The paradoxical politics of China's economic reforms

Guy de Jonquières,
Senior Fellow at European Centre for International Political Economy

Speech to York University Economics Society, 4 February 2015

Let me start with a confession. I have been visiting, analysing and commenting on China on and off for the past 20 years. During that time, one thing has become increasingly clear to me: the more I learn about the country, the less I actually know for sure. Many other China-watchers, if they are honest, would say the same. Indeed, privately, many do.

It is not just that China is a vast and extraordinarily diverse, complex and fast-changing society. Nor that government curbs on free expression and a lingering mistrust of outsiders tend to discourage many Chinese from speaking their minds freely, especially to foreigners. It is also that the deeply opaque and intensely secretive nature of China's government, its political system and its policy machinery makes working out what is really going a guessing game that relies on gathering disparate scraps of not always reliable information, weighing them up and trying to piece them together in some kind of pattern that makes sense. On many important questions, in truth, we are all groping for answers in the dark.

That, inevitably, creates much scope for ambiguity and wildly divergent and often conflicting interpretations. For proof, one need only to look at the wide spectrum of books on contemporary China that have hit the shelves in recent years. At one extreme are triumphalist titles such as "When China Rules the World" by Martin Jacques; at the other, and equally implausible, are darkly apocalyptic ones, typified by Gordon Chang's "The Coming Collapse of China". That, by the way, is an outcome that the author has declared to be imminent every year for more than a decade but which, so far, has stubbornly failed to materialise.

So, China can be viewed as a kind of giant Rohrshach test, a pattern recognition exercise that often reveals more about the observer's own psychology, preconceptions and values than it does objective truths about the country itself. Or, perhaps, as a vast cinema screen, onto which the audience projects either its greatest hopes or darkest fears.

This afternoon, I shall do my best to avoid falling into that trap and to strike a fair balance by steering clear from the shrilly alarmist and the purely speculative and basing my analysis, as far as possible, on verifiable evidence rather than on unprovable hypotheses and personal predilections. I shall also be candid about saying when I do not know the answers. I hope I succeed.

Since you are economics students, I assume you are all familiar with the work of

Joseph Schumpeter, the Austro-American economist who originated the concept of creative destruction. Schumpeter once observed that all economics is actually "politics, politics, politics". Of nowhere is that truer than of China - and never more so than today.

Ever since Deng Xiaoping embraced liberalisation and market opening at the end of the 1970s, China's Communist Party has staked its legitimacy and future on delivering to the populace a better tomorrow, in material terms at least, through sustained and substantial rises in GDP, employment and living standards.

For three decades, the wager paid off. By channeling abundant domestic savings into massive fixed asset investment, China has been able to build gleaming modern infrastructure and vast new cities, while becoming the world's largest manufacturer and exporter and doubling GDP every decade since 1980. In the process, it has lifted some 400 million people out of poverty.

However, those achievements, impressive as they are, have come at a heavy price, and today the bill is falling due. Over-investment has spawned massive excess capacity in many industries and a property glut – along with environmental damage that will be expensive to repair. Meanwhile, investment has become a steadily less efficient growth driver: it takes as much as five times more capital to generate an extra dollar of GDP today than seven years ago. An officially-sponsored report late last year found that almost seven trillion dollars of investment since 2009, about half the total, has been completely wasted. That is capital misallocation on a truly gargantuan scale.

The costs have been greatly increased by the tidal wave of credit unleashed that same year in response to the global financial crisis. The stimulus prevented a sharp economic contraction and kept growth going in the short-term. But it has bequeathed a toxic longer-term legacy of speculation, asset bubbles and a debt mountain that has almost doubled in five years to about 250 per cent of GDP, slightly higher than the US level. And despite government attempts to curb new lending, it continues to expand – almost twice as fast as the economy – with an estimated one third of new loans being used just to roll over existing debt.

