Two Trains Running: Supply-Side Reform, SOE Reform and the Authoritative Personage

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The publication of a new article by "Authoritative Personage" on May 9, 2016, threw into the open two unresolved issues of Chinese policy: Who is making economic reform policy? What is the mix between reform and growth? These two unresolved issues lie behind the enormous difficulty policy-makers have had in coming up with a coherent reform strategy lately. This difficulty is most manifest in the case of state-owned enterprise reform, which is floundering.

Since the beginning of the Xi-Li administration in 2012, economic policy has been hobbled by two big unresolved issues, one related to process and power, and one related to content. The first concerns the locus of policy-making. In the Chinese system, while the general secretary has the final word, day-to-day economic policy has been made and implemented by the premier. This has been established procedure since the days of Zhao Ziyang in early 1982.[1] Xi Jinping, from the beginning, has claimed many hands-on economic decision roles unprecedented in the past 30 years, and while Li Keqiang has been busy, it has been hard to perceive how far his authority extends. The second big unresolved issue is the question of what costs, if any, policy-makers are prepared to pay in order to implement serious reforms. As discussed in the previous edition of the *Monitor*, there have been two camps on this issue for a while. Some economists believe that it is important to maintain growth at all costs, that even major reforms and restructuring will be easier to carry out in a growth environment. Indeed, for some of these economists, this is one of the crucial lessons of the Chinese reform experience over the past 30 years. They support relatively loose credit conditions, government infrastructure investment, and increased fiscal deficits to maintain a rapid growth rate. And of course this group is also supported by some interest groups who actually don't want any reforms at all. By contrast, a different group of reformists believe that China must gain control over credit and limit its growth, impose hard budget constraints on state-owned enterprises (SOEs) and other firms, and force economic actors to invest only in profitable projects. Such a policy would inevitably cause a growth slowdown at first, but advocates of this approach believe the slowdown would be modest, and China would be put on a more sustainable medium-rapid growth pace in this manner.

Clearly, these groups also have different attitudes about China's high and rising debt load: the first group believes that China can sustain its current debt levels, and should even increase government debt, while the second group believes that rising debt endangers China's economic stability. Until recently, these two unresolved issues were not tied closely together; individuals and policies were intertwined on occasion, but there was no "great debate" between two camps, except occasionally among academics.

The situation changed dramatically with the publication of a new article by "Authoritative Personage" on May 9, 2016. As discussed in the previous edition of the *Monitor*, the "Authoritative Personage" (权威人士) responsible for the earlier articles was most likely Liu He, or at the least, a writing group under his close personal direction. The core message of the new article was certainly consistent with that of the earlier article by "Authoritative Personage": that priority must be given to "Supply-Side Structural Reform." However, the tone of the new article is more urgent, the scope is wider, and the political implications are greater than was the case in the earlier article. Indeed, the article has already brought about a flurry of attention and a rash of commentary. Some of this commentary has been overheated, including an article claiming an "open split in the Chinese leadership."[2] To see why a simple economics article has elicited this kind of response, and to draw out the truth and limitations of such reactions, we need to dive into the context of recent policy moves.

Background: Policy in the New Year, 2016

At the end of 2015, and the beginning of 2016, Chinese economic policy was in an especially difficult place. Growth was slowing more sharply than policy-makers were comfortable with. Capital outflows were large. Then, still another stock market fiasco emerged in January, as the "circuit-breaker" was repeatedly triggered by large drops in the market. The circuit-breaker suspends trading when sudden declines occur, and it is supposed to stabilize the market by giving market participants a chance to cool off and arrange liquidity to avoid forced sales. Such mechanisms exist in advanced country markets, but are rarely triggered. The repeated suspension of Chinese market trading did quite the opposite of what was intended, spreading panic and once again making Chinese regulators look foolish or unprepared.

