Supply-Side Structural Reform: Policy-makers Look For a Way Out

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PRC Policy-making with respect to economic reform has been extremely inconsistent since early 2015. Some of this inconsistency can be traced to different conceptions of reform, and some to different centers and channels of policy-making. The recent introduction of "Supply-side Structural Reform" is an important development best understood in the context of the problems that emerged over the past year.

As a leader, Xi Jinping appears in most respects to be bold, charismatic, and decisive. Yet, remarkably, economic policy over the past year has been inconsistent, ineffective, and on occasion entirely counterproductive. Quite a few commentators have noted that the aura of infallibility—or at least of extreme competence—that once surrounded the Chinese leadership has now evaporated. Policy-makers seem to have lost their compass. As Paul Krugman put it, "Judging by their current flailing, they have no clue what they're doing."[1] Why have China's policy-makes lost their knack? This piece argues that there are two proximate causes of the current mess: deep divisions about the appropriate relationship between reform and growth or macroeconomic policy, and uncertainty and confusion about the channels of policy-making and who is charge of economic policy on a day-to-day basis.

These divisions not only help understand why the outcomes of most reforms have been disappointing over the past year, they also provide an appropriate context to interpret the most recent new development: "supply-side structural reform." Announced in November 2015, supply-side reform has been receiving steadily increased attention during 2016. In the narrow sense, this is an effort to deal with surplus industrial capacity; in a broader sense, it is an important initiative designed to overcome both of the divisions that have hampered reform policy. However, those divisions will not be easy to overcome.

Maintaining Growth: How Much is Necessary?

The most fundamental fact facing China's economic policy-makers is that the age of "miracle growth" is over. Powerful changes in demographic and labor force conditions, magnified by exhaustion of traditional investment opportunities and a global economic slowdown, mean that the years of growth at 10 percent annually or more are gone forever. The end of supercharged growth is intrinsically difficult to manage: Japan stumbled once in 1973 and again in 1992; Korea tripped seriously in the Asian Financial Crisis in 1997. Under the best of circumstances, such sharp changes in economic conditions are hard to manage.

As growth slows, the understandable instinct of policy-makers—in China as earlier in Japan and Korea—is generally to carry out economic stimulus in order to keep growth from falling too much.[2] As policy-makers give in to this natural temptation, they increase investment and push up debt (again, in China today and earlier in Japan and Korea). Soon the growth slowdown has been combined with a serious debt problem: not only is the aggregate debt burden higher, but more of it is tied up in projects that—given the new economic conditions—will never generate the revenues needed to repay creditors. As debt becomes a bigger and bigger problem, it influences all of the policy issues concerning reform and growth, which were already difficult.

At this stage in China, policy-makers are uncertain how to respond. At the risk of over-simplification, we can identify two opposite responses. One group says, "Let the growth rate fall and find its own level; we must vigorously reform the economy and tackle the debt burden. Market pressures will accelerate debt liquidation and restructuring and we will lay the foundations of sustainable future growth more rapidly." In their eyes, a relatively restrained macroeconomic policy—which includes a restrained credit growth rate and a relatively strong RMB—will help both debt restructuring and reform. These reforms prefer a relatively orthodox monetary policy, even at the cost of slower growth, because it will facilitate the liquidation of inefficient producers and misconceived investment projects. An opposing group thinks that policy-makers have a responsibility to maintain a kind of floor to the growth rate in order to anchor positive expectations of the economic future. In essence, this group continues to say, "Growth is below expectations, let's have more stimulus." They believe that all economic problems (including reform) will be easier to resolve if the country can maintain stable economic growth. This group, to be sure, includes various interest groups who may not support reforms at all and just want to maintain their access to cheap credit and government support. However, it also includes reformers who may worry that financial structures are even more fragile than the other group of reformers believes, and think it would be irresponsible to let debt problems spiral out of control for the sake of a foolish macroeconomic policy consistency.

Each group has its strong and weak points. The "stimulus" group can be faulted for trying to stimulate the economy beyond its underlying growth potential, something that is manifestly impossible for more than a very short period. The "orthodox" groups, on the other hand, can be faulted for not recognizing that short-term financial panics can do enormous harm to an economy and must be prevented, even at the cost of enduring distortions for years at a time. The issues are complex and there is no simple answer, particularly because nobody knows for certain what China's current growth potential actually is, and nobody knows which apparently trivial episode might end up triggering large-scale financial turmoil.

