this. Editorials in the *People's Daily*, statements by stock market officials and off-the-cuff remarks that Xi Jinping himself may or may not have made, but which were allowed to be posted and reposted on Weibo and WeChat. Whatever these individual comments add up to—and I have not done any of the detective work that would be required to evaluate them—this story gained enormous currency in China. Among potential investors in the urban middle-class, the idea was universally accepted that Xi Jinping wanted a booming stock market, because this gave his "China Dream" an immediate realization.

To allow such an idea to spread among China's investment community, at a time when China has still not yet managed to establish a healthy functioning stock market, was deeply irresponsible. The relevant financial officials should instead have been loudly proclaiming, "stock markets go up and they go down; we do not prefer a market above some target level; and markets are very risky." Of course, some financial officials *did* issue such warnings, but they were presented in the official media in ways that encouraged the public to ignore them. That is, the propaganda departments, no doubt giddy with success at their ability to pump up the top leader to new heights of popularity, seized a new opportunity. Not only do we have a China Dream, it is being realized right now with our newfound prosperity: look at the stock market!

The turning point of the popular narrative comes on the weekend when Premier Li Keqiang returned from Europe, and immediately took charge of a market rescue operation. He convened State Council meetings on Saturday and Sunday (July 4 and 5), in order to bring together all of the important players on the financial side. These matters are described cautiously and circumspectly by *Caijing* magazine as follows:

> On July 4, the State Council convened a meeting of the central bank and the three Regulatory Commissions [Securities, Bank and Insurance], along with the Ministry of Finance and the responsible head of several large central state-owned enterprises to discuss market rescue policies, and top leader(s) were inclined toward extreme measures. On the afternoon of July 5, the China Securities Regulatory Commission announced that the People's Bank of China would provide liquidity support to the China Securities Finance Corporation [证金公司] through multiple channels. This showed that the market rescue measures from multiple ministries and commissions, coordinated by the State Council, were beginning to be implemented, and that the China Securities Finance Corporation was to be the platform for market rescue. Liquidity provided by the central bank is the largest scale support. [这标志着，以国务院协调的多部委联动救市开始实施，证金公司作为救市平台。央行提供流动性，则是最大限度的支持.][2]

The highly personal role of Li Keqiang in coordinating the fight against the stock market panic is a staple of the popular, "rumor" version. However, this *Caijing* mention is about as close as you will find in the Chinese press.[3] Why is Li's role downplayed so severely? In the first place, it is because these measures, to the surprise of nearly everybody, at first didn't work. The market briefly stabilized on Monday, July 6, but resumed its plunge on July 7 and 8. Indeed, it was this rapid fall—*after* everybody knew that the government had mobilized its resources to stop the market decline—that led to near-panic conditions on Wednesday, July 8. In the face of this renewed wave of panic, further massive intervention was launched. Indeed, in the face of potential panic of this scale, it would have been irresponsible not to take extraordinary measures to achieve stabilization. This was done, and some preliminary stabilization of the market was achieved after July 13. However, since it is not yet clear if government efforts have been successful, it is early to declare heroes in the struggle.

There are other, more profound reasons for the downplaying of Li Keqiang's role and actions in the official media. Such prominence would be incompatible with the Xi Jinping style of rule. Jiang Zemin might have allowed Zhu Rongji to take such a prominent role (or Hu Jintao allowed Wen Jiabao). However, there is no indication that Xi Jinping would ever allow any subordinate's role to be dramatized. All decisions, and all wisdom, must be seen to emanate from the very top. At the same time, nobody would seriously question the obvious fact that Xi Jinping would have supported, approved, and perhaps even initiated the market rescue operations (this is something we know nothing about). Centralization of power certainly extends to key decisions in emergency situations.

Further, the style of government intervention in this case makes many people nervous. The measures taken were clearly extra-legal, and perhaps illegal. Stock market regulation was mishandled, both on the way up and the way down, particularly with respect to provisions that allowed, then disallowed, then allowed again, margin trading. Moreover, the ultimate form of State Council intervention was almost certainly a top-secret State Council order. This top-secret document, perhaps a joint document with the Party Center, would have gone out on Sunday, July 5. There are some reports that it was a 21 article document, which we can consider to have been obliquely referred to in the *Caijing* story quoted above. Indeed, the closest the official press got to reporting this came when an intrepid blogger noticed that a provincial government agency had referred to the need to carry out the "spirit and demands of the State Council" in an urgent document posted online.[4] This report was then widely reprinted because it was the one kind of unambiguous confirmation media could print without violating secrecy requirements. This method of handling crisis echoes that employed during the Global Financial Crisis in November 2008. The government and Communist Party prefer to keep these urgent commands secret.

