Xi Jinping's Economic Policy in the Run-up to the 19th Party Congress: The Gift from Donald Trump

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In the run-up to the 19th Party Congress in the fall of 2017, Xi Jinping has a strong interest in sustaining three narratives: the Chinese economy is growing stably, economic reform is moving forward, and a rising China is playing a more important role on the global scene. Xi has a good chance of sustaining all three of these narratives to his domestic audience, in part because of the valuable gift given him by the new U.S. president, Donald Trump.

While we do not know the specific mental calculus being made by Xi Jinping, it is reasonable to assume that he is giving great attention to preparations for the 19th Party Congress, to be held in October or November of 2017. For Xi, there is much at stake. While his reelection as first party secretary is a foregone conclusion, the composition of the leadership group is still undetermined. According to the recently established norms of the Chinese Communist Party, only two of the seven current standing committee members—Xi himself and premier Li Keqiang—will continue on to the next standing committee. Whether Xi will respect the recent norms of leadership selection (per Alice Miller's "three rules" for the selection of Standing Committee members) is not yet known.[1] Without doubt, the choice of the other five members will determine the extent to which Xi succeeds in consolidating power and whether—if he chooses—Xi will be able to elevate his personal power above the institutional norms of the Communist Party.

This piece does not speculate on Xi Jinping's intentions. Rather, I assume that Xi wants to be in the strongest possible position to influence these personnel choices and to maximize his own personal power for at least one more term. Economic policy is obviously an important part of his overall political calculus, and this piece argues that Xi has three fundamental, short-term objectives for economic policy, each of which reflects the need to sustain a positive domestic narrative about his leadership. The three narratives are:

1. The economy is growing stably (at least up through the Party Congress).
2. Economic reforms are moving ahead.
3. A revitalized China is playing an increasingly important leadership role in global economic policy.

Xi looks set to be able to maintain the plausibility of all three of these narratives through 2017, greatly strengthening his political position.

The Great Economic Growth Stabilization of 2016

Xi Jinping entered 2017 in good shape. The economy in 2016 delivered a growth rate of 6.7 percent, exactly what was targeted. Moreover, this achievement came in the wake of widespread worries about Chinese economic stability in the early part of the year. What did Chinese policy-makers do to turn around the situation? Essentially, they were able to sustain growth by stabilizing and increasing investment. There were two main components. First, housing investment made a strong recovery, helped along by a big increase in mortgage lending to Chinese households, and by clearly supportive government policies through most of the year. Second, infrastructure investment, predominantly by state-owned enterprises, increased rapidly. On the back of these two rapidly growing demand components, the economy was able to stabilize and maintain moderately rapid growth. In addition, the Supply-Side Structural Reform (SSSR) was able to claim successful short-term results. Prices of steel and coal stabilized, and recovered, underpinning a stabilization in industrial profits (including SOE profits). The amount of capacity that was nominally mothballed over-fulfilled the government's targets.[2] This was not surprising, but still goes on the positive side of the ledger.

To be sure, these successful short-run outcomes have only the most tenuous relation to the long-run performance of the Chinese economy. Short-term growth was achieved at the cost of deferring many long-run problems. Credit growth remained high, supporting state-led investment, but adding to China's already worryingly high debt load. More fundamentally, the continuing easy credit environment made it much more difficult to impose "hard budget constraints" on firms performing poorly, making restructuring less systematic. Taken together, these effects make restructuring and reform more difficult in the long run. These complex problems are outside the scope of the present short article. For current purposes, the simple point is that economic policy-makers were required to deliver on certain economic objectives, and they did so. They executed surprisingly skillfully. Thus, while many problems have been swept beneath the rug, most of them will stay there for a year or so. Moreover, the widely held belief in China that the party wants economic stability and has the tools to produce it, at least until the party congress, creates a self-fulfilling prophecy of stability. The timing of risk events tends to be pushed back until after the party congress. This achievement is likely sustainable through the next party conference.