The more immediate problem is that Chinese policy has been inconsistent. Neither of these groups have dominated Chinese policy-making over the past year. Instead, policy has lurched back and forth between them, policy-makers have stumbled repeatedly, and overall the achievements in market-oriented reform have been meager. Even more ominously, precious little has been achieved in reducing debt burdens in a sustainable way. As a result, expectations for reform breakthroughs have ebbed, and whatever momentum was established by the November 2013 Third Plenum has been lost.

Who's in Charge?

As readers of previous issues of *China Leadership Monitor* will know, China now has two different, sometimes overlapping, systems of economic policy-making. The traditional system, based in the State Council and headed by the premier, still operates and handles day-to-day decision-making in the economy. At the same time, a new Communist Party system of decision-making has taken an increasingly prominent role. This second system is based on two CCP Leadership Small Groups, both headed by Xi Jinping. The Finance and Economics Leadership Small Group, in existence since 1980, has a theoretically broad mandate but played a restrained role until the beginning of the Xi administration. The new Deepening Reform Leadership Small Group, set up after the 2013 Third Plenum, has a mandate that centers on reform but goes beyond economics. Either of these Leadership Small Groups (LSGs) can potentially pronounce on economic matters. The policy output of both of these systems—that is, decisions of either the State Council or the Party LSGs—must be ratified by the Standing Committee of the Politburo (PBSC). While this has always been the case, PBSC ratification used to be more of a formality, whereas the PBSC has now taken a more active role in discussing and approving economic policy decisions, further strengthening the party decision-making channel. Thus, the strengthened party system has significantly diminished the traditional authority over economic policy exercised by the State Council and premier.

Once again, the major problem is that the Chinese policy-making process has become inconsistent. In the past, economic policy-making had been a quite orderly process, with the premier typically presiding over a consultation process, and then making a decision. The decision would then be ratified at a subsequent PBSC meeting. In the last year, though, important decisions have emerged from the State Council, or from one of the LSGs, sometimes with consultation and preparation, and sometimes not. It is not accurate to say that the State Council and Premier Li Keqiang have been displaced and are unimportant. On the contrary, important decisions and day-to-day policy-making continue to be in the premier's portfolio, and most concrete implementing measures come out of the State Council. But one is never sure where the limits of the premier's decision-making authority are, and so one never knows which initiatives will be limited, halted, or over-turned. Policy exhibits an abruptness, a stop-and-start quality, that reflects the fact that decisions may be checked at the top by Xi Jinping, or suddenly made irrelevant by a new initiative coming from one of Xi's LSGs. The inconsistency of policy makes it hard for expectations of the future to settle in, which in turn makes it harder for businessmen and politicians both to transition to a new kind of economic model. These problems have been evident throughout the past year, and help explain the current situation as well.

2015: The *Annus Horribilis* of Economic Reform

Very few of the reform initiatives launched in 2015 were successful. Perhaps only in the financial arena were a few important measures carried through, including the de-regulation of deposit interest rates and important technical steps to make the capital account more transparent and somewhat more open. In many other areas, though, initiatives miscarried, and this was often because of the oscillation between different visions of what growth rate was acceptable and flip-flops between different policy-making channels. Whereas reform seemed to be gaining momentum during the final quarter of 2014 (*CLM* 46), those initiatives ended up disappointing in 2015. A full review of the policy initiatives of 2015 is beyond the scope of this short piece, but a brief review of four important policy initiatives from 2015 will illustrate the point:

1. *Restructuring Local Government Debt*

As described in *CLM* 46 and 47, an ambitious program of local government debt restructuring was laid out by Finance Minister Lou Jiwei by the end of 2014. The centerpiece was that local governments were allowed to sell bonds to replace existing debt to banks and non-bank financial institutions. The policy as originally designed was abruptly aborted after an April 30, 2015, Politburo meeting at which growth worries were the center of attention. Clearly, the fear that local governments unable to resolve their funding difficulties were curtailing spending and hurting growth was the impetus for the sudden shift.

The character of the local debt restructuring was abruptly changed. Instead of local governments having to convince the market to accept their new municipal bonds, commercial banks were instructed to buy local bonds despite their low interest rates, marking a de facto debt write-down and a considerable concession to local governments. This program then expanded rapidly to cover a swap of over 3 trillion RMB in debt during 2015, scheduled to reach an additional 5 trillion RMB worth of local debt in 2016. This flip-flop reflects both of the patterns of inconsistency described in the beginning of this piece: worries about the growth rate caused the abrupt alteration of an agreed policy, and the CCP policy track—in this case a Politburo meeting—was used to suddenly overrule the State Council-set policy.

