Evening Glow: The Final Maneuvers of Zhu Rongji

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Economic policy reform slowed markedly at the end of 2001 and beginning of 2002. However, since June 2002, Premier Zhu Rongji has assumed a higher profile, and resumed a more authoritative role in policymaking. This increased activity should be regarded primarily as a defensive strategy. It is designed to prevent Zhu from becoming irrelevant at the end of his term and to avoid the problems that might develop if the central government were seen as weak or passive. Presumably, it is also designed to solidify Zhu's position in history. Some of the new policy activity may smooth the return to a more activist policy regime after the 16th Party Congress.

There were a number of signs in mid-2002 that Zhu Rongji was playing a game of catch-up. After the virtual disintegration of any significant reform agenda in the beginning of the year, Zhu seemed to suddenly shake himself out of lethargy in the summer. After the Beidaihe meetings in August, Zhu was especially prominent in the media. Zhu's renewed activity needs to be seen in the context of the economic situation that was developing at the beginning of 2002.

It was widely accepted in early 2002 that in the run-up to the 16th Party Congress in November, major initiatives would be put on hold. This was a special period of political sensitivity in which stability and the appearance of stability would override most other considerations. But the absence of significant policy initiatives also raised the specter of a more serious problem--the potential for a weak, lame-duck administration that would allow its authoritativeness and grip over economic policymaking to slip away. If allowed to occur, this lack of control could have significant negative consequences for macroeconomic policy, and could increase the risk of financial crisis indirectly by suggesting to market players that financial difficulties might not be met by a prompt and authoritative response.

By the end of 2001, it was clear that the era of Zhu Rongji was nearing an end. As I discussed in "Zhu Rongji: The Twilight of a Brilliant Career" from *CLM* 1 (fall 2001), the Zhu Rongji agenda seemed to be winding down. Beijing was suffering from "Zhu Rongji fatigue," and it was becoming clear that Zhu would be unlikely to advance the reform agenda significantly before the end of his career. Subsequent events through the first half of 2002 reinforced that judgment. In the crucial area of stock market reform--one of the few policy arenas still active in late 2001--the early months of 2002 saw the definitive end of a major policy initiative, as the program of "selling down state shares" was shelved (see "Selling Down the State Share: Contested Policy, New Rules" in *CLM* 2 [winter 2002], and "The Politics of the Stock Market" in *CLM* 3 [summer 2002]). The absence of any significant economic policy activity around the National People's Congress (NPC) in March 2002 merely confirmed this point.

But starting around midyear 2002, Zhu's prominence on the economic policy scene substantially increased. It is not that any really significant policy initiatives emerged during the third quarter of 2002. Rather, it seems as though Zhu was responding to the danger that the central government would be perceived as passive or inert, and that his administration would be seen as lame duck. In China, if the central government is not actively pushing a policy agenda, there is always the danger that government effectiveness will begin to erode. Local governments and private actors are continuously maneuvering for advantage. Without prompt government response, these maneuvers have the potential to undermine central government capabilities. Zhu seems to have responded to these dangers and attempted to reassert the image--and perhaps the reality--of an activist, involved central government.

The Perils of Excess Spending

Submerged economic dangers lurked during the political “election campaign” leading up to the 16th Party Congress. There is, of course, no real election taking place at the party congress. However, both Jiang Zemin and Zhu Rongji have displayed a strong motivation to have the congress thoroughly under their control, and to have their plans for the leadership succession ratified by an overwhelming majority at the congress. In that vein, they have been increasingly generous in providing benefits and support to a wide range of local actors. Support and acquiescence at the party congress have been purchased by means of considerable generosity with central government resources.