As a result of these problems, Chinese policy shifted to full-on "stability" mode in early 2016. Additional controls were put on the stock market and over capital outflows. However, most importantly, a flood of credit was unleashed into the domestic economy. State enterprise investment soared, prices of heavy industrial commodities such as steel and coal jumped, and industrial growth stabilized. By the time of the National People's Congress (NPC) meetings in March, Premier Li Keqiang was able to preside over what appeared to be a victory celebration: all the first-quarter numbers were coming in better than expected, global short-term worries about China were receding, and it was possible to declare the first quarter as being the beginning of a good year.

Despite the cheerful rhetoric of the NPC, there were growing worries behind the scenes. The expansion of credit in January had been huge, literally unsustainable. The stabilization of heavy industry meant that the structural change to a more service-oriented economy was being postponed once again. The worst news of all was that the growth of private investment fell far short of SOE investment, so most of the growth was being channeled into the state economy. The short-term panic had been averted, but at what cost in terms of the long-run processes of growth, restructuring, and reform?

Authoritative Personage Speaks Again

In this context, Authoritative Personage's remarks landed like a bombshell. Most immediately, Authoritative Personage inveighed against complacency. The first quarter results were not nearly as good as they seemed. China's growth would not recover quickly: there would not be a V-shaped recovery, or even a U-shaped recovery, but an "L-shape." Rather than being a recovery, this is a smooth transition to a lower growth rate. Do not expect growth to pick up, is the essence of the remark. Moreover, growth should not be the sole benchmark, as there are many interrelated problems. It is "unrealistic and unnecessary to add leverage to pump up the economy." Finally, it is dangerous: debt cannot grow indefinitely, "trees cannot grow to the sky." Leverage is a problem, and there must be a process of de-leveraging sooner or later. Almost philosophically, Authoritative Personage argues that China does not just face a single dilemma, or growth versus change, it faces multi-sided dilemmas, of structural change, reform, growth, and de-leveraging. The most dangerous thing is to think you can have it both ways, that you can avoid tough choices and not make a decisive judgment call. The key to everything is to be measured, to follow the right policy priorities:

> We have the institutional advantage; we must create consensus, be resolute, move forward without stopping, put implementation first and achieve results by being practical.[3]

In practice, this measured but powerful implementation means maintaining the highest priority for supply-side structural reforms. The good news in the first quarter is just temporary, but the commitment to supply-side structural reform is long-term. The five central tenets of supply-side structural reform are forcefully restated.

What Do Authoritative Personage's Remarks Mean for Policy-making?

The publication of the editorial by Authoritative Personage has been taken by many as an attack on Premier Li Keqiang. In one sense, this is unfair and unreasonable. The entire political leadership agreed, in December at the Economic Work Conference, to increase macroeconomic stimulus as a concomitant and offset to supply-side structural reform. Every version of supply-side reform has included a commitment to increased demand-side stimulus (to offset the initial contractionary impact that—it is acknowledged—supply-side reforms will have in their early stages). Moreover, there was widespread agreement that nervousness in global markets, combined with more bungling in the stock market, meant that policy at the beginning of the year had to stress stability and overcome panic. Finally, it was widely known that Xi Jinping had insisted on a 6.5 percent minimum growth rate for the 13th Five-Year Plan (2016–2020), and nearly everybody concluded that a moderately stimulative macroeconomic policy was necessary to maintain that growth rate in the opening year. The overall policy stance, then, was clearly a group product of the entire top leadership.

If fell to Li to present the public face of policy, particularly during the run-up to the National People's Congress. In fact, Li did this part of his job fairly well: the situation was stabilized, panic prevented, and everything looked nice at the NPC. In fact, things perhaps looked a little bit too nice, and some people began to wonder whether supply-side structural reforms were really necessary after all. Passive resistance to the cutbacks required by supply-side structural reform increased, especially as prices of steel and other goods rebounded. In this scenario, it was essential that someone—Authoritative Personage—step in to remind everybody that there were serious structural challenges that needed to be faced. No "power struggle" here.