This policy outcome is not an unalloyed bad. Restructuring debt quickly and on a massive scale lowers the cost of debt for local governments and improves their liquidity. It is, in fact, a massive bailout. Bailouts are sometimes necessary, but they are not the same as reform. They send a strong message that politicized spending is always OK, and that local officials will not be penalized for reckless spending.[3] In this case, policy flipped from contractionary to expansionary, and the policy developed by a government technocrat was overturned at a Politburo meeting.

2. *Equity Market Reform*

The Chinese stock market was in 2015 the center of a widely acknowledged fiasco. Important stock market reforms had been designed in 2014, including a limited opening to foreign investors through the Hong Kong-Shanghai connect, and a shift in the procedures for listing new firms that would allow any firm to list after it met regulatory requirements. However, these promising reforms fell by the wayside in the wake of an enormous boom and bust in the market, supported by misleading government policy. On the one side, Xi Jinping knowingly or unknowingly allowed the official media to promote the stock market boom as a positive consistent with his "China dream," thereby "blowing up" the bubble in the market in the first half of the year. On the other side, after the market collapse, Premier Li Keqiang clearly took charge of the stock market bailout in August, personally assuming control immediately upon his return to China from Europe.

What has remained utterly murky is whether Xi Jinping ever had any coherent attitude toward the stock market, and whether or not he ordered Li Keqiang to carry out a stock market rescue in August. Since the policy is widely viewed as a disaster, it is perhaps not surprising that to this day, nobody is responsible for it.[4] In this case, authorship of policy has been unknown, and policy has been held hostage to fears of a larger financial crisis that could conceivably emerge if a stock-market panic spread to other areas of the economy.

3. State Enterprise Reform

State enterprise reform is a story with a very different trajectory: the impetus for a new round of state enterprise reforms came out of the Third Plenum, in the document theoretically guided by Xi Jinping and in practice importantly influenced by Xi's close economic adviser Liu He. The Third Plenum document floated a number of suggestive, and potentially powerful, concepts for state enterprise reform. These included "managing SOEs as capital rather than assets," "mixed ownership," and "investment funds." While these concepts were vague, they unmistakably pointed to a shift to a system of SOE management that was more like wealth managements (as in a sovereign wealth fund) and consistent with the development of capital markets. Clearly, these vague concepts needed to be given specific shape through a policy formulation and specification process.

In practice, implementation promptly deadlocked, with different groups advocating different ideas. The Ministry of Finance quickly came up with a plan for investment funds, and the Party Organization Department came up with a plan to limit managerial salaries. The overall state enterprise reform plan was then delegated to a State Council drafting group headed by Vice-Premier Ma Kai and staffed by State Councilor Wang Yong. This was not a group which you would expect to draft a dramatically market-oriented SOE reform: Wang Yong had headed the existing "ownership agency" SASAC (the State Asset Supervision and Administration Commission), and under his leadership all of the problems associated with state ownership had gotten worse. Having him staff the reform office was a recipe for disaster, and when the document was finally released, it utterly failed to give meaningful substance to any of the vague ideas in the Third Plenum document. The concepts reappear, but even more vague and contradictory than before, to the extent that some parts of the document are simply incomprehensible. Most important, it gives no guidance whatsoever for what is supposed to happen at the top of the ownership pyramid, where one would expect to see new investment managers playing a role. Instead, it has harmful provisions, including those that encourage lower-level SOEs to take stakes in private firms and those calling for a strengthening of Communist Party influence and control over boards of directors.

In this case, the flip-flop of policy design and implementation between the CCP and State Council systems also failed, but in an opposite manner from that of the local government debt case. Here, the party yielded control of the policy design process to the bureaucrats who, predictably, came up with a program that protected bureaucratic interests, but did nothing to advance reform. This is especially remarkable because the author of those Third Plenum document ideas, Liu He, was the head of the specialized group pushing implementation of economic reforms under the Deepening Reform LSG. In principle, Liu was in the most strategic position to push his own vision of what those vague ideas might mean, but somehow, he let control of this crucial plank of the overall reform program slip out of his control and end up staffed by veteran bureaucrat Ma Kai. Being in the authoritative party position does not necessarily mean that you have the instruments to achieve implementation of the kind of vision you have been able to lay out.