Throughout China in the past year, new parks have been built and university campuses have been beautified. There is no doubt that urban amenities are overdue in many parts of China. Yet, the timing of this burst of public building clearly reflects the current political and economic conditions. Pre-congress electioneering is taking place in a context in which central government finances have strengthened considerably since their weakest point in 1995. The central government, for the first time in almost a decade, has some discretionary resources to use. Moreover, with the economy still sluggish because of continuing weakness in global and domestic demand, the Chinese government has been willing to engage in substantial deficit spending in order to keep the economy moving ahead. The 2002 draft budget projected a fiscal deficit of 3 percent of the gross domestic product (GDP), a record high for the People’s Republic of China (PRC). With patronage money flowing relatively freely through the system, political relationships are eased at all levels. Central government leaders purchase support from local politicians for their political coalitions and policies; local politicians use the resources to burnish their credentials with their local constituents.

This type of patronage or “pork barrel” spending is to some extent inherent in the most prominent and highly publicized central government program currently underway, the Western Development Program. This program, which took concrete shape during 2001, is complex and multistranded, but at its core it constitutes a significant acceleration in central government financing of infrastructure projects.[1] These projects range from enormous national projects--such as the West-to-East gas pipeline--down to thousands of small-scale local projects. Road building to county towns, urban construction, electricity and telephone lines--the ability to distribute these projects makes it much easier for central leaders to purchase support and build coalitions. Political relationships had already been relatively easy to manage in coastal areas, since local populations are aware of their recent prosperity, and local leaders have abundant resources with which to reward their supporters. But in the poorer and slower-growing inland areas, locally influential groups and politicians are now being rewarded for loyalty with access to governmental support through the Western Development Program. This East-West coalition enables Jiang Zemin and Zhu Rongji to go into the 16th Party Congress fairly confident of their ability to manage the agenda. The in-between regions that do not fall into either of these groups--the Northeast and the central provinces--suffer the most from inadequate resources, stagnant farm incomes, and stubborn urban unemployment.

Increased fiscal spending also takes place with the primary motive of purchasing social stability. The central government has increasingly been using central government funds to plug gaps in local pension and unemployment compensation funds. This willingness was already evident in 2001, but it seems to have increased in the wake of the large-scale protests by laid-off and retired workers in the Northeast--at Daqing and Liaoyang--in March 2002.[2] Lower-level governments--and especially those in rural areas--have limited budgetary resources of their own. This constraint leaves them dependent either upon transfers from higher levels (counties are particularly dependent) or upon extra-budgetary revenues from levies on their own populations. As rural and inland areas have lagged behind in China's growth, the central government budgetary authorities have increasingly relied on ad hoc transfers to local authorities to fill the gaps in local budgets, and particularly in local wage accounts. In 2001 such transfers totaled 89 billion yuan (5.4 percent of total national revenues), and this amount was budgeted to increase to 118 billion yuan (6.6 percent of total revenues) in 2002.[3]

Similarly, the central government allocates funds to plug holes in the national social security program. Particularly since the failure of the program of selling down state shares, there is no alternative to the use of general revenue funds for social security, given shortfalls in the overall program. In 2001, 31 billion yuan (1.9 percent of budgetary revenues) was used to replenish the national social security fund, and the amount will be far higher in 2002. Put together, more than 7 percent of budgetary revenues in 2001, and probably 10 percent of budgetary revenues in 2002, will go to these stopgap expenditures. Thus, overall spending for discretionary government projects and for funds to cover shortfalls in social welfare spending is taking an increasing share of the total government budget.

This pattern of politicized "pork barrel" and welfare spending has a long-run cost, and it also presents a short-run danger. The long-run cost is that this system of politicized payoffs is an alternative to more fundamental fiscal reforms. By their nature, such policies create perverse incentives and encourage a kind of welfare dependency. Local governments that fail to cover wages and pensions can reasonably expect to be bailed out. Over the long run, these perverse incentives will erode the predictability and authoritativeness of central government budget policy. But the short-run danger is more relevant to the immediate policy environment tracked by *China Leadership Monitor*. In essence, budgetary practices become slacker for the poorer and more backward areas. But, the benefits are not distributed according to regular formulas or transparent regulations. Instead, regions with exceptional problems or unusual clout increasingly drive special bargains. Special regions not only receive more incoming transfers, but they also end up receiving more slack in meeting their revenue targets. Once this environment sets in, it tends to erode the progress made in establishing a larger and more authoritative central government budgetary presence.