But in another sense, Authoritative Personage's intervention was undoubtedly a slap in the face for Li Keqiang. Some of the expressions criticized in the article were virtually identical to expressions Li had used. The article clearly rebukes a kind of standard confidence-building line that had recently been expressed by Li Keqiang (as part of his job of convincing especially foreign businessmen that everything is fine in China). Moreover, the tone of the article is certainly, indeed, *authoritative*, much more so than the previous articles. While it expresses the views and economic thought of Xi Jinping's top economic adviser Liu He, it also expresses a kind of casual first-person confidence, different from other Liu He essays, that seems to indicate it has been personally approved by and linked to Xi Jinping. This impression is underlined by the fact that the very next day, a speech by Xi Jinping first made in January was reprinted in the very same venues.[4]

Li Keqiang has been placed in an impossible position. He has to maintain the growth rate (and perhaps wants to maintain the growth rate), and he certainly doesn't have control over the economic reform process, so he can't really push any radical initiatives. He is essentially forced to become a pork barrel premier, one who develops investment projects and development programs that sound good and which build a constituency. (This role was brilliantly pioneered by Wen Jiabao, by the way). Li increasingly has to preside over China, Incorporated, and of course part of that is putting the best possible face on things and presenting it to the world. But now Authoritative Personage has come along and said, no, it's not true. It is, unavoidably, a vote of no confidence that must be a personal humiliation.

Concretely, this means that actual policy-making responsibilities are being taken over by the Finance and Economics Leadership Small Group (FELSG). Of course, the erosion of the premier's authority over economic policy has been going on since the Third Plenum, when a new Leadership Small Group (LSG), the "Deepening Comprehensive Reform LSG" was established by Xi at its head to oversee the reform process. However, that reform process was so vast and diffuse that setting up a formal party-headed process only somewhere and sometimes occluded Li Keqiang's government apparatus. By the end of 2015, many of the Third Plenum Reform initiatives had run out of steam and, as we saw in the previous issues of *CLM*, had been replaced as the top policy theme by supply-side structural reforms. Of course, supply-side structural reforms had, from their initiation, come out of the FELSG, the office of which is headed by Liu He. The significance of the new Authoritative Personage article in this sense is that it asserts, authoritatively, that the implementation of supply-side structural reforms is indeed the top policy theme of the year in all senses, and that its interpretation rests firmly with the FELSG (and most certainly not with Premier Li Keqiang's State Council). For 2016, then, economic policy-making will be directed out of the FELSG, which is to say, out of an administrative organ directly under Xi Jinping. The long-standing tradition that the premier makes economic policy and implements it through the State Council, having been eroded over the past three years, has now been overturned.

Intensifying Debate

In the wake of Authoritative Personage's latest intervention, disagreements have intensified. An example is a collection of views put together by a reporter named Gao Yiping.[5] Gao's assemblage of views is tricky, because he includes excerpts of varying lengths from nine different economists. Some are pointedly critical of current policy; some take mild exception to some of the formulations or assumptions at play. So it would be a mistake to conclude that all the economists quoted—who range from Lin Yifu to Yu Yongding, and include Zhang Jun and Chen Ping—make up a "camp." However, all the quoted economists do support a stronger infrastructure effort, additional public sector debt, and a faster growth outcome. To a certain degree, all reject the claims of Authoritative Personage that China cannot grow out of its debt, that the effectiveness of debt-financed investment is inevitably becoming less effective, or that Chinese growth will be characterized by an L-shape going forward.

Strikingly, most of the snippets quoted from these economists express worry that Chinese macroeconomic policy will become too contractionary. Beginning in April 2016, the pace of credit growth slowed rapidly. The official view is that this change was not a shift of policy, simply a correction of a short-term, but obviously excessive, burst of credit created in January and February. Moreover, the official view holds that technical factors—the swapping of large amounts of local government debt for bonds—makes policy look a lot more contractionary than it really is. But these "growth economists" dissent. They worry that the credit outcomes in April and May (the most current as of this writing), along with Authoritative Personage's strong rhetoric, represent a shift in policy toward more macroeconomic austerity. This is what they have been worrying about all along, and in their eyes it will make it harder for China to transition to a high-efficiency, high-technology future.