That leaves policy makers treading an extremely fine line. Breaking the economy's addiction to debt and bringing the credit boom under control is increasingly essential to stabilise the economy. Yet China's rulers also fear that the cure could prove worse than the disease if it caused a slump in growth – currently a little over 7 per cent and slowing – triggering a property market collapse, a financial crisis and social unrest. However, the only way to keep growth up in the near-term is to keep credit flowing. Clearly, that situation cannot go on forever, and the longer it lasts, the bigger the eventual reckoning. The price of achieving an economic soft landing today may be a much harder one tomorrow.

So getting the economy right soon is not only essential to China's continued development and its aspirations to be a great global power. It is, quite simply, a survival issue for the Communist Party.

That is the background to the far-reaching 60-point reform programme endorsed by the Party leadership at its Third Plenum 15 months ago. Its aim is not to restore the heady double-digit annual growth rates that China enjoyed for three decades. Nobody in authority believes that is either possible or desirable. Indeed, it is widely accepted that the blind pursuit for far too long of GDP growth at almost any cost has been the cause of many of China's current problems.

Rather, the aim of the reforms is to lay a more stable foundation for development, wealth creation and continued prosperity by replacing investment with consumption as the main growth driver and tackling the many distortions created by China's existing economic model. I will not rehearse the details now but would merely note two things. One is that taken at face value, the programme amounts to a blueprint for the wholesale restructuring of China's economy. The other is that the country's rulers have stated that market forces will play a "decisive" role in that process.

China's leaders have talked for years, and with growing urgency, about its economy's problems and the need to "rebalance" it. But only recently have they started to act. So why now? The gathering economic and financial storm clouds, made more threatening by the slowdown since 2007 in global growth, are one reason. Another is the anointment of Xi Jinping as China's president and, more important, general secretary of the Communist Party.

In barely two years, Mr Xi has accumulated more power than any Chinese leader since Deng and has wielded it vigorously, even brutally. He has also articulated an ambitious – if still ill-defined - vision of where he wants to take the country. Called the "China Dream", its stated aim is "the great rejuvenation of the Chinese nation". And Mr Xi is moving speedily to try to achieve it.

The term "rejuvenation" implicitly acknowledges ageing and loss of vitality – an interesting admission. But is Mr Xi really talking about China - or about the Communist Party? In his eyes, probably, the two are indistinguishable. But the signs are that the latter is his overriding preoccupation.

For all its air of monolithic solidity, the Party today confronts formidable challenges, quite apart from and in addition to the deteriorating economy. Rampant corruption has undermined discipline in its own ranks, while provoking growing public anger and cynicism. Despite a massive internal security machine, costing more than the national defence budget, the internet and social media have opened up fertile new channels for criticism by a population that is increasingly urbanised, educated, connected, demanding, exposed to outside influences – and geared to raised expectations. Popular complaints abound about worsening pollution and low standards of product safety, education and health care.

Unchecked, those developments pose a potentially serious threat to the Party's supremacy and the right to exercise absolute control that underpins its monopoly on power.

Taking their cue from Deng Xiaoping, China's rulers have fashioned a response along two, strikingly divergent, tracks. One is promotion of broadly liberalising economic reforms; the other, in contrast, is a determined reassertion of political control that includes a relentless crackdown on corruption, more stringent Party disciplines, harsher repression of dissent and tougher restrictions on the media and academic freedom. It also often has a distinctly backward-looking tone, deliberately invoking the era of Mao and reviving some of its rhetoric and practices, such as self-criticism sessions. Mr Xi, it seems, is trying to advance China economically by turning the clock back politically.

At one level, those two opposing tendencies – economic loosening, political tightening - might nonetheless be mutually reinforcing. Many observers think the anti-corruption purge is needed to ram through economic reforms against deeply entrenched resistance from rent-seeking “vested interests”: those in the Party, in state-owned enterprises, in regulatory agencies and in central and local government whom the existing system has made rich and powerful. Meanwhile, overhauling and streamlining unwieldy Party machinery, to make it more effective at implementing commands from the centre, is probably essential to effective policy delivery.

So far, so good. But look a bit further ahead, and the path Mr Xi is travelling is strewn with many obstacles, uncertainties and risks. I will identify four in particular:

First, the relentless anti-corruption drive could gum up the machinery of government by terrifying party members and officials into inaction, slowing implementation of the economic reform programme. Some recent reports suggest that this “chilling” effect may already be happening. Furthermore, there is no sign of when, or even whether, the drive will end.

