China's Reform Agenda

A victim of its own success.

BY CHI LO

Chinese leaders announced a sweeping reform blueprint in the so-called "Decision" policy document on November 15, 2013, after the Third Plenum of the 18th Central Committee of the Chinese Communist Party. From a strategic level, it indicates a turn to market-oriented policies for setting the future structural reform direction, including interest rate and currency liberalization, land reform, and changes in a wide range of economic, social, administrative, and judiciary issues. This has revived the world's expectation of China kick-starting another big wave of structural reforms and changing to a more responsible economic power in the future.

Optimists who are arguing for fast structural reforms, beware. If implemented quickly, the reforms prescribed by the Decision will destroy the system that has made China successful, causing unintended effects. Political reform is key to deepening structural changes. But any serious political reforms are implausible in the short term. So Chinese President Xi Jinping may be trying to strengthen Party control now in order to leverage on the current system to fight against vested interests and maximize his ability to impose economic reforms.

When fully implemented, these reforms will open up China's system for efficiency gains and significant foreign participation in its asset market. However, the blueprint is one

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Top Chinese leaders attend the third Plenary Session of the 18th Communist Party of China Central Committee in Beijing, November 12, 2013.

thing; implementation is quite another. The inherent reform obstacles that Beijing's senior leaders are facing—notably the monetary stake that vested interests have built in the system, the tight-knit patronage networks at the local levels, and the entrenched resistance to changes—have not been changed by the Decision. They remain a barrier that President Xi must overcome.

There is still hope for political reform, however. It lies in President Xi's second term in 2018, when five of the seven members in the Politburo's Standing Committee will retire and be replaced. Until then, it is unrealistic to expect Beijing to implement any "big bang" reforms.

BE CAREFUL WHAT YOU ASK FOR

Within the existing framework, there are some "low-hanging fruit" reforms that can be carried out more easily than those that are entrenched in the nerve center of the political and vested interests. Some players argue that the Decision marks a turning point for China to speed up structural reforms. The answer is not yet, perhaps, and they should be careful what they ask for. If those deep changes prescribed by the Decision were implemented as quickly as these players want, the Chinese system would not be able to withstand the shock as they would destroy the very system that has made China successful for over three decades.

Take financial liberalization, including capital account convertibility, for example. It is a process that many players said would be implemented swiftly. Its ultimate goal is to have market-driven interest rates to allow efficient capital allocation across borders. But to achieve this, Beijing will have to uproot its economic management model, which has been based on a closed financial system that has allowed it to keep interest rates low without having to worry about arbitrage and volatility of fund flows; to direct economic growth using policy discretion without having to worry about damaging bank asset quality; and to engage in bailouts without being concerned about capital flight and exchange rate volatility. These benefits are only possible with a closed capital account, which shields the domestic system from international market discipline and locks up local funds at home.

Fast structural reforms, if implemented quickly, will destroy the system that has made China successful.

Opening the capital account, say by 2015 as some players have opined, will change the game. Beijing would have to remove many of the domestic restrictions that have given it the power to "manage" the economy at will. It would have to integrate the domestic capital market into the world markets, which would undo state-directed banking practices. It also means that Beijing would have to conduct economic management under free capital flows, a task that it has not been exposed to before. Perhaps worst of all, these changes would have to come more or less at the same time, raising the risk of policy misstep and systemic chaos.

Hope in a Second Term?

There is still hope for political reform. It lies in President Xi's second term in 2018, when five of the seven members in the Politburo's Standing Committee will retire and be replaced.

—C. Lo

Xi Jinping

A VICTIM OF SUCCESS

These aren't the only issues. Changes without sufficient preparation will disrupt the real economy, risking derailing the reform plan. Consider this. Cheap labor, low-cost bank funding for infrastructure construction, and large-scale fiscal spending funded by land sales have all contributed to China's economic success. However, economic distortions have also emerged, labor and land costs are rising, cheap money is risking property bubbles, and marginal returns on investment are falling and creating overcapacity.

The blueprint is one thing; implementation is quite another.

In other words, China has fallen victim to its own economic success. The solution, as correctly prescribed by the Decision, is to shift China from export-induced investment-driven growth to domestic consumption-driven growth, from state-dominated production to private sector-driven production, from industry to services, and from government control to market mechanisms. These expenditure-switching moves are needed to revive economic vigor and generate sustainable growth.

However, rapid changes will clash with the vested interests, causing immense economic pain. The state companies will lose their subsidized land and loans and monopolistic power; the Party and state bureaucracies will lose power and rent-seeking opportunities. The local governments are especially desperate due to their rising debt burden and shrinking land revenues on the back of rising requirements to provide social services and city infrastructure. Urbanization suddenly does not sound like such a good idea to them. No wonder there is fierce resistance to change, and it will make implementation a long struggle.

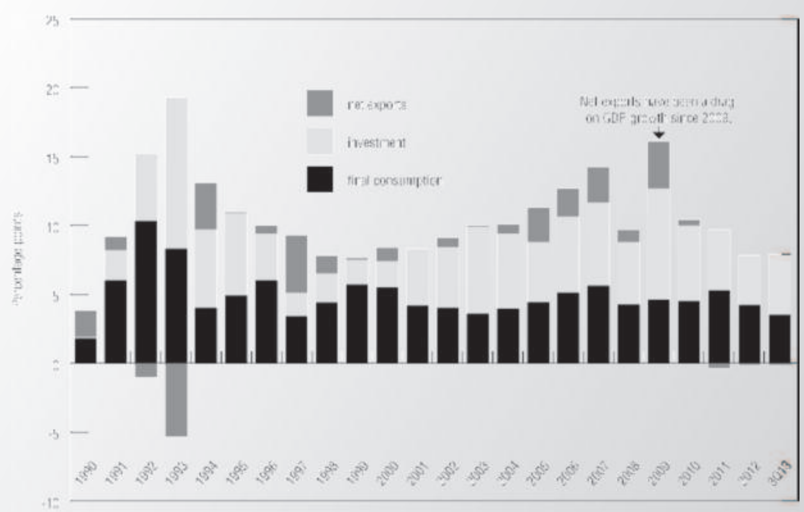
NOT STARTING FROM SCRATCH

The good news is that President Xi's administration has gotten off to a good start with an anti-corruption campaign that targets some of the powerful vested interest groups, thereby weakening their reform resistance. The economy has also started rebalancing, albeit so slowly that is not easily discernible.

The domestic sector has started to take over as an economic growth driver in recent years, with the share

Local governments are especially desperate.

China: Contributions to Real Growth



Sources: CEIC, BNPP IP Asia

of tertiary production in GDP doubling to over 40 percent for the past thirty years. Meanwhile, net exports have not contributed to growth since 2009 (see figure). Domestic income growth is rebalancing towards the inland from the east coast, and investment and industrialization are also migrating westward. All this is evidence of economic restructuring even before the Decision was announced.

These changing dynamics are essential for the eventual structural shift towards a consumption-driven economy. Urbanization follows industrialization because labor, and thus consumption, only moves to areas where jobs exist, and jobs are created where there is investment. The east-west migration of investment and industrialization are thus mega trends that will facilitate the structural shift toward consumption-driven growth over time.

GENUINE CHANGES WAITING IN THE WINGS

So President Xi is not building structural reforms from scratch. But he is facing a significant political risk of pushing reforms against fierce opposition when economic growth is slowing down structurally. While he knows that deep structural reforms need the