This scenario seems to be exactly what happened in the first quarter of 2002. The first-quarter fiscal results were alarming. Government revenue rose only 3.4 percent in the first quarter, compared to a budgeted figure for the year of 10 percent growth. Meanwhile, spending gained 23.9 percent, compared to a budgeted 12 percent increase in spending.[4] Alternately stated, first-quarter revenues fell 24 billion yuan short of the budgeted figures, while expenditures went 34 billion yuan over. Since the budget had been officially promulgated by Finance Minister Xiang Huaicheng only a month earlier, the first-quarter results were something of a shock.

Thus, by mid-2002, some unpleasant trends were emerging. For a period, reforms were stagnating, and budgetary discipline seemed to be eroding. This combination was particularly threatening given the unanimous opinion (both inside and outside China) that China faces serious risk of financial crisis. It is widely accepted that China's financial institutions are fragile. The ability to fend off widespread financial panic therefore depends significantly upon the level of confidence actors in financial markets have in China's leaders and in the health of China's budget. If leaders can act decisively and mobilize fiscal resources when needed, then China can deal with the fragility of its financial system. But if leaders are unable to mobilize a prompt and effective response to financial difficulties, and if fiscal resources are limited and hard to redirect, then financial problems can easily snowball into large-scale financial crisis. Thus, the problems described above not only were significant in their own right, but they also contributed to the danger of financial crisis in the medium term. In short, all these factors could be seen as threats to Premier Zhu Rongji's legacy.

Zhu Responds

The first evidence that Zhu saw anything amiss and was prepared to act came in June. Zhu suddenly called an open-agenda conference of economists for June 24. While this meeting was certainly a minor event in itself, it was nonetheless significant for what it disclosed about the policy process and about political communication. Particularly interesting is the way the conference was publicized and thrust before the public. Twelve economists were asked to speak about the main economic problems China was facing and about ways to approach those problems.[5] Zhu Rongji was present, as were Wang Zhongyu, his secretary-general, and a number of minister-level bureaucrats. The responsible officials from central party offices, the NPC Standing Committee, and the Chinese People's Political Consultative Conference also attended. Five major problems--none of them unexpected--were identified: nonperforming bank loans, reduction of state ownership and reform of listed company governance, unemployment, budget deficits, and the urgent need to increase rural incomes.[6] According to insider accounts, Zhu was affable, the atmosphere was relaxed, and the discussion was wide-ranging. Not surprisingly, Zhu generally defended existing government policies, while the economists present tried to push for somewhat more dramatic reforms, particularly with respect to stock markets and pensions.

The meeting produced a near consensus on the fact that the main economic challenges were still deflation and sluggish growth. Sluggish growth, in turn, was of concern mainly insofar as it contributes to the persistent stagnation of rural incomes and stubbornly high levels of urban unemployment. At the same time, many of the economists were uncomfortable with the level of the fiscal deficit. The pressure to spend has been so great that money has been lavished on projects with low economic returns, and with serious quality problems resulting from corruption and haste. Moreover, a deficit of this size would not be sustainable for very long, and it may already be time to start reining it in. But with the economy still weak, simply shrinking the deficit rapidly is likely to cause an unacceptable slowdown of the economy, with particularly serious effects on urban unemployment and slow-growing rural incomes. Thus, a theme that runs through the various economists' comments is the search for continued stimulus to the economy, but stimulus that imposes less of a burden on the budget. Continuously increasing stimulus through an ever larger deficit would be unsustainable and ultimately disastrous.