SOE Reform: Agenda in Turmoil

Reform of state-owned enterprises (SOEs) was an important element of the 2013 Third Plenum Resolution on Economic Reform. The SOE section of the resolution was bold, because it pushed SOE reform into new territory ("mixed ownership") and it was intellectually coherent. Moreover, it was clever, because it managed to sweep past many of the ideological land mines that had been laid to constrain progress in SOE reform. It reawakened hope that SOE reform might be a key element of policy reform in the first Xi Jinping administration.

However, a policy as important as this quickly elicits the participation of many interested parties. SOE reforms, like other critical planks of the Third Plenum, were supposed to be coordinated by the "Deepening Reform Leadership Small Group," chaired by Xi Jinping. This Leadership Small Group in turn naturally had to delegate the drafting of different elements of an SOE reform program to different parties. A program like SOE reform is simply too complex and involves too many different economic, political, and personal-interest elements to go through a purely technocratic drafting process.

Instead, elements of SOE reform were broken down into at least three different drafting processes (described in earlier *CLM*s). First, the Ministry of Finance produced a proposal in which the principle of "mixed ownership" for SOEs would include the establishment of multiple, potentially competing funds or ownership agencies, rather like the Singapore system (Temasek and the Government Investment Corporation) in which government ownership is exercised at arms' length, and funds are at least implicitly compared on their realized investment returns. Second, the existing ownership agency, SASAC (State Asset Supervision and Administration Commission) produced its own proposal that also had different investment funds, but assigned each fund a specific sectoral focus. This approach would inevitably assign a panoply of "strategic" and interventionist functions to the funds. Having nonfinancial objectives would in turn encourage the funds (or their superiors at SASAC) to use administrative control and planning whenever there were crises or unanticipated events. In other words, SASAC's approach would essentially maintain their existing power in a new form, different and dangerous, and potentially even less market-oriented than the current system. Third, the government Ministry of Personnel (but more realistically the Communist Party Organization Department) developed a plan for changing the terms of compensation for SOE managers. These three proposals were clearly in conflict and would require a process of consolidation, compromise, and adjudication.

Instead, the Personnel Departments moved preemptively. Since SOE managers are public servants, and since Xi Jinping had launched his massive anti-corruption campaign, the Personnel Departments presented a radical proposal to the Deepening Reform Leadership Small Group in August 2014. The Small Group and the Politburo approved it immediately. In essence, this policy enacted a massive pay cut for SOE managers. Since they were public servants, appointed by the Communist Party, it was decreed that SOE managers' salaries should be comparable to those of bureaucrats of the same rank. More specifically, SOE manager salaries were to be reclassified into three parts: base salary, annual bonus, and multiyear contract completion bonus. These are not dramatically different from the existing system, but there are three new limitations. Base salary is now to be set at twice the average wage of workers in the firm in the previous year; annual bonus is capped at twice the base wage; and the contract completion bonus cannot be more than 30 percent of the average annual total wage. This would imply that a manager's total salary could be no more than about 5 times the average wage in the firm (average wage x 2 x 2 x 1.3), although other accounts consistently say that managerial salaries will be capped at 7 to 8 times the average wage in the firm.[5] This is a huge salary reduction for the manager of a big SOE who has been accustomed to getting base salaries that are multiples of ministerial salaries, plus various kinds of stock options and perks. Many news reports referred to pay cuts of over 30 percent, but even these must understate some of the reductions.[6] An additional (and potentially highly positive) aspect of the new system is that managerial perks and benefits are also to be limited and made transparent. Specific regulations on matters as diverse as golf club memberships and health insurance plans were also promulgated. Moreover, this massive pay cut was applied to financial institutions as well, including banks and investment funds.[7] Some state firms were potentially to be re-classified as purely competitive business firms, while others would be designated as "public interest" firms. This provided the possibility that managers of competitive firms would receive market-based compensation, while managers of public interest firms would be compensated according to bureaucratic pay scale. However, this important issue of firm classification would obviously need to be resolved as part of the broader program of SOE reform.