4. Exchange Rate and Capital Account Liberalization

Generally speaking, the individual steps and overall program of financial liberalization have been guided by central bank head Zhou Xiaochuan, with the apparent support of top politicians. Zhou achieved some substantial successes in 2015, but his accomplishments were greatly undermined by the shock to confidence that came from modest devaluation moves in 2015 and again in early 2016. Between August 2015 and February 2016, Zhou Xiaochuan said nothing and did not appear in the media. Partly as a result, markets did not have an authoritative voice explaining changes in the exchange rate determination mechanism. Again, partly as a result, pressure on the RMB increased dramatically, and capital outflows became large. Zhou's low profile at the end of 2015 has been criticized by everybody from Goldman Sachs to Bloomberg News. We do not know exactly why Zhou was so quiet for so long: we don't know whether he was (slightly) out of favor, out of alignment with policy, or simply choosing to keep a low profile. However, we can easily understand the structural circumstances in which Zhou finds himself: the People's Bank of China is not independent. Zhou must carry out the monetary and exchange rate policies agreed by the State Council and the top of the Communist Party. Therefore, he cannot step forward and announce in the public media that he is carrying out a given policy in his own name; he can only speak when authorized by his political superiors. Yet at crucial points in the last six months, it was unclear whether his superior was (as is normal) Premier Li Keqiang, or (as is more fundamental) Party Secretary Xi Jinping.

Summary

The most disheartening aspect of policy-making in 2015 is that important and difficult reform measures were initiated in multiple areas, but the efficacy of every single one of these reforms was undermined by inconsistent implementation and uncertainty as to who the ultimate author of the policies was.

Supply-side Structural Reforms

On January 4, 2016, a mysterious commentator appeared on page one of the *People's Daily*. A prominent article hailed the views of "Authoritative Personage" (权威人士), and all of page two was taken up with an interview with "authoritative personage." The topic of these articles was "Supply-side Structural Reform" (供给侧结构性改革) .[5] Shortly thereafter, the article was republished as a small pamphlet from People's Publishing House, the title printed in red ink, signifying a very important document with unquestioned backing from the top.[6] In fact, the official media made the provenance of "supply-side structural reform" unusually clear, rather like the chain of bread crumbs left by Hansel and Gretel so they could find their way back home.

The concept of "supply-side structural reform" was first introduced at an official forum at the 11th meeting of the Finance and Economics Leadership Small Group (FELSG) on November 10, 2016. On December 14, the whole Politburo met to set the stage for the annual Economic Work Conference, which followed on December 18 to 21.[7] The Work Conference for the first time brought supply-side reform to the attention of a large audience, and also placed it at the core of economic policy for the first time. Subsequently, on January 26, 2016, the 12th meeting of the FELSG convened and again emphasized supply-side reform.[8] A striking fact is that each of the four meetings described is run by the party, and three of the four are specifically run by the FELSG. The Central Economic Work Conference is one of the few economic policy meetings that has always been chaired by the party's FELSG and therefore organized by the Office of the FELSG. Even when economic policy was firmly controlled by Zhu Rongji or Wen Jiabao at the State Council, the FELSG Office convened the annual Central Economic Work Conference. This was partly just tradition, but more importantly because the primary function of the annual work conference has always been to coordinate economic work for the coming year across all agencies that engage in economic work. This primarily means government ministries, of course, but also includes some departments that are under stronger party influence than government influence (such as rural work and defense industry). In the past, the general result has been that the outcome of the Central Economic Work Conference was often banal, stressing stability or vague slogans that could be adapted to a wide range of circumstances. Actually using the Central Economic Work Conference to deliver a dramatic new departure in economic policy is quite unusual. It would not be unusual for such a meeting to ratify a policy initiative laid out by the premier: indeed, this would be a standard aspect of the party's traditional role to confirm or veto economic policy. However, the adoption of Supply-side structural reforms as a key policy initiative at a party meeting is rather different from past practice. It exemplifies the extraordinarily proactive stance taken by the party in recent economic policy-making. In practice, the party means Xi Jinping, and in economic policy, his key adviser is Liu He, who is head of the office of the FELSG.[9] Indeed, press reports have traced the provenance of "supply-side reforms" to Liu He and in particular to comments he made on October 10, 2015, while touring Guangdong Province as head of an inspection team from the FELSG office. At that time Liu He said, "we have to pay more attention to supply-side adjustment."[10] Thus, there can be few doubts. The "authoritative personage" is Liu He, or at the least, a writing group under his close personal direction.