This emphasis on continued stimulus, combined with the marked erosion in budgetary performance, ultimately led to some new policy directions, which included:

- An emphasis on increased collection of the personal income tax (because the income tax is only levied on high-income individuals, it promises a way to raise revenues without affecting the average person);
- A decision to allow increased entry of medium-sized banks not controlled by the central government, in order to provide better financing opportunities for small and medium-sized enterprises; and
- An increase in spending on small-scale rural infrastructure.

The list of problems and proposed policies is less significant than the fact that Premier Zhu--famously self-confident--felt the need to hold a workshop to explore the question of "what should we be doing next." It could hardly be anticipated that the invited economists would say something really new or unexpected, and indeed, from published accounts it seems as if the discussion of issues was quite predictable. After all, the invited were all prominent economists whose views were quite well known to the premier.

Equally significant was the amount of publicity given to the meeting. This seems to have been the first time in recent memory that an open-ended discussion of this sort was given extensive press coverage. The publicity kicked off with a brief front-page report in *People's Daily (Renmin ribao)*.[7] Following up on this story were extensive reports elsewhere. Two articles in *International Finance* (*Guoji jinrongbao)*, posted on the *People's Daily* web site, are particularly interesting in this regard. A substantive article on the discussions was published on June 28, but two days earlier a front-page article in the original source provided a buildup to the subsequent coverage. The article went out of its way to identify all 12 of the economists participating, and provided thumbnail biographies and links to the participants' recently published articles. The account even makes a point of introducing four of the participants who are not household names, and it mentions six high-profile economists who were notable for not having been present.[8]

What were the purpose and impact of publicizing such a meeting? Is it possible that the state media are simply promoting increased transparency by reporting on the premier's process of consultation? This interpretation is not likely. Nor is it likely that the premier simply sought an update on current economic views and new thinking. Rather, the meeting and its attendant publicity must be understood first and foremost as a way to signal that the reform policy agenda was not moribund. By holding--and publicizing--the meeting, Zhu was able to signal that the policy stance was going to change, without actually committing himself to a specific policy initiative. The main message is: "Your leaders are actively engaged in grappling with your problems, and solutions will be forthcoming soon." The account of the meeting in *International Finance* specifically instructs its readers that although economists do not all agree on specific measures, the shape of future policy will emerge from the areas of common understanding at a meeting such as this one.

Second, by announcing that the reform agenda had moved off life support, Zhu was also asserting that he was still in charge and capable of governing China's economy decisively and authoritatively. In that sense, the discussion of reform is at least as important for what it presages in the area of budget implementation as for what it indicates about the implementation of specific reform measures. By announcing his renewed presence, Zhu served notice that he will soon be enforcing greater fiscal discipline.

Third, and finally, by meeting with Beijing economists, Zhu showed that he could listen to advice and have good relations with outside experts. This ability is important, of course, precisely because more and more people were saying that he couldn't do so. Zhu's famous arrogance has caused a steady deterioration in his relationship with economists. The press coverage "gave face" to prominent senior economists, such as Wang Luolin and Wu Jinglian, while also giving participating younger economists more visibility and prestige. Thus, this meeting can be seen as an effort on Zhu's part to rebuild bridges--or at least to create the impression of rebuilding bridges--to the specialist community from which he had become alienated. This apparent reconciliation could also serve to deflect the notion, gathering force among analysts of China, that Zhu's policies were increasingly reflecting either his own personal wishes or caprices or the dictates of political necessity. A meeting such as this one creates an impression of consensus-building that can contribute to the success of policy later on.

The Economy Stirs to Life

In the final analysis, most of this activity is political theater, rather than real policymaking. Nevertheless, we can in fact see some substantive policy change in the wake of this meeting. The first significant impact has come precisely in the area of budget implementation. After a miserable first quarter, budgetary performance improved in each successive quarter, and by the third quarter implementation was essentially on track. Exactly what pressures were exerted behind the scenes to achieve this result, we do not generally know. But one high-profile element has been a substantial and highly publicized crackdown on personal income tax evasion.

