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Long Reads

What’s Next for China’s Political Economy?

Aug 2, 2019 | **KEVIN RUDD**

LONDON – To understand where the Chinese economy is headed, it is important to understand the wider context surrounding Chinese debates about what the future holds under President Xi Jinping. The centenary of the Communist Party of China (CPC) in 2021 is the first weigh station for evaluating the progress made toward realizing Xi’s “Chinese Dream.” In 2013, the year after he became China’s paramount leader, Xi promised that by the centenary, poverty would be eliminated and the country would achieve “moderate prosperity,” which is usually interpreted in official Chinese outlets as middle-income status.

Whatever the actual numbers, the CPC will undoubtedly proclaim that both benchmarks were achieved with flying colors. It is central to Xi’s legitimacy that this be the case. Yet in the meantime, the 2021 target will add to the pressure on China’s economic managers, who must not allow the country’s growth rate to slow too much, regardless of the downside risks, foreign or domestic.

There has been much discussion about why US President Donald Trump needs to temper his trade war with China and secure accommodating monetary conditions to support his re-election bid in 2020. But Xi, too, will face a “re-election” challenge at the 20th CPC Congress in 2022. Despite having abolished term limits for the Chinese presidency, he will be feeling significant political pressures of his own.

Xi’s main concern will be his government’s struggle to sustain annual economic growth above 6%, which is viewed as necessary to guarantee rising living standards and avoid unemployment. A faltering economy, particularly at this

critical political juncture, would be deeply problematic for Xi, and potentially destabilizing for the regime.

China's Enduring Dilemma

I believe that China's post-1978 political economy has reached a crossroads. Part of the issue is the US-China trade war: the risk of a wider economic decoupling of the two countries has brought new pressures to bear on China's domestic economic-policy debate; and Trump this week announced another round of tariffs on Chinese imports.

A larger question, though, concerns Xi's vision for China's future, and whether he is prepared to give up absolute party control and allow market forces – particularly private firms – to shape economic outcomes.

Ever since Mao, China's leadership has faced this central dilemma, or what CPC ideologists would describe as its "dialectic." In a Marxist-Leninist party, there is a fundamental tension between the imperative of maintaining absolute political control and the need for economic success, which necessarily implies some role for free markets.

Indeed, for the CPC to fulfill its national mission, it must achieve two fundamental economic objectives. The first is to generate sufficient growth to boost living standards and sustain employment opportunities, thereby entrenching the party's long-term popular legitimacy. The second objective is to enhance China's national economic capacity so that it can defend its core interests and bolster its global standing and influence.

Neither of these goals is possible without a fully functioning market economy – and virtually every Chinese economist recognizes that fundamental truth. Still, the implementation of market-oriented economic reforms since the late 1970s has always been an uncomfortable process for the CPC.

Usually, it has meant a relative loss of political control, because the party's ideological apparatus has had to yield to a growing phalanx of economic and financial technocrats taking up position in various state agencies. Likewise, China's lumbering, Leviathan-like state-owned enterprises (SOEs) have had to yield market share to an expanding army of nimble, entrepreneurial private firms. But most critically of all, the CPC itself has had to contend with the freer flow of information, ideas, and people as China has opened its economy to the world.

To be sure, during the first 35 years of the reform process, China realized spectacular economic gains. But significant financial and economic vulnerabilities emerged as well. The inefficiency and indebtedness of China's financial system has been particularly problematic, as was chronic corruption within the CPC until Xi's rise. All told, though, the trend line was relatively clear. With an increasingly open economy producing a new generation of private firms at scale, companies like Alibaba were beginning to take on the world.

Xi-conomics

Following Xi's rise to power, however, the compact between party and market began to be rewritten. Like the earlier reforms, the process has been uneven, but the trend line has clearly changed direction. Owing to a range of ideological, political, and economic factors arising from China's 2015 stock-market crash, the core organizing principle under Xi has been to reassert the centrality of the CPC in national life.

This process has gone through three complex and largely unplanned phases since 2012. The first, lasting until 2015, was marked by two key decisions. First, in 2013, Xi launched the largest anti-corruption campaign in the CPC's history, leading to the incarceration and disciplining of hundreds of thousands of party members, as well as a widespread purge of Xi's principal political opponents. Second, the party in 2013 adopted what is known as the "Decision," inaugurating the next phase of China's economic-reform program under the "new economic model." After ferocious internal debate, the market was for the first time explicitly proclaimed to be the central organizing principle for the allocation of resources in the economy.