How should these different proposals be "harmonized"? The solution was to create still another Leadership Small Group (LSG), this one under the State Council (and thus a government body, rather than a Communist Party body). The new State Enterprise Reform Leadership Small Group is headed by Ma Kai, a vice-premier with long experience in the economic management organs. Ma Kai is considered to be a highly capable bureaucrat, a good listener and a good manager. He is likely to come up with a workable reform program—perhaps by September 2015—but it is unlikely to contain much that is daring or radical. However, the Personnel Departments, by moving pre-emptively, had achieved significant influence on the composition of this LSG. Indeed, the head of the working office of the State Enterprise LSG is Wang Yong, a state councilor who was previously himself head of SASAC. Wang Yong's tenure at SASAC made it a much more conservative agency, with little commitment to the reformist agenda that accompanied its birth. This was not surprising, since Wang Yong came from the personnel side of things, representing managerial control and traditional political interests (rather than the business management side of things, which is inclined to be more market-oriented). With Wang Yong managing the flow of paperwork, and Ma Kai presiding over the process, the odds for a real breakthrough in state enterprise reform have declined significantly. The personnel side was able to seize control of the agenda.

Top-down Leadership and Policy Entrepreneurship

The stories of stock market rescue and SOE reform tell us a great deal about China's policy process, insofar as it affects economic policy. The system is still certainly top-down. The secret central document that lies behind the stock market rescue, and about which we know little, certainly exemplifies this basic fact.

Centralization has its limits. China is far too complex an economy and society to function with decision-making concentrated in a few hands. However, Xi Jinping at the beginning of his administration clearly increased the decree of direct oversight he exercised over economic policy, and emphasized his own personal role in the economic reform decisions of the Third Plenum. This was a significant change from previous practice: Since the 1980s, economic policy has been primarily in the hands of the Premier, with some degree of oversight by the Standing Committee of the Politburo.

The events of the last few months show that this type of centralization doesn't work very well, and that the delegation of economic policy roles to the premier has its own intrinsic logic. It is not accidental, then, that both of the stories narrated above involve a transference of practical decision-making to the State Council level. Li Keqiang played a central role in the stock market rescue, and SOE Reform proposals have been transferred to the State Council. This is not necessarily the result of any particular personal capabilities of Li Keqiang. Rather, it shows that effective and responsive policy has to be decentralized. Economic events move fast and they require a full-time hand on the tiller. No matter how vast Xi Jinping's nominal accumulation of power, he simply doesn't have the bandwidth, to say nothing of the interest, to manage the economy in his spare time, while also running China's foreign and security policy, and restructuring Chinese society.

This type of extreme dominance from the top is an illusion. It doesn't really streamline the decision process or make it more effective. Indeed, Pope Francis, the reformist head of another highly centralized and authoritarian organization recently pointed this out: "Excessive centralization, rather than proving helpful, complicates the Church's life." (December 2013). How does excessive centralization complicate an effective policy process? In effect, by opening up new opportunities for policies entrepreneurs to hijack the agenda.

China is a deeply entrepreneurial society. Business entrepreneurship flourished despite 30 years of socialist planning, and we should also expect entrepreneurship in political circles. Policy insiders quickly perceive that the rigidity of top-down control actually opens up opportunities for them to re-create the agenda on the ground. They can take actions that foreclose other kinds of action, and that give them the initiative. We can see this quite clearly in the stories told in this piece. The propaganda organs seized the initiative to paint the stock market recovery as a sign of Xi Jinping's China Dream. It is evident in SOE reform, as well. The personnel departments moved preemptively to define SOE reform, and took the initiative away from the financial departments. These policy entrepreneurs understand that Xi Jinping's ideological inclinations are in their direction, so they have space to seize the initiative.

There have always been many policy entrepreneurs in China. Recently, the managers of state enterprises have lost what Hicks described as the greatest of all monopoly profits, namely, a quiet life. As a result, these managers now have no choice but to become policy entrepreneurs, and we see them already trying to reposition themselves and their organizations in the wake of the new situations created by the stock market. For example, Lin Zuoming, the long-time head of AVIC, the Aviation Industry Corporation of China, has declared that the stock market crisis was "an attack by the enemy on the five-star red flag."[8] While such an approach is not going to help the Chinese improve the functioning of their capital markets, it probably does a good job of positioning this SOE manager as a patriot, and helps him shift his entrepreneurial instincts from the business side to the policy side. Not surprisingly, Lin Zuoming is a big opponent of SOE reforms that include any "privatization."