Wang Qishan, the Party leader in charge of it, has admitted that it is still tackling only the symptoms of corruption, not the underlying causes. Attacking the problem at its root and durably embedding higher standards of party conduct will need to involve, at a minimum, new incentive structures, stronger accountability mechanisms and effective quasi-judicial institutions to enforce them. As anyone who has ever tried it knows, changing the culture of any organisation is a complex and lengthy task. In China, it may prove an impossible one if the party continues to subordinate every other institution to its own *diktats*.

Indeed, there are already signs that, for that reason, Mr Xi’s drive may be proving counter-productive. The clearest is Transparency International’s latest Corruption Perceptions Index, which found that China had actually fallen 20 places in the rankings over the past year. TI cited a widespread perception that the campaign was, in its words, “partial, opaque and politically motivated, casting doubt on its efficacy”. It said it needed “stronger laws on bribery, access to information, whistleblower protection, more open budgets and asset declarations”, adding that more transparency and judicial independence would also help.

Worse still, the campaign could simply degenerate into another old-style party purge, aimed at prosecuting personal vendettas and eliminating political opponents and rival factions. Some observers believe it already has. The risk would grow even greater if the economy deteriorated further and the reforms stumbled, throwing China’s leaders onto the defensive. That could leave Mr Xi highly exposed because, by taking so much power to himself, he has marginalised any plausible scapegoats on whom to pin the blame if things go wrong.

Second, meaningful structural reforms will unavoidably inflict disruption and pain. They almost always do, which is why politicians fight shy of them unless they have no option. Many of China’s proposed measures are likely to depress growth further in the near-term and could also fuel inflation. Many dominant state-owned enterprises are bloated with high costs and overmanning and survive only thanks to subsidies and preferential financing. Cutting them down to size could throw millions out of work, while subjecting China’s protected state-controlled banking and financial system to market forces would raise significantly SoEs’ capital costs and lower their already meagre profitability. None of these developments is conducive to the political and social “stability” – coded language for the perpetuation of Party rule – that China’s leaders prize so highly.

Third, the task of reform is more daunting than in Deng Xiaoping's day, because China's economy today is so much bigger, wealthier and more complex. In retrospect, Deng's agenda looks relatively straightforward: do some basic agricultural reforms, bulldoze some obvious obstacles to growth, expose the economy to foreign competition, knowhow and investment, close down failing state companies and open the door a little to private enterprise.

Then, China could look to export-oriented manufacturing and construction to cushion adjustment and power growth. Today, however, the priority is to cut back those sectors while seeking other ways to generate the better paid jobs and higher levels of household income needed to make domestic consumption the driver of demand. The obvious – perhaps only - place to look is China's under-developed services sector.

Enabling service industries to prosper means not only lowering barriers to market entry erected by SOE monopolies and oligopolies; it means, above all in more sophisticated sectors such as finance, technology-intensive and network industries, creating clear rules for market conduct and effective mechanisms for implementing them. Here, once again, building robust institutions that command public trust - a commodity not in overwhelming supply in China - will be key.

In some areas, such as banking supervision and regulation, China has made an encouraging start – though it still has far to go. But in others, it is struggling to find its way. Anti-monopoly policy is a glaring topical example. Fought over by three rival branches of government, each seeking to best the other, it has prompted cries of foul by foreign companies, which complain that it is being used, not to promote competition, but as a protectionist tool that discriminates against them and in favour of local rivals.

More broadly, if market forces are truly to play the "decisive role" assigned to them in 2013 by the Third Plenum, then, axiomatically, the functions and operating methods of the state need to be radically re-defined. That means replacing haphazard, arbitrary and politically motivated government intervention with a more transparent framework of governance, stronger property rights, rule of law and impartial enforcement.

At last November's Fourth Party Plenum, China's leaders made a tentative nod in that direction by announcing a number of reforms intended to make the legal system more efficient and less opaque, corrupt and vulnerable to local government meddling. But they also insisted that the Party's overriding constitutional supremacy – and therefore its right to intervene politically – should remain sacrosanct, and that there was no question of creating an independent judiciary, free from the Party's political writ.