In each of these meetings, the following identical statement has been made, generally by Xi Jinping himself. "At the same time that we appropriately expand aggregate demand, we must strengthen supply-side structural reforms." In other words, the emphasis on supply-side reform is (among other things) an attempt to come up with a pragmatic compromise regarding the appropriate demand-side policy. On the one hand, pushing supply-side policy means policy-makers have accepted that expansionary demand policies by themselves cannot sustain growth. On the other hand, supply-side reform is not to be taken as a shift toward more orthodox or contractionary policies. Instead, because some of the supply-side policies may have a contractionary impact on the economy, they are to be offset by more expansionary demand-side policies. If "reform" on the supply-side can be accelerated, then increases in aggregate demand might be more effective.

What Are Supply-side Structural Reforms?

Formally, supply-side reforms include five elements, or "keypoint responsibilities":

1. Eliminating excess capacity
2. Reducing excess housing stocks
3. De-leveraging
4. Reducing costs
5. Strengthening weak points

Aside from the fifth point—tagged on at the end to make the program sound more cheerful—each of the elements is straightforward conceptually, but practically full of challenges and difficulties.

A. Excess Capacity

As the Chinese economy has slowed, demand for heavy industrial products has slowed even more, and in many cases dropped. However, capacity has continued to grow. The result is massive overcapacity in many sectors. The two hardest-hit are coal and steel, which have been earmarked as the first targets for reduction in capacity.

A basic approach has coalesced over the past few months that is likely to be the main form of this initiative. In this approach, the central government provides a modest amount of subsidies to facilitate the closing down of capacity. With this funding as sweetener, local governments are being pressed hard to (a) fulfill quotas for closing down capacity; (b) stop subsidizing money-losing firms; and (c) concentrate on assisting laid-off workers through welfare and job-switching programs. A particular focus of this approach is on closing down "zombie firms" (僵尸), that is, companies with debts and no profits that are kept alive by local government support.[11]

In the case of steel, the government has established an "Industrial Structure Adjustment Fund" and a target of 100 to 150 million metric tons (MMT) of capacity reduction.[12] This will provide about 20 billion RMB in subsidies to close down 40–50 MMT of capacity annually for about three years. For coal, problems are much more regionally differentiated. The provinces of Henan, Shandong, and Anhui are taking the lead, but their problems are less severe; later Inner Mongolia, and eventually Shanxi and Shaanxi will tackle the most intractable problems. It is expected that a special national policy will be enacted for them.[13] After steel and coal, overcapacity is to be tackled in cement, electric power, and non-ferrous metals, with other sectors, such as petroleum refining and petrochemicals—and even export sectors like garments—queued up for a later round.

B. Reducing Stocks

Reducing stocks conceptually could cover getting rid of any kind of surplus, but in practice is centered on reducing stocks of unsold housing in second- and third-tier cities.

While housing markets in top-tier cities like Beijing, Shanghai, and Shenzhen are relatively healthy, smaller cities still have an enormous backlog of unsaleable housing. Policies under this rubric have not yet been fleshed out, but they focus on efforts to make them affordable to rural-urban migrants. An interesting approach is to create local housing authorities and fund them to purchase housing in order to rent to low-income residents (including, but not limited to, migrants).[14]

C. De-leveraging

De-leveraging means restructuring debt. It is an enormous task. Not only is China's debt burden huge and worrisome, nobody is entirely sure where in the economy this debt is held and by whom. The banking system is certainly at the center of the debt problem, but many other financial markets are also involved. Shutting down zombie firms means writing off their debts, including debts to banks, to local governments, and other obligations in other capital markets. Exactly how this is to be achieved as part of supply-side reform is far from clear.

D. Lowering Costs

Closing redundant capacity and restructuring debt would allow firms to reduce their costs. This additional element refers to further policy measures that would help firms reduce costs and increase competitiveness. These could include tax reductions, reductions in burdensome regulation, and, perhaps, reductions in social security contributions.