This distinctively Chinese approach is quite different from the way in which most Western economists view the challenges of the Chinese economy. Most Western economists—I include myself in this generalization—believe that China has to establish credit discipline over firms, especially state-owned enterprises, in order to make them responsible for their own investment decisions. When firms establish "hard budgetary constraints" it is possible to then address their existing debt through a combination of debt forgiveness and equity losses. However, without some macroeconomic credit constraint, it is impossible to de-leverage, because firms will simply take on new debt to rebuild their capital and behavior will not change.

These economic dissents are highly academic. They are also high level: they are expressed at the level of effectiveness of demand-side policy versus effectiveness of supply-side policy, and conditions for reliance on each. (Both sides acknowledge the importance of both, but each side accuses the other of neglecting one of these two important pillars of economic policy). Government officials do not participate in these discussions. Still, if one were to project ideas onto officials, one would undoubtedly find that most government officials tend to agree with the "growth economists," and also, to a certain extent, with Li Keqiang's approach. They may also feel discomfited by Authoritative Personage's forceful intervention.

The Two Trains: SOE Reform from Two Sides

This reality has implications for almost every aspect of economic reform policy-making. Let us take briefly the example of SOE reform. There is a remarkable degree of consensus that it has, at a minimum, progressed too slowly and, at a maximum, failed altogether. In a spectacularly ironic development, the Central Discipline Inspection Commission sent inspection teams to all the main government agencies, provinces, and large SOEs as part of its anti-corruption mission. The team sent to the State Asset Supervision and Administration Commission (SASAC, the SOE overseer agency) not only found irregularities in oversight, it also criticized SASAC for not pushing SOE reform energetically enough.[6] Now, we have a provisional resolution. SOE reform will essentially be merged into supply-side structural reform. Supply-side structural reform is not explicitly about SOEs, except that it is. Excess capacity and "zombie firms" are far more prevalent among SOEs. Moreover, in the current ideological environment, SOEs (like all state officials) are expected to be dynamic, bold, leaders:

> As the core force of national economic development, SOEs should play the leading function in supply-side structural reforms. They should carry out every aspect of reform in a model way, and become the pioneers and main force of the reform.[7]

In short, the key process of restructuring SOEs—envisaged as part of an overall SOE reform process—will now take place under the guidance of, and under the rubric of, supply-side structural reform. How did we get here?

The SOE Reform Process Shunted onto a Sideline

The few paragraphs spent on SOE reform in the 2013 Third Plenum Reform document were some of the most striking in the entire reform program. While the terms were vague, they were new, and they suggested a vision of SOE reform that went far beyond current practice. They *suggested*, without making anything clear, a vision in which government control of SOEs shifted to a kind of wealth-management approach, in which government-run investment funds operated at something like arm's length, trying to maximize the wealth the public held, through government, in their SOEs. However, there was a huge distance to travel between concept and reality, and during that distance, SOE reforms lost their compass.

The overall reform program of the Third Plenum was disaggregated into 336 initiatives in early 2014. Thirty-four initiatives dealt primarily with SOEs, and these were distributed mainly to SASAC, the Ministry of Finance, the National Development and Reform Commission (NDRC), and the Ministry of Labor (which works closely with the party's

Organization Department). The result was a chaotic mess: each agency advanced its own views, with no effective coordination. There was certainly no consensus.

In August 2014, the party's top reform policy body—the Comprehensive Reform Leadership Small Group, headed by Xi Jinping himself—made some crucial decisions of its own. First, the LSG accepted proposals from the Ministry of Labor that tied the compensation of enterprise managers to that of government officials of the same bureaucratic rank. This not only cut salaries, but it essentially took compensation issues out of the reform process and placed them within the scope of Xi's anti-corruption campaign. Second, Xi spoke clearly in favor of maintaining strong SOEs, which he described as pivotal for Communist Party rule and having "a dominant role in important sectors and crucial areas that affect national security and the commanding heights of the economy."