With a knack for generating publicity, Zhu Rongji moved against one of China's most famous and beautiful movie stars, Liu Xiaoqing, who was arrested for income tax evasion on July 24. One version of the story holds that during March, the national tax bureau had published a list of the 100 private enterprises that had paid the most tax to the nation's treasury. A clever reporter at one of Beijing's evening newspapers had the bright idea of comparing the tax list to the *Forbes* list of the 100 richest people in China… and discovered that the two lists shared only four names.[9] A hue and cry was set off about tax evasion by the rich, and a report from the tax bureau landed on Zhu Rongji's desk. After seeing the report, Zhu is said to have asked: "Why is it that the richer someone is, the less tax that person pays?" This comment set off a scramble among wealthy Chinese--especially, one presumes, those on the *Forbes* 100 list--to make voluntary supplementary tax payments. Liu Xiaoqing, however, who had long been suspected of avoiding taxes, refused to make any additional payments. The tax bureau reported to Zhu on tax compliance in the wake of his comments, and specifically asked for guidance in the case of Liu Xiaoqing. Zhu replied: "Handle it according to the law." Thus was Liu Xiaoqing made an example in the income tax compliance campaign.[10]

This decision instantly produced greater recognition for income tax enforcement, and a higher profile for Zhu, as well. The movie star made irresistible copy: Within 60 days of the arrest, there were already three different books on bookstore shelves in Hong Kong combining accounts of Liu Xiaoqing's life with versions of her crime and imprisonment. At the same time, the event allowed Zhu to act out one of his favorite roles, that of the virtuous official crusading against public corruption and private laxity. These well-staged events, then, marked a shift in the economic policy atmosphere in Beijing.

In fact, some of the paralysis that afflicted economic policy at the beginning of 2002 seems to have been shaken off by the fall. It is far too early to assess these signs of increased life, but a number of indicators show a revitalization of reform policy. Long-delayed legislation on the stock market has been promulgated in fairly quick succession. First, the China Securities Regulatory Commission (CSRC) published regulations on mergers and acquisitions (September 28). In November, this move was followed by two joint regulations from the top government commissions on explicitly foreign participation in mergers and acquisitions (November 4 and 11). At the same time, on November 8, the CSRC announced that it would permit foreign investment funds to enter the Chinese stock market through the mechanism of the Qualified Foreign Institutional Investor (QFII). Under this system, a limited number of foreign investment funds will be allowed to set up Chinese market mutual funds (the initial dollar value will be fixed). These "closed-end funds" will be permitted to hold A-shares heretofore limited to Chinese citizens.[11] These initiatives are, to be sure, less complex and less controversial items than the program of selling down state shares, which remains in limbo. In particular, these regulations liberalize conditions under which foreign funds and firms can buy into the Chinese market, creating additional buyers and tending--if anything--to prop up stock prices. In that sense, the measures have the opposite effect to that which would result from the government selling off its own shares, an action which tends to depress the market. Thus, the regulations are much more likely to be welcomed by market participants, who have been battered by the long bear market.

Other signs of life are more tentative, and even more difficult to evaluate. There are reports that the pace of privatization of small, local government-owned firms has increased. These smaller firms were privatized in large numbers in the late 1990s, but the rate of privatization seemed to slow in 2000-2001. Anecdotal reports indicate larger numbers of firms going on the block in the second half of 2002. Relatedly, there are reports of a more permissive attitude toward the entry of small-scale, private financial institutions into the banking arena. Such shifts often signal broader changes in the overall policy environment, and that pattern may hold in the current situation.

Conclusion

It is commonly said that the new leaders China installs at the 16th Party Congress will have to hit the ground running. The economic challenges are great, and new leaders will have little breathing room, little time to focus solely on the consolidation of power. But in the run-up to the congress, there are now some indications that the policy process is once again inching forward, breaking through the paralysis that characterized the first half of 2002. The new leaders will have some policy innovations in the pipeline that they can push forward and take credit for.