Reductions in excess capacity have been given clear priority. They have been launched first, and some (but not all) of those policies have been fleshed out. The State Council on February 1, 2016, promulgated two documents on steel and coal industry restructuring respectively.[15] The steel industry document stresses that the reduction of capacity is to be driven by five regulatory standards: pollution, energy consumption, output quality, occupational safety, and technology (effectively a minimum size requirement). If this is actually carried through and results in a strengthening of the regulatory agencies responsible for these standards, that would certainly be a benefit of the program. The coal program lacks the strong emphasis on regulatory standards, and presents a much more differentiated program of different local governments improvising programs.

In both the steel and coal industry programs, there is a strong emphasis on taking care of laid-off workers. Both programs contain an identical sentence: "No plan for reassigning workers can be implemented if it is incomplete; if the funding for worker reassignment is not in place; or if the plan has not been approved by the Worker Congress or a discussion by all workers" (安置计划不完善、资金保障不到位以及未经职工代表大会或全体职工讨论通过的职工安置方案，不得实施). The central government funding available to the steel industry is to be used primarily (and first) for worker reassignment. Whether or not this program will lead to large layoffs, policy-makers are clearly doing their best to cushion the impact on those workers affected. As in the late 1990s, when layoffs were large, substantial programs are being rolled out to provide for retaining workers within the corporation (with new jobs), or for channeling them to new jobs or early retirement.

Despite the priority given to closing excess capacity, the supply-side reform program is consistently presented as a comprehensive, coherent program. As "Authoritative Personage" put it in the *People's Daily* article, "there's an arithmetic relationship among the five elements . . . Long-term they all strengthen the developmental impetus, but in the short-term they have a hedging function. For example, reducing housing stocks has an "additive effect," offsetting the "subtractive effect" of cutting excess capacity. Cutting excess capacity can also adjust supply-demand relations, preventing a macroeconomic contractionary response. Because of this the five main elements must be carried out together."[16] As I discuss later, this also clearly links supply-side reform to discussions and debates on the appropriate macroeconomic policy.

Where Are Supply-side Structural Reforms Going?

The "Supply-side Structural Reform" initiative is complex and will play out over the next two to three years. At present, it is too early to tell how sustained the program will be or what variants it will morph into. However, one thing is obvious. The several different strands and objectives of supply-side structural reforms are related conceptually, but not at all related in terms of the institutions, procedures, and policies needed to implement them. This is most obvious by looking at the relationship between two key planks, closing excess capacity and "de-leveraging" or restructuring debt. Closing down excess capacity is a traditional activity of the Chinese state. Since 1978, there have been several rounds of excess capacity consolidation, some predominantly market-driven, some predominantly administrative. In either case, there are bureaucratic instruments at hand that are accustomed to the operation. In essence, two things are done: the planners (today, the National Development and Reform Commission 发改委) target specific low-quality, polluting and/or backward capacity for closure; and the governmental hierarchy is used to pressure local governments *not* to subsidize or otherwise protect loss-making firms under their jurisdiction. Both of these policies are familiar and the institutional channels that will be used to implement them are familiar as well. Indeed, the NDRC has been engaged in significant rounds of capacity reduction for the past three years, at least.

By contrast, de-leveraging is fraught with difficulties and uncertainties. Writing off debt means assigning permanent losses to one party of another. There is resistance and opposition. Only an authoritative body, entrusted with significant power over creditors and debtors can carry out such a de-leveraging. It is true that China did this once before, between 2003 and 2005, when a massive writeoff of bad SOE bank loans occurred.[17] That restructuring was a gigantic undertaking, beginning years earlier with the creation of asset-management companies, and proceeding through the listing on the stock market of the state-owned banks. It involved nothing less than a kind of mobilization of all the best economic minds of the Chinese administration across ministries and departments. Moreover, at that time, virtually all the bad debt was concentrated within the traditional banking industry, and a top-down initiative affecting the entire industry was appropriate and feasible. Today, there is no "off-the-shelf" institution capable of leading or coordinating policies like this in the current environment. Perhaps one can be established, but it will be a prolonged process of institutional creation. Current initiatives do not yet envision anything of this magnitude. For example, the plan for coal industry consolidation envisions local governments taking the lead with debt restructuring, giving them enormous powers to provide funding, protect (or not) creditors' property rights, and otherwise achieve results.[18]