China's previous economic model had featured labor-intensive, low-wage manufacturing for export, high levels of state investment in public infrastructure, and a significant (albeit reduced) role for SOEs – all implemented with scant regard for the environment. By contrast, the new model sought to expand the role of domestic consumption as the principal engine of economic growth, which has been driven almost exclusively by a rapidly expanding private sector, particularly in services. The new model has also further limited the role of SOEs, which are restricted to a defined subset of critical industries, and imposed new standards of environmental sustainability.

The 2013 "Decision" was accompanied by a detailed blueprint outlining 66 specific reforms across the entire economy. It was seen as Xi's answer to what had generally been called the "ten wasted years of economic reform" under his immediate predecessors, former President Hu Jintao and former Premier Wen Jiabao. The overall political-economic model that seemed to be emerging during this first phase thus rested on a CPC that had been strengthened by the restoration of its moral integrity, while remaining committed to the next generation of economic reforms.

The second phase of the Xi era began with the Chinese financial crisis of 2015, which was no run-of-the-mill stock-market crash. The authorities struggled to manage a price bubble that had been driven by excessive liquidity and financially illiterate investors who saw share purchases as the next best thing to the gambling tables in Macao. Owing to the proliferation of marginal lending, Chinese consumers had borrowed heavily from financial institutions to make investments in what was then seen as a permanently booming economy.

At the onset of the crisis, both state and private institutions – what became known as the "national team" – were directed to invest heavily in equities to stabilize the market, but this resulted in further losses. By the time markets stabilized – at

much lower prices – in early 2016, the damage had been done. In July 2015 alone, the Shanghai Composite Index fell 32%. After peaking at $10 trillion in 2015, its market capitalization was still just $5.73 trillion in September 2018.

More to the point, the events of 2015 enraged the central leadership. With millions of citizens blaming the party and the government for their lost savings, the political appetite for further market reforms abated considerably. The pace of reform ground to a virtual halt, and tight controls were implemented to prevent capital flight, making it even more difficult for Chinese firms to expand abroad.

Meanwhile, owing to the growth of a largely unregulated shadow banking sector, not to mention ballooning local-government debt, concerns over China's debt-to-GDP ratio began to spike. The Chinese government responded with a strong regulatory clampdown on shadow lenders and a large-scale deleveraging campaign, all of which had a suffocating effect on private firms that had since become the engine of economic growth. At the same time, bloated and unproductive SOEs were given favorable access to credit, shielding them from the impact of the broader deleveraging effort, usually at the expense of the private sector. Many troubled private firms were either bought up by the state sector or allowed to go bust.

The third phase in the evolution of Xi's political economy began to emerge in late 2018, when the CPC leadership finally realized the extent to which Chinese growth had slowed – largely owing to faltering private-sector business confidence – during the course of that year.

Here, it is important to note that the growth slowdown started well before any actual or perceived effects from the trade war had been felt. Moreover, the reasons for declining private-sector business investment extended well beyond the blunt and brutal impact of the post-2015 deleveraging campaign. Other important factors included the CPC's lack of clarity in signaling how large private firms would be allowed to expand; the growing role of party secretaries in the management of private firms; and the continuing vagaries of China's legal system, which, coupled with the anti-corruption campaign, caused increasing angst among Chinese entrepreneurs.

Responding to the Growth Slowdown

The CPC has developed a five-prong strategy to respond to China's growing crisis in private-sector growth. First, it has re-embraced the private sector rhetorically. In a major speech by Xi in November 2018, he stated that "private firms are an essential part of our economic system; private firms and private entrepreneurs are of our own." Similarly, a few weeks earlier, Chinese Vice Premier Liu He reminded the country that the private sector is responsible for 90% of employment growth, 80% of urban development, 70% of technological innovation, and 50% of the country's taxation.

This rhetorical shift was followed by a number of policy measures to rekindle private-sector growth and restore business confidence. The government took

pains to channel credit to small private-sector borrowers, by reducing banks' reserve requirements and directing large state-owned banks to increase their lending to such borrowers by 30%.
In some cities, such as Ningbo in eastern China, regulators also urged banks to expand their definition of collateral, thereby allowing small businesses to list patents, trademarks, and other assets beyond just real estate, to which many lack access. More recently, the State Council has echoed these moves by calling for intellectual property (IP) to be used as collateral more frequently. According to Chinese regulators, loans to small businesses from China's largest state-owned banks increased by nearly 17% in the first quarter of 2019. Yet, according to other measures, loans to private firms rose by only 6.7%, compared to overall growth in bank lending of 13.7%

With respect to fiscal policy, the government has reduced the value-added tax (VAT) for the manufacturing, agricultural, transport, construction, leasing, wholesale, retail, and real-estate sectors. It has also cut income taxes by increasing the personal tax threshold from CN¥3,500 ($500) to CN¥5,000 ($725) per year, and reversed the implementation of social-security reforms, easing the financial burden on private-sector firms.