The Future

The next steps of China's policy reforms will develop in difficult to predict stages. The policy entrepreneurship evident in many areas of China is also evident on the side of reformers. Those reformers are well aware that events in the Chinese stock market over the past few months have seriously damaged the credibility of Chinese policy-makers and of the reform process. We should anticipate that they will also move positively, and perhaps even preemptively, to reestablish the Chinese reform agenda. [These words were submitted to the *China Leadership Monitor* on August 3, 2015. On August 11, the People's Bank of China announced a new, more flexible exchange rate system; on August 8, international media began to report that the State Council had approved a new SOE reform program, though no details were available.[9] It remains to be seen what contribution these measures will make to the broader reform effort.]

Notes

[1] Jiang Fei 蒋飞 and Liu Caiping 刘彩萍, "How Beijing Intervened to Save China's Stock Market" (A股救市苦战), *Caixin Weekly* (财新周刊), July 13, 2015, accessed at http://weekly.caixin.com/2015-07-10/100828060_all.html (Abridged English version available at http://english.caixin.com/2015-07-16/100829521.html); Wang Xiaolu 王晓璐,

Li Yong 李勇, and Qu Yili 曲艳丽, "Revealing the secret story of how the market was rescued; the head of the biggest Securities Companies said 'Chairman Xiao, we'll do whatever you tell us'," (A股救市全解密 券业大佬称肖主席说怎么办就怎么做), *Caijing* (财经), July 20, 2015, accessed at http://finance.sina.com.cn/stock/marketresearch/20150720/114822736860.shtml; Andrew Polk, David Hoffman, Ken DeWoskin, and Peter Larson, "Beijing's Pyrrhic Victory Over the Equity Rout," The Conference Board, China Center for Economics and Business, July 2015.

[2] "Revealing the secret story of how the market was rescued."

[3] Of course, there are reports that describe Li Keqiang's role, but they are essentially outside sources reporting on the rumors. For example, see Mi Qiang 米强 and Wu Jiabo 吴佳柏, "Li Keqiang takes charge of the stock market counter-attack," (李克强主持股市反击战), *FTChinese*, July 8, 2015, accessed at http://www.ftchinese.com/story/001062900; "Li Keqiang thunders: The center will save the stock market with overwhelming force!" (李克强大发雷霆 中央就是要暴力拯救股市!), [Hong Kong] Apple Daily (苹果日报), July 4, 2015, accessed at http://news.creaders.net/china/2015/07/04/1552271.html.

[4] Ji Maoxin 鸡毛信 (pseud.), "Official media reveal for the first time the State Council is rescuing the market; Guangxi SASAC demands its firms carry out the spirit of State Council stabilization measures," (官方首次透露国务院救市 广西国资委要求贯彻国务院维稳股市精神), July 13, 2015, accessed at http://stock.caijing.com.cn/20150713/3924462.shtml.

[5] "The salary reform plan has been set for 72 central SOEs; Salary cannot exceed 8 times average wage" (72央企负责人薪酬改革方案确定：不超职工8倍), *Renmin Net* (人民网), November 25, 2014, accessed at http://finance.china.com.cn/roll/20141125/2810737.shtml; Suo Hanxue 索寒雪, "Breakthrough with central SOEs; comprehensive reform of SOE management compensation," (突破央企 国企高管薪酬全面改革), *China Business Journal* (中国经营报), July 13, 2015, accessed at http://news.cb.com.cn/html/economy_9_26248_1.html.

[6] "Four provinces report on implementation of SOE Managers Salary Reform; Maximum reduction of 50%" (四省国企老总限薪绩效差最高降50%), *Beijing News* (新京报), August 15, 2015, http://news.xinhuanet.com/fortune/2015-08/15/c_1116261982.htm.

[7] An exception was made for managers who had been "recruited from the market," rather than those appointed through administrative (i.e., traditional Communist Party nomenklatura) methods. However, this affected a relatively small proportion of important managers and created a new gray area for managers who had been initially market recruited, but then had their appointments ratified by administrative means.

[8] "The AVIC Board of Directors chairman reveals his support for the stock market; the enemy has attacked the five star [red] flag" (中航工业董事长披露护盘A股：敌人是冲着五星红旗来的), Phoenix Finance (凤凰财经), July 19, 2015, accessed at http://finance.ifeng.com/a/20150719/13849221_0.shtml.

[9] Keira Lu Huang, "How China's Singapore-like plan will 'boost growth' by shaking up state-run behemoths," *South China Morning Post*, August 8, 2015 [Updated August 11, 2015], accessed at http://www.scmp.com/news/china/economy/article/1847787/long-awaited-blueprint-details-how-make-chinas-state-run.