The policies supporting growth in 2016 will be less effective in 2017. Already, sharp increases in housing prices have led to the resuscitation of various purchasing restrictions. The housing market has cooled sharply and this implies that housing construction will make a much smaller contribution to growth in 2017 than it did in 2016. It is unlikely that government infrastructure investment can maintain the torrid pace of 2016. Indeed, the Economic Work Conference in December 2016 is widely interpreted to have signaled tolerance for slower growth in 2017.[3] The work conference did not set a growth target for 2017; this doesn't necessarily mean there will not be a target adopted by the NPC in March, but it implies that much less effort will be spent pumping up the economy to achieve a predetermined growth target. As provincial governments held their People's Congress meetings in January 2017, there was a notable anticipation of lower economic growth for 2017. In a survey of 19 provinces meeting, five governments had lowered their growth target, including Shanxi, Henan, Hubei, Hunan, and Heilongjiang.[4] Provinces justified lower growth by the need to carry out more reform and improve environmental conditions. In any case, if nothing goes wrong, Xi's objective of doubling GDP by 2020 seems within reach.

The one clear threat to this picture of stability is the danger of disorderly currency depreciation. Capital outflows from China were very large in the last quarter of 2016, and put enormous downward pressure on the value of the RMB. The People's Bank of China (PBC) is now trying to defend two psychologically important levels: the RMB value above seven yuan to the dollar, and the stock of official foreign reserves at around $3 trillion (down from a peak of just below $4 trillion). The RMB came close to the 7 yuan/dollar level and would certainly have pushed below it, were it not for a set of extraordinary steps taken by the PBC.The monetary authorities clamped down hard on cross-border capital outflows, reviewing each item individually, and requiring state-owned banks to informally restrict capital outflows so they wouldn't exceed the inflows recorded for that bank. These are extreme measures. They would not be taken by any government in normal times. For now, they seem to be working, but just barely. The RMB strengthened by one percent in January, while reserves slipped to $2.998 trillion, an iota below the $3 trillion line. The measures, and their associated outcomes, demonstrate how deadly serious Chinese authorities are about preventing the global shockwaves that would follow from a sudden drop in the RMB value to below 7 yuan to the dollar.

The Chinese Economic Reform Process

More than three years ago, at the November 2013 Third Plenum, China rolled out an extraordinarily broad and impressive program of economic reforms. Activity has moved forward on multiple fronts since then, and the picture is complicated. However, it is impossible to resist the conclusion that the reform process overall has stumbled and is in serious trouble. The prospect of a large package of interrelated reforms achieving success together has disappeared, and many complex multi-stage reforms are in limbo. For example, ambitious fiscal reforms are more than two years behind schedule and seem paralyzed. A number of individual reforms have been watered down, including changes in the rural land market, and the relaxation of access to urban household residence (*hukou*) status. Most tellingly, financial reforms of the stock market and capital account liberalization have been spectacular failures. Reforms that miscarried have created situations in which direct government interventions are more pervasive and harder to remove than they were before the reform initiative. Have Xi Jinping's reforms failed?

In the short run, it is essential for Xi to prevent a perception of failure from becoming widespread among the Chinese population. Because economic conditions in general are relatively good, Chinese households are not particularly sensitive to criticisms of Xi Jinping's economic reform record. While few would claim much from the recent reform process, few are moved to challenge the official portrayal of a robust, ongoing reform process either. In order to feed the domestic perception that reforms are complex but going ahead, the first 2017 meeting of the Central Deepening Reform Leadership Small Group, on February 6, called for acceleration of reforms and thorough implementation of reforms already agreed.[5] It is hard to resist the feeling that Xi's most essential purpose is to ensure that a counter-narrative does not emerge and become entrenched. Xi needs to continuously generate activity that makes it seem as if the reform process is on track. This dynamic is especially evident in the reform of state-owned enterprises (SOEs).

State-Owned Enterprise Reform

Among the "themes" released by the 2016 Central Economic Working Conference (held in the last few days of December) was the idea that 2017 be viewed as "a crucial year for implementing mixed-ownership reform at the grass-roots level."[6] January saw 28 provinces hold their NPC & CPPCC meetings (the National People's Congress and the Chinese Political Consultative Conference), and to no one's surprise, an emphasis on mixed-ownership reform showed up in at least 20 of these local governments' resolutions for the year.[7]

This process is to be carried out through the selection of pilot enterprises. There is no single model, but pilot firms are typically given boards of directors and renovated corporate governance institutions. In other cases, emphasis is put on "financializing" government assets, often with all ownership claims consolidated into a single corporation and some shares then redistributed or sold to the public. None of the provinces have published detailed instructions nor fully unveiled the reform.[8]