Thus, while supply-side reform makes some sense as an economic concept, it lacks any coherent framework or structure for implementation. This is intrinsic to the design, but also becoming manifest practically. At the recent 50 Economists Forum—the event sponsored by an organization co-founded more than a decade ago by Liu He—worries were expressed about the implementation of supply-side reform. Wu Jinglian, dean of China's reformers, was described as saying that for the previous month, reforms had been stuck. Documents were issued by leadership bodies, but before the lower-level organizations had finished studying one document, another would arrive. "We need to be sufficiently vigilant about [this possibility], that reforms are stuck in neutral, or that they stay little more than rhetoric" (这样的改革空转，或者说改革成为了修辞，应该引起我们足够的警惕). Those are polite but strong words from an eminent economist who has consistently supported serious market-oriented reform.[19]

Conclusion

Supply-side structural reforms are an important policy initiative. To a certain extent, their adoption represents the fact that the reform program laid out at the Third Plenum in November 2013 is failing. Policy-makers needed to come up with another approach, and they have. I concluded the previous issue of the *Monitor* (no. 48, Fall 2015, published August 3, 2015) by saying, "We should anticipate that [China's economic reformers] will also move positively, and perhaps even preemptively, to reestablish the Chinese reform agenda." In a way, "supply-side structural reform" is a confirmation of that prediction. It is an important new initiative designed to reinvigorate the reform process.

At the same time, it is impossible to be unreservedly optimistic. Supply-side reform to a certain extent reflects the constraints under which reformers now operate. Loss of credibility by policy-makers means that economic policy is now more constrained in terms of exchange rate policy and capital market policies. Political tightness means there are limits to the "entrepreneurship dividend" that reform could reap if it were seen to be really de-monopolizing and opening up areas of the economy to private business. In a first best outcome, policy-makers would throw open markets and steadily restore confidence and credibility. If that first best outcome is out of reach, supply-side reform may be the only second-best initiative available.

Still, supply-side reform itself has a number of obstacles it needs to hurdle. It lacks clear implementation paths for many of its crucial components. There are built-in tensions between the way closing excess capacity (for example) depends on stronger regulation and more powerful market forces, on the one hand, and the fact that the actual implementation of the capacity closure is delegated by the party apparatus to local governments and party secretaries, on the other hand. In any case, this is an important policy initiative that will continue to be at the center of attention for the next couple of years. It will have a positive impact if and only if it enables policy-makers to escape from the deep divisions about growth policy and the uncertainty over who makes policy, and how.

Notes

[1]Paul Krugman, "China's Naked Emperors," *New York Times*, July 31, 2015, accessed at http://www.nytimes.com/2015/07/31/opinion/paul-krugman-chinas-naked-emperors.html.

[2] This instinct was reinforced in China because their stimulus intervention in 2009 in the face of the global financial crisis had been so successful, and had gained them widespread praise. Indeed, this was the event that cemented the reputation for extreme competence that policy-makers had established over three decades of high-speed growth. However, it is the continuing stimulus of the economy *after* 2009 that is under discussion here.

[3] To be sure, the Ministry of Finance is trying to craft new rules for local government debt that will restrain reckless spending. But after all, there were rules before, too.

[4] The main facts are described in *China Leadership Monitor*, no. 47. The head of the China Securities Regulatory Commission recently lost his job, but nobody seriously thinks he had more than ancillary responsibility for the debacle.

[5] Gong Wen 龚雯, Xu Zhifeng 许志峰, and Wang Ke 王珂, "Supply-side structural reform can lead the 'new normal'"(供给侧结构性改革引领新常态), *People's Daily* 人民日报, January 4, 2016, p. 1, accessed at http://paper.people.com.cn/rmrb/html/2016-01/04/nw.D110000renmrb_20160104_2-01.htm; Gong Wen 龚雯, Xu Zhifeng 许志峰, and Wang Ke 王珂, "Seven questions about supply-side structural reform—'Authoritative person' discussed what to do in the current economic situation" (七问供给侧结构性改革——权威人士谈当前经济怎么看怎么干), *People's Daily* (人民日报), January 4, 2016, p. 2, accessed at http://news.xinhuanet.com/2016-01/05/c_128594408.htm.

[6] The pamphlet included an earlier article by "Authoritative Personage" in the May 25, 2015, edition of *People's Daily*, describing China's current economic condition and arguing that the "new normal" was not cause for dismay. The pamphlet has the same title as the earlier *People's Daily* article: *Seven questions about supply-side structural reform—'Authoritative person' discussed what to do in the current economic situation* (Beijing: Renmin, 2016, January).