Shortly after this meeting, Xi authorized the establishment of a State Council Leading Small Group on State Enterprise Reform. Creating a targeted LSG like this is a standard way of resolving policy conflicts in the Chinese system. All the key bureaucratic actors are brought together in one LSG, assigned a kind of policy-specific "rank" within the group, and told they must agree on a policy. In short, the LSG is a tool to overcome fragmentation and to force consensus.

However, in this case, the group was headed by Vice-Premier Ma Kai, a long-serving economic bureaucrat who previously headed the NDRC, and its office was placed in SASAC and led by State Councilor Wang Yong. Not only was Wang Yong a former head of SASAC, his background before coming to SASAC was in the party's Organization Department. Wang Yong's key role in the SOE reform process made it almost inevitable that established interest groups within the government bureaucracy (especially SASAC) and within the party (especially the Organization Department) would be prominently represented. The ultimate outcome was thus pretty much a foregone conclusion.

It took almost two years for the ideas in the Third Plenum document to be expressed in an official "Guiding Opinion" document, which was publicly released on September 13, 2015.[8] This is a typical "keystone" document that lays out broad principles; a large number of implementing regulations have also been successively appearing. This pattern has been dubbed "1+N" because while between 10 and 15 implementing regulations have already been issued, there are several more still in the pipeline, so no one is sure of the ultimate "N." This adds to the complexity of the changes, particularly since the initial "Guiding Opinion" is vague and contradictory, even by the standards of this type of document.

SOE reform is a broad and complex topic, but we can simplify many aspects of it here from the perspective of our current discussion. The SOE reform that emerged in September 2015 represented the complete defeat of the more radical potential "wealth management" approach suggested by the Third Plenum, and the complete victory of the SASAC approach. In the SASAC approach, there are still indeed "capital investment and operation funds," so that reorganization can be presented as "reform." However, these investment funds are very different because they have specific restructuring and reorganizing missions. Initially, SASAC would have liked them to be organized around industrial sectors, but this approach was dubbed too extreme by even the most lukewarm reformers, since it would come perilously close to reconstituting the old industrial ministries. What has emerged instead is a mandate for the creation of multiple investment funds with developmental objectives. That is, these funds are expected to foster the creation of big, competitive firms, develop emerging industries, to intervene in markets precisely in order to shape specific developments. If it is true, as the Third Plenum document states, that government is to withdraw from microeconomic interventions in the economy, these investment funds suggest that the government withdrawal would be accomplished simply by delegating the government's objectives to these investment funds, which would be partially market-oriented operators. On the ground, though, it doesn't represent much improvement at all, and in the reform context, it is a step backward.

Now it is possible to see where supply-side structural reform fits in to all this. The top item on the five-item list of the supply-side reform agenda is reducing excess capacity. That objective is 100 percent compatible with traditional programs of state sector restructuring. (Advocates of supply-side reform, like Authoritative Personage, hope to *limit* the traditional bureaucratic aspect of supply-side restructuring, and rely as much as possible on market forces, but they acknowledge that a large part of it is unavoidably carried out through administrative intervention.) The "reformed" asset managers and investment funds are happy to carry out these activities. Closing down excess capacity in steel is not quite as exciting as fostering new high-tech industries, but the activity is not as different as it seems at first. In both cases, bureaucrats are intervening in markets, doing important things, maintaining their political (and implicit economic) value by making decisions that affect resource allocation. It's not too difficult to imagine the two tracks, SOE reform and supply-side structural reform, merging into one.

Conclusion

The intervention of Authoritative Personage in May 2016 turns out to be just as important as it initially appeared to be, and perhaps even more so. From a policy standpoint, it clearly signals that the fundamental economic policy decisions will now be made by the advisers around Xi Jinping. Supply-side structural reform is the dominant policy orientation for all of 2016 and probably all of 2017, and the interpretation and implementation of that policy comes from the FELSG, headed by Liu He and answering to Xi Jinping. Already, we see more and more effort to stuff new content into supply-side structural reform, as policy entrepreneurs see that as the main vehicle for getting their proposals accepted and implemented. That, however, is a story for a later issue of the *Monitor*.