A popular version of this is asset securitization, in which local governments specify their objective for the percent of the real assets of an SOE or holding company that are to be matched to a paper security, usually stocks. Asset securitization is seen as an essential prerequisite for mixed ownership reform, designed to serve the purpose of later restructuring between state-owned and non-state enterprises. Locally, in the next five years, Tianjin aims to achieve 40 percent securitization of operational state-owned assets; Beijing, Gansu, and Hubei aim to achieve 50 percent by 2020; and others are higher: Jiangxi (60 percent), Guangdong (70 percent), and Chongqing and Hunan (80 percent). Central enterprises participate in this effort as well.[9]

These measures have in common the feature that local officials intervene in a hands-on way, but in limited scope. The officials can do something, reward allies, notch achievements, and not do so much damage. To be sure, some of the provincial experiments are bolder and have more content. In Yunnan, a private pharmaceutical company has been allowed to acquire a controlling 50 percent stake in a troubled state-owned drug firm.[10] Guangzhou City declared that it would publicly list all assets of all SOEs in competitive sectors, a rare example of a principled, across-the-board commitment.[11] These actions at least count as real reforms, but their scope is as yet still tiny.

Another prominent item in the official media now is the employee stock-ownership program (ESOP). ESOPs were mentioned in the 2013 Reform Program, generated a brief wave of enthusiasm, and then disappeared for two years. Now, they're back in the spotlight, with their own webpage, and a new-found urgency. Several local governments in China announced that they will launch experimental reforms, in Jilin, Beijing,[12] Shaanxi, Gansu, and Shandong[13] provinces, among other places. Although these programs aim to stimulate incentives inside SOEs, implementation is also controlled within strict limits. For example, Beijing's regulations say that total shares held by employees cannot exceed 30 percent and individual holdings are capped at 1 percent. All this activity might eventually coalesce into a coherent reform program, but today it is little more than the nervous seeking for a new package, after three years that have produced few noticeable benefits.

Along with these measures, Xi Jinping has reaffirmed his intention to stress party control over state enterprises. In other words, the ongoing reform progress not only includes market-oriented practice but also intensifies partial control, monitoring and supervision, some of which will be exercised by government bodies. The state ownership agency, SASAC, will create three new supervision bureaus to carry out enhanced supervision.[14] More important are the plans to implement the dual position of party secretary and director of the board in SOEs.[15] SOEs would apply a form of joint appointment in which the top SOE leader would serve simultaneously as party secretary and board chairman. Rather than separating managerial objectives and party priorities, China is moving to intensify the party influence on SOEs. The CCP is trying to align SOE behavior with party interest more tightly. Particularly during the present period, when mixed ownership reform and the search for private capital investment is a priority, more centralized personnel control will have a perverse effect, undermining private capital's desire to participate in the mixed-ownership reform. Furthermore, SASAC has declared that any substantive decision-making involving strategic areas such as macroeconomics, corporate strategy, or national interests must be discussed by the Party Committee, which will make a recommendation before passing on the matter for a final decision by the the board of directors. Apparently, the role of the Communist Party is increasingly embedded into corporate governance in state enterprises. Indeed, the managerial autonomy of the CEO, hard-won during the 1980s, is now being squeezed between expanding party and governmental control and a more assertive role for workers. Very little of this activity has the potential to lead to meaningful SOE reform, but it sustains a narrative of active and ongoing "reform."

The Gift from Donald Trump

One of the biggest blind spots in Donald Trump's view of the world is his seeming inability to distinguish between friends, rivals, and enemies. Trump asserts that virtually every country in the world has taken advantage of the United States. He seems willing to confront a close ally like Australia as readily as he embraces a geopolitical rival like Russia. Whatever one thinks of the impact of the Trans-Pacific Partnership (TPP) on American workers, it is unquestionably a grouping of America's friends and allies. China, whose relationship with the U.S. is much more complex, was never a participant. The idea that TPP was "excluding China" has always been an exaggeration, and there was always the long-run possibility that TPP would benefit China by encouraging a broader (competitive) opening of the Chinese economy. In the short run, however, Trump's withdrawal from the TPP, announced on his first working day as president, dissolved an economic agreement primarily among like-minded allies, and inevitably benefitted China in its role as economic and geopolitical rival of the U.S. While TPP was not directed against China, the end of TPP will have three positive impacts on China and especially on Xi Jinping.