In other words, in the Party's eyes, the primary function of the law remains as an instrument of political control by the centre, not a source of impartial justice. Though China's leaders speak of rule OF law, it is clear that what they really mean is rule BY law. Eight hundred years after England's King John signed Magna Carta, its basic principles, such as statutory guarantees of individual rights, due process and constraints on the abuse of political power, which today form the bedrock of many constitutional democracies around the world, have yet to find a foothold in China.

Fourth, China's leaders are not just out to correct the manifest structural problems in its economy. Their sights are set higher, on a loftier goal: to transform the country into an advanced economic power and innovation powerhouse that no longer competes on the basis of low labour costs and vast injections of cheap capital, but as a global leader in science, technology and sophisticated knowledge-based industries, from genetic engineering to aerospace, alternative energy and the internet of things.

That means vaulting over what is known as the “middle income trap”, the unenviable no man’s land in which developing economies get stuck because they can no longer compete just on cheap labour and capital but lack the skills and resources needed to joint the ranks of advanced economies. In recent times, very few countries have succeeded in making that leap.

China undoubtedly holds some strong cards: rapidly rising spending on R&D; an education system that turns out millions of highly literate and numerate graduates annually; a government commited to supporting advanced industries; excellent modern infrastructure; and some successful and fast-growing entrepreneurial tech companies, such as Alibaba, Lenovo, Huawei, BYD, Baidu, Xiaomi and Tencent.

However, China also suffers from serious self-inflicted handicaps. One of the biggest is the government’s systematic repression of dissent and its steadily growing restrictions on freedom of expression and thought. All worthwhile innovations, by definition, involve challenging received ideas and the established order. Yet such challenges are not encouraged by a political system that increasingly demands rigorous adherence to party dictates, rigid disciplines and policies and harshly punishes transgressions. Meanwhile, scientists and academics are starting to complain that the pursuit of intellectual inquiry and the international exchange of ideas essential to their work are increasingly constrained by heavy-handed internet censorship and curbs on cross-border information flows.

Critics, both within and outside China, point to another weakness, as well: an education system which, while effective at instilling knowledge and facts, does not encourage students to think for themselves. In the words of one Chinese educator, “We teach our students how to give the right answers, not how to ask the right questions”.

Now, I am not saying that the planned reforms are necessarily doomed to wither or fail. The leadership’s political will and commitment to their success should not be under-estimated. And there are clearly signs of progress being made – though opinions differ on how much and how fast. Here, again, people tend to see what they want to see. As so often with China, optimists view the glass as half full, pessimists as half empty. In both cases, though, there is broad agreement that a vast amount remains to be done and that a huge effort will be needed to do it. The essential difference between the two camps is how much – or how little - confidence each has in the capacity of the ruling Communist Party to deliver. Ultimately, prognoses for the fate of the reforms come down, to a large extent, to an act of faith.

Beyond that lies a much larger and more fundamental question. On the one hand, China’s leaders are acutely aware that far-reaching **economic** reforms are essential to the party’s survival. On the other, they continue adamantly to rule out **political** reforms that might call into question the party’s monopoly on power. Indeed, they appear to view the maintenance of its unchallenged political dominion as the indispensable key to the successful implementation of economic reforms.

Yet the scale and nature of the economic transformation they are seeking may be hard or even impossible to achieve without some loosening of the political reins: not full-blown democracy, of course, but some kind of gradual and selective movement towards greater personal, media and academic freedom, coupled with a degree of greater independence for economic and market institutions.

But if control were loosened, would it then be possible to keep the genie in the bottle and prevent a steady erosion of the foundations of China's political system? Might the price of saving the party turn out to be undermining its authority and much of what it stands for? For China's leaders, that would be too high a price to pay.

That is the essential paradox at the heart of China's reform policies under Mr Xi. I do not pretend to know whether or how it will be resolved. In truth, nobody, perhaps not even Mr Xi himself, does. But I do not think the paradox will go away soon. Indeed, it seems a fair bet that China's leaders will continue to wrestle with it for many years to come.