The second prong in the government's response has been to embrace financial-sector reform by liberalizing interest rates, changing the exchange-rate regime, and increasing foreign participation in China's financial-services sector. In March of this year, Yi Gang, the governor of the People's Bank of China (PBOC), committed to the structural reform of interest rates, rather than further rate cuts, to support the slowing economy. Details were thin, yet his stated desire to increase competition in the banking sector and enforce price transparency was clearly aimed at improving credit access for small- and medium-size private firms, by effectively lowering borrowing costs.

Then, in May, the PBOC issued plans to reform its exchange-rate-formation mechanism. And as of June, owing to increased downward pressure on the renminbi, Yi appeared more open to allowing the renminbi's exchange rate against the US dollar to fall below seven-to-one. Here, the PBOC's stated policy objective has been to make the currency more responsive to market signals, rather than being subject to a simple administrative peg.

Even more significant is the Chinese authorities' decision to allow greater foreign participation in China's $45 trillion financial-services sector. In April 2018, regulators introduced timelines for allowing majority foreign ownership in Chinese securities companies and mutual funds, while unveiling similar policies for foreign insurance firms. Meanwhile, foreign ownership limits on banks were removed in August 2018, and foreign credit-rating agencies were granted full market access in January 2019, when S&P Global became the first wholly foreign-owned credit-rating agency to operate in China.

Foreigners have also been given greater access to Chinese equities markets. In February 2019, MSCI announced plans to increase the proportion of mainland

Chinese shares in its emerging-markets index by a factor of four, to a weighting of 3.3%. And amid great fanfare this past June, the London-Shanghai Stock Connect scheme was launched, giving foreign investors the opportunity to purchase shares in Chinese companies, and likewise providing Chinese investors the chance to purchase shares listed on the London Stock Exchange. Finally, the Bloomberg Barclays Global Aggregate index began including 364 Chinese fixed-income securities this April.

On the surface, this is an impressive train of developments. But one should be cautious when interpreting these announcements, as we have yet to see how China's regulatory machinery will adapt to the changes. For example, conversations I have had with fund managers feature stories of overwhelming bureaucratic red tape. Or consider JPMorgan's ambition to become the first foreign firm with majority ownership of an asset-management business in China. According to reports, its bid for a controlling stake in its own joint venture is marked up by 33% against an independent valuation because that is the minimum bid price permitted by Chinese authorities.

Clearly, policy announcements need to be weighed against foreign firms' actual ability to capitalize on them. After all, China's motive for making these changes is not philanthropic. Rather, China's authorities are driven by several clear policy objectives.

First, the government is trying to improve the Chinese financial system's efficiency in allocating credit, because the current system reaches, at best, only 50% of international benchmarks in terms of its effectiveness in wealth creation. Second, Chinese authorities want to spread out the current risks in the Chinese financial system. The recent high-profile public takeover of Baoshang, a privately held bank, highlights the risks that now suffuse the system, owing to uncontrolled lending.

What happened at Baoshang, moreover, does not appear to be an isolated case: a number of other small and medium-size banks are rumored to have been recapitalized in a quieter fashion. Moreover, there are additional risks stemming from shadow banks' surging reliance on short-term interbank lending.

A third factor underpinning China's financial reforms is the country's declining current-account surplus. China has consistently maintained an external surplus for around 25 years, but some analysts predict that a deficit is imminent, owing to rising domestic consumption, which is beginning to reverse a long trend of high household savings. And as the population ages, more people will be drawing on retirement reserves, leading to a further erosion of savings.

Of course, whether China will actually report a current-account deficit will depend largely on market prices of imported commodities. With a narrowing surplus comes the incentive to attract foreign capital to plug the gap, thereby strengthening reformers' argument for opening up the financial system further.

Further Lines of Defense

Beyond support for the private sector and financial-market liberalization, the Chinese have also re-embraced "institutional" economic reform in response to a slowing economy. This was explicitly announced by Xi himself at a Politburo meeting in April, which is also when the CPC leadership rejected the text of the draft trade agreement with the US.

Before Xi's announcement, China's senior leadership had not used the language of systemic economic reform for many years. Xi's statement was then reinforced in June by Liu, who candidly admitted that China was facing "some external pressures" that would "help us improve innovation and self-development, speed up reform and opening up, and push forward with high-quality growth." He also noted that these pressures were spurring the creation of stronger domestic capital markets and more innovative industrial supply chains, which are welcome trends in China's transition "from being big to being strong."