First, TPP would have improved the competitive position of some of China's economic competitors, especially Vietnam. Exporters of labor-intensive manufactures are currently leaving southern China and setting up shop in Vietnam. This is an inevitable trend, and one that China welcomes as long as it is gradual. However, Chinese labor costs have gone up rapidly in the last few years, and the possibility of a mass exodus of garment and toy production is a very real threat. The end of TPP reduces the competitive pressure and the threat of rapid disorderly exit.

Second, TPP would have oriented the economies of member countries more toward the U.S. market. This would have reduced China's overall bargaining power because TPP members would have been less dependent on the Chinese market. TPP members like Chile and Australia already export more to China than to the United States, and TPP would have increased American economic influence as a counterweight to Chinese influence. Now China doesn't need to worry about that.

Third, TPP would have created a new template of international economic regulation. The TPP template went deep behind national borders to harmonize regulations in a variety of service and high-technology sectors. Indeed, in a way, TPP wasn't even primarily a trade deal as much as an investment and regulation agreement. Vietnam's market access to the U.S. and Japan for manufactured exports, and the U.S.'s ability to ship agricultural exports to Japan would have been economically significant. However, even more important were provisions opening service sectors in which the U.S. has competitive advantage. These rules naturally reflect American interests, and would have paved the way for broader multinational agreements that incorporate the same rules. For example, TPP includes very strong protection for intellectual property rights (IPR). By contrast, China prefers much looser international rules on IPR and fewer commitments to harmonize its domestic regulatory apparatus with world best-practice. The demise of TPP leaves no viable alternative to the default Chinese position of trade liberalization, primarily in goods, backed by strong mercantile governments. Trump's cancelling of TPP was a gift to China

The Economic-Strategic Opportunity for Xi

As the U.S. under Donald Trump abdicates its leadership role in the global economy, it creates an obvious opportunity for China. That the Chinese leaders also perceive it this way is shown by Xi Jinping's visit to Davos. In his speech to the World Economic Forum, Xi argued for continued economic globalization and implicitly asserted China's leadership role.[16] Particularly in Europe the possibility of a China-E.U. combine to take the place of an absent U.S. is already under active discussion.[17]

Yet while many welcomed Xi's speech, it didn't take long for observers to point out that China was an unlikely champion of globalization. Not only is the Chinese economy substantially more closed to foreign investment than most developed and even developing countries, it is widely perceived to be moving in the wrong direction. Not only have reforms stalled, but the treatment of foreign companies in China has deteriorated markedly. To put it mildly, China lacks credibility as a champion of globalization. Talk is cheap.

Conclusion

We can see Xi Jinping pushed in two directions by the imperatives of the party meeting and the arrival of a Trump presidency in the U.S. On the one hand, the existence of Donald Trump combined with the stabilization of the economy in 2016 puts Xi in a very favorable position. As things stand now, Xi is essentially on a glide path to re-coronation at the party congress. Whatever his objectives, they have been facilitated by the current political landscape. Xi is in a position to claim a stronger political mandate even without much in the way of further achievement. However, this would be a shallow accomplishment: economic risks loom, and without dramatic actions, Xi's pretensions to global leadership will quickly dissipate.

On the other hand, the payoff to bold moves of economic reform and opening is now stronger than ever. A dramatic opening of some of China's service sectors, for example, could still excite interest among multinational corporations. Moreover, such an opening could easily be crafted in a way that excludes the U.S. and therefore could be part of a repertory of responses to Trump administration protectionist measures. Such steps would have enormous importance in burnishing Xi's reputation domestically as a reformer and world leader.

The contours of the Trump administration's economic policy are still completely uncertain. In particular, nobody knows the extent to which actions will be targeted on China or simply part of a broader protectionist impulse. However, China has plenty of tools that allow it a luxury of choice. It can react progressively with tit-for-tat responses to U.S. actions or it can choose to take the high road and defer immediate response.

For several years Xi Jinping has been telling his colleagues and the Chinese people that the international situation is unprecedentedly complex and dangerous. This is an obviously self-serving message, intended as a rationale for continuing Communist Party rule and for Xi's consolidation of strongman powers. Until recently there was remarkably little evidence to support this characterization. But now Donald Trump has come along to show just how irrational and unpredictable and dangerous the world can be. Of course this is an enormous gift to Xi Jinping. Now, Xi must display boldness and vision if he is to seize the opportunity. That would mean doing the thing he has consistently failed to do since 2013: pay serious political costs to push forward a meaningful program of market-oriented reform.

Notes

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