In a similar sense, we see an implicit abandonment of the Third Plenum agenda. Certain aspects of that agenda, such as SOE reform, simply have not worked out. By absorbing those elements into supply-side reform, there is an opportunity to reinterpret and—who knows—reinvigorate those initiatives. In China, policies never fail; they simply get reinterpreted until they can be declared successful, or else be forgotten. Certainly SOE reform is now moving into this gray zone.

Finally, and to some this will be most important, Authoritative Personage has moved in May 2016 to actually become authoritative. Economic policy has moved in a fundamental way into Xi Jinping's shop, and out of Li Keqiang's shop. Li cannot be happy with this, and it is hard to see how the Xi-Li relationship can be maintained under these conditions. Of course, at this point many people are beginning to look to the next Party Congress, which now looms only a little more than a year away.

Notes

[1] Barry Naughton, "Economic Policy," in David S. G. Goodman, ed., *Handbook of the Politics of China*. Oxford, UK: Edward Elgar, 2016, pp. 165–186.

[2] Keiichiro Moriyasu, "Mystery Chinese official calls for reform over growth," *Nikkei Asian Review*, May 12, 2016, accessed at http://asia.nikkei.com/Politics-Economy/Economy/Mystery-Chinese-official-calls-for-reform-over-growth; Xie Yu, "Stimulus or reforms? Investors confused as Chinese leaders grapple with an L-shaped dilemma," *South China Morning Post*, May 18, 2016, accessed at http://www.scmp.com/business/markets/article/1946752/stimulus-or-reforms-investors-confused-chinese-leaders-grapple-l.

[3] "Asking about the overall situation in the opening quarter; Authoritative Personage talks about the current Chinese economy" (开局首季问大势—权威人士谈当前中国经济), *People's Daily*, May 9, 2016, accessed at http://paper.people.com.cn/rmrb/html/2016-05/09/nw.D110000renmrb_20160509_6-01.htm.

[4] Xi Jinping 习近平, "Speech at the Specialized Study Session for Provincial and Ministerial Important Cadres on implementing the spirit of the Fifth Plenum of the 18th Congress," (在省部级主要领导干部学习贯彻党的十八届五中全会精神专题研讨班上的讲话), January 18, 2016, *People's Daily* (人民日报), May 10, 2016, p. 3, accessed at http://paper.people.com.cn/rmrb/html/2016-05/10/nw.D110000renmrb_20160510_3-03.htm.

[5] Gao Yiping, "Where is China going? Their views are worth listening closely to," ObserverNet (观察者网), June 7, 2016, accessed at http://www.guancha.cn/ZhangJun/2016_06_07_363210.shtml.

[6] China Disciplinary Inspection Commission 中纪委, "The Circumstances of the 14th Central Inspection Team giving SASAC feedback from the specialized Inspection Team," (中央第十四巡视组向国资委党委反馈专项巡视情况, June 2, 2016, accessed at http://www.ccdi.gov.cn/special/zyxszt/djlxs_zyxs/fkqk_18jzydjl_zyxs/201606/t20160613_80379.html. The idea that SASAC might have been slowed down in its work reforming enterprises because they were worried about a large team of people with subpoena power combing through their books for the past six months seems not to have occurred to the team.

[7] "Xinhua News Agency says SOE development is facing unprecedented difficulties" (新华社：国有企业发展确实遇到前所未有的困难), June 10, 2016, accessed at http://finance.ifeng.com/a/20160610/14475324_0.shtml.

[8] Communist Party of China and State Council, "Guiding opinions on Deepening Reform of State-owned Enterprise" (中共中央、国务院关于深化国有企业改革的指导意见), Xinhua News, September 13, 2015, accessed at http://news.xinhuanet.com/politics/2015-09/13/c_1116547305.htm.