The political message from both Xi and Liu was clear: adverse external events are now driving China in the direction of more vigorous internal market reforms. Once again, however, we must wait for evidence that the systemic reform program first announced in 2013 is really back on the agenda.

As a fourth component of their response to the economic slowdown, the Chinese have begun to universalize trade, investment, and other economic reforms that they were previously offering just to the US in the trade negotiations. This was made clear most recently at the G20 summit in Osaka in late June, when Xi announced a range of reforms, including an updated "negative list" that permits foreign investment into the mining, manufacturing, services, and agriculture sectors.

Xi also announced plans to implement penalties for IP infringement as part of a new law on foreign investment in 2020. Premier Li Keqiang subsequently fleshed out the details of some of these plans at the World Economic Forum's meeting in Dalian this past July.

These general commitments to reform have been met with cautious optimism by the international business community, which has heard similar announcements from China's leaders before. It has long been assumed that whatever commitments China makes at the policy level can easily be undone at the administrative level. Or as the Chinese say of their own system, "Above there are policies; while below there are counter-policies."

China's fifth response to slowing growth is economic stimulus. In addition to cuts in the VAT and personal income taxes, this has taken the form of targeted packages to stimulate consumption, with a focus on electronics, communications, automobiles, and construction. There has also been fresh infrastructure investment, particularly in urban rail projects.

China's leadership has consistently voiced confidence in the country's ability to withstand the economic impact of the trade war. For example, ahead of the G20

summit in Osaka, Yi, of the PBOC, asserted that "the room for adjustment" in China's fiscal and monetary policy "is tremendous," and added that there is "plenty of room" in interest rates and in required reserve ratios.

Officially, then, the party's message is that the Chinese economy remains healthy, with no major risk to growth for the time being. Or, as Liu put it: "No matter what happens temporarily, China's long-term growth remains positive, which won't change." This is all code language for saying that China will do whatever it takes to keep the growth rate above 6%, even in the event of a prolonged trade war. If that means adding further to the budget deficit or increasing the debt-to-GDP ratio, so be it. China is confident that it has considerable flexibility at its disposal, since practically all its debt is domestically denominated and the domestic savings rate remains relatively high.

But there is still a problem. Despite the party's assurances to the contrary over the last six months, stimulus has become a consistently attractive alternative to substantive economic reform. In the end, overreliance on fiscal and monetary expansion could prove lethal to China's long-term economic trajectory.

The Great Decoupling

China's longstanding difficulties with private-sector business confidence have been compounded by uncertainties arising from the Sino-American trade and technology war and the growing debate about a wider decoupling of the US and Chinese economies. It has long been my view that there will be a trade agreement of some kind between the countries before the end of 2019. The reason is that both sides need a deal to stabilize their markets and economies going into the politically critical seasons that lie ahead – a presidential election year in the US, and the lead-up to the CPC centenary in China. Though there will be much debate about the intrinsic economic quality of any deal, there will nonetheless be a deal that both sides can live with politically.

But the end of the trade war is highly unlikely to bring about an end to the technology war. Despite Trump's ambiguous language at the G20 summit in Osaka, it appears that Huawei will remain blacklisted, along with at least five other Chinese entities. At the same time, China has announced its own list of "hostile" foreign firms, though it has yet to add any individual companies to it.

Beyond the trade and technology war, the sense in Beijing is that the US is preparing for a much broader economic decoupling. The next domain to be affected, at least in China's calculation, is e-commerce and digital payments and finance, which China increasingly dominates through Alipay, WeChat Pay, and UnionPay. After that, the US may move on to the finance sector in general, drawing on its formidable advantage as the issuer of the world's main reserve currency, and on the fact that US financial institutions remain globally dominant. Chinese leaders, watching what they regard as America's weaponization of the dollar and the international financial system through its use of secondary sanctions, are anticipating that it might deploy similar measures against China.

Finally, one must consider the unfolding consequences of unraveling global supply chains, as Chinese, US, and international firms seek to insulate themselves from tariffs, technology bans, and the longer-term possibility of financial sanctions. Companies – foreign and domestic – with supply chains linked to now-sensitive Chinese sectors have begun to relocate manufacturing facilities as a precautionary measure. Even if the trade and technology wars are resolved, these decisions are unlikely to be undone. Corporate decision-makers will continue to see significant geopolitical risks stemming from Sino-American relations.

Putting aside the long-term global consequences of various decoupling scenarios, the bottom line is that all the aforementioned factors – real or imagined – are affecting business confidence in China. As such, they represent yet another element of China's increasingly complex, near-term growth challenge.

As for the effectiveness of China's response to the slowdown, the economic data so far have been mixed. At 6.2%, second-quarter GDP growth slowed once again, after appearing to stabilize in the first quarter. A significant portion of this growth is believed to have been fueled by the recent economic stimulus – and thus remains dependent on policy support.

June's domestic consumption was up 9.8%, increasing from 8.6%, although this was largely driven by rebates pushing a surge in auto sales. Industrial production has been steady, although, again, economic stimulus has bolstered this. The official unemployment figure has dropped slightly to 3.67%.

According to one recent survey, almost half of Chinese exporters view the trade war as a permanent or long-term fixture of bilateral Sino-American relations. Worse, that sentiment, and its impact on business, has steadily strengthened over the past few months. Conversations with business owners in second- and third-tier cities indicate that a cloud of anxiety and uncertainty is hovering over China's private sector. Entrepreneurs still don't trust the central government, and many are sitting on their hands, foregoing new investment decisions. That is the situation now. A decisive non-resolution of the trade war could cause a full-scale washout in business confidence.

A Most Consequential Decision

China's political economy is thus at a crossroads, with party control running in one direction and the market in the other. These incompatible imperatives bear contradictory demands for sustained and systemic economic reform, on one hand, and a continuing recourse to stimulus, on the other. Over the past 40 years, the Chinese economy has become increasingly integrated into global supply chains, technology markets, and financial flows; now the country must worry about being gradually cut off from all these sources of growth if decoupling becomes a reality.

The question now is how Xi will respond. One possibility is that the internal pressures on China's growth, as well as the external pressures from trade, technology, and finance, will accelerate economic liberalization, in accordance with the 2013 blueprint. As part of this approach, China could also embark on an

ambitious program of international trade, investment, and capital-market liberalization.

This process could take many forms. Within Asia, China could use the planned Regional Comprehensive Economic Partnership (RCEP) – which, if it is signed in 2020, would comprise 16 Asia-Pacific economies – to deepen regional economic integration. The CPC leadership is also debating whether to seek membership in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), now that the US has withdrawn from that arrangement. And China is seeking to accelerate negotiations for a proposed Northeast Asia free-trade agreement with Japan and South Korea.

In Europe, the EU-China Comprehensive Agreement on Investment is likely to enter into force in 2020, and could be used by China to turbocharge its wider economic engagement with the 28 – soon to be 27 – EU member states. China views Europe as an important strategic economic partner, and not just because of the European economy's size and technological sophistication. The Chinese believe that Europe is not as energized by US security concerns in Asia as the US probably would like it to be.

Finally, on technology, in particular, China will likely pursue deeper engagement with Japan, Germany, and Israel, where it has already sought to become a significant investor. And in terms of global governance, it may try to become a substantive champion of the World Trade Organization and the global rules-based system it underpins, particularly now that the US is engaged in a systematic assault on the WTO.

There is, however, an alternate script: China could increasingly turn inward, toward even greater party control, economic self-reliance, and mercantilist practices abroad. If Chinese leaders conclude that the US has embraced a strategy of systematic economic decoupling, they may adopt a more radically conservative response, cracking down domestically on perceived hostile forces operating within.

In this case, China may seek to accelerate the expansion of domestic demand in the hope that higher consumption spending can offset some of the impact of a much more hostile international economic environment. And rather than open its markets more to the world, or even to the non-American world, China may try to expand its selective economic engagement with friendlier countries linked to its Belt and Road Initiative, where Chinese goods, services, and technology standards are more welcome.

A third and more likely response would comprise some untidy combination of these two approaches. Given China's uncertainty about the precise contours of America's own strategy – whether under Trump or a succeeding Democratic administration – and the additional uncertainty about whether US friends and allies will adopt the same approach, China's leaders may proceed more cautiously until the strategic landscape is clearer.

At any rate, China is now conducting an internal review of its strategy to assess how much its external circumstances have changed, and how it should respond. Xi's recent reported remarks are nonetheless telling. He has said internally that China should expect another "30 years of containment and provocation from the United States" – that is, until 2049.

As a recent McKinsey Global Institute report warned, not only has the world changed China over the last 40 years, but China has changed the world, through the sheer size of its economy, its impact on global consumer prices, and the significance of its markets. Whatever happens in the near term, the global strategic and economic landscape is undergoing a fundamental change. How China responds to its own domestic growth challenges and the real or perceived Sino-American decoupling is a matter that concerns us all.

This commentary has been adapted from the author's remarks at the Chatham House conference "China's Economic Future: Emerging Challenges at Home and Abroad."

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9 Commentaries

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