We can attribute this state of affairs to several causes. First is certainly the sheer magnitude of the economic challenges China faces, which constantly generates pressure to adapt policies and respond to problems. Second, without doubt, is the pressure generated by China's World Trade Organization (WTO) membership, which is steadily eliciting policy responses from regulators and entrepreneurs at all levels. But, one final factor has turned out to be Zhu Rongji's attention to his public role, image, and place in history. During the last few months of his term, Zhu has resumed a relatively high profile and insisted on his own continuing relevance as the one indispensable player in Chinese economic policy. So far, this role has been largely symbolic, and really substantial policy innovations have not emerged. Still, we may see a last burst of activity before the end of Zhu's term in March 2003, as he seeks to consolidate his position in history.

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Notes

[1] State Council Western Development Office, "Guanyu xibu dakaifa ruogan zhengce cuoshi to shishi yijian" (Opinions on implementation of several policy measures for western development), August 28, 2001, www.chinawest.gov.cn/chinese/doc/xbzc/200112252632.htm.

[2] These protests were widely reported in the West. See, for example, Erik Eckholm, "Leaner Factories, Fewer Workers Bring More Labor Unrest to China," *New York Times*, March 19, 2002.

[3] Xiang Huaicheng, "Report on the Implementation of the Central and Local Budgets for 2001 and on the Draft Central and Local Budgets for 2002," Fifth Session of the Ninth National People's Congress, March 6, 2002.

[4] "The deficit danger," *HK iMail*, April 17, 2002.

[5] The twelve were Wang Luolin, Wu Jinglian, Wu Shuqing, Huang Da, Xie Ping, Hu Angang, Lin Yifu, Fan Gang, Cheng Dongqi, Lu Zheng, Jia Kang, and Ma Xiaohe. See also footnote 8 below.

[6] "Zhu Rongji yu xuezhe shangtao jingji wuda nanti" (Zhu Rongji discusses five major economic problems with scholars), Hong Kong *Xinbao*, June 29, 2002, 9.

[7] "Zhu Rongji yaoqing bufen jingjijie zhuanjia xuezhe zuotan dangqian jingji gongzuo" (Zhu Rongji invites some specialists and scholars from the field of economics to discuss current economic work), *Renmin ribao*, June 25, 2002, 1, www.people.com.cn/GB/paper464/6543/642227.html (Chinese) and english.peopledaily.com.cn/200206/25/eng20020625_98479.shtml (English).

[8] Hui Feng, "Zhu zongli yaoqing zhuanjia huitan jingji: Wuda nanti guanzhu ridian" (Premier Zhu invites experts to discuss the economy: Five problems focus of concern), *Guoji jinrongbao*, June 28, 2002, 4, www.people.com.cn/GB/jinji/36/20020628/763231.html. (A rough English translation can be found at english.peopledaily.com.cn/200207/04/eng20020704_99119.shtml.) Also, Lu Yuanqiang and Cheng Huijian, "Zhu Rongji wence 12 jingji zhuanjia: Tamen zuijin shuoguoxie shemma?" (Zhu Rongji solicited policy advice from 12 economic specialists: What did they recently talk about?), *Guoji jinrongbao*, June 26, 2002, 1, www.people.com.cn/GB/jinji/31/179/20020626/761459.html. I am indebted to Erica Downs for sharing these sources with me.

[9] The *Forbes* list is available at www.forbes.com/free_global/2001/1112/032.html.

[10] "Zhulaozong liangdao zhishi jiang minxing Liu Xiaoqing xongjin dalao" (Premier Zhu's two directives send celebrity Liu Xiaoqing to prison), Hong Kong *Kaifang*, September 2002, 13.

[11] Chinese and English versions are at www.csrc.gov.cn. See also business.sohu.com/28/53/article204105328.shtml and www.drcnet.com.cn/html_document/guoyan/secu/2002-11-11/139889d.