[7] "Central Economics Work Conference held in Beijing" (中央经济工作会议在北京举行), *People's Daily* (人民日报), December 22, 2015, accessed at http://politics.people.com.cn/n1/2015/1222/c1024-27958128.html; "2015 Central Work Conference opens; May raise supply-side reform for the first time" (2015 中央经济工作会议召开：或首提"供给侧改革"), Sina Finance, December 18, 2015, accessed at http://finance.sina.com.cn/stock/t/2015-12-18/doc-ifxmttme5773718.shtml.

[8]Xinhua News Agency (新华社), "Xi Jinping chairs the 12th meeting of the central Finance and Economics Leadership Small Group" (习近平主持召开中央财经领导小组第十二次会议), January 26, 2016, accessed at http://news.xinhuanet.com/politics/2016-01/26/c_1117904083.htm.

[9] Liu He is also co-head of the specialized group for Economics and Environmental Civilization under the "Deepening Reform Leadership Small Group."

[10] Qian Jing 钱竞, "Investigations, discussion meetings, visiting the grassroots, establishing a new system and rules; that's how Xi Jinping spent the crucial year of reform" (调研、座谈、走访基层、建章立制 改革"关键之年，"习近平这样走过), *Southern Weekend* 南方周末, February 4, 2016, accessed at http://www.infzm.com/content/115132.

[11] The concept of zombie firms was initially popularized by the economist Takeo Hoshi, who demonstrated their harmful impact on the Japanese economy in the 1990s. See Ricardo J. Caballero, Takeo Hoshi, Anil K. Kashyap, "Zombie Lending and Depressed Restructuring in Japan," National Bureau of Economic Research, Working Paper w12129, April 17, 2006.

[12] Capacity is about 1,050 MMT, so this would amount to approximately 14 percent reduction in capacity. Golden State Policy United Industry 国金策略联合行业, "The specific policies of supply side reform will emerge around Chinese New Year" (春节前后或有供给侧改革政策陆续出台), Phoenix Comprehensive Finance (凤凰财经综合), January 26, 2016, accessed at http://finance.ifeng.com/a/20160126/14190061_0.shtml.

[13] Li Huiyong 李慧勇, of Shenwan Hongyuan Securities, quoted in "Supply Side Reforms will first affect these sectors; Analyzing the investment opportunities" (供给侧改革将率先影响这些行业 投资机会解析), *Securities Daily Website* ()证券时报网), February 4, 2016, accessed at http://wap.stcn.com/article/79090.

[14] Yang Weimin 杨伟民, "We need to establish a new housing system" (必须建立新住房制度), Sina Finance Weibo (新浪财经 微博), February 19, 2016, accessed at http://house.sina.com.cn/news/2016-02-19/19496106414068758000294.shtml?wt_source=newshp_news_10.

[15] State Council 国务院, "Opinion on Resolving Coal Industry Excess Capacity and Returning to Healthy Growth" (关于钢铁行业化解过剩产能实现脱困发展的意见), Document 6 of 2016, February 1, 2016, accessed at http://www.gov.cn/zhengce/content/2016-02/04/content_5039353.htm; State Council 国务院, "Opinion on Resolving Coal Industry Excess Capacity and Returning to Healthy Growth" (关于煤炭行业化解过剩产能实现脱困发展的意见), Document 7 of 2016, February 1, 2016, accessed at http://www.gov.cn/zhengce/content/2016-02/05/content_5039686.htm.

[16] "Supply-side structural reform can lead the 'new normal'" (see endnote 5).

[17] Barry Naughton, "Waves of Criticism: Debates over Bank Sales to Foreigners and Neo-Liberal Economic Policy" *China Leadership Monitor*, no. 17, Winter 2006. There is a lively and personal description of some aspects of this restructuring in Henry Paulson's *Dealing With China: An Insider Unmasks the New Economic Superpower* (New York: Twelve, 2015, pp. 132–173).

[18] State Council, "Resolving Coal Industry Excess Capacity," Article 15.

[19] Wu Jinglian 吴敬琏, "Be vigilant against supply-side reform being stuck in neutral" (警惕供给侧改革出现空转), Sina Finance (新浪财经), February 19, 2016, accessed at http://finance.sina.com.cn/china/gncj/2016-02-19/doc-ifxprucs6260629.shtml. Sina Finance has many interesting reports on this conference, neatly presented on "The 2016 Meeting of the China Economics 50 Person Forum" front page. See http://finance.sina.com.cn/focus/50rlt2016nh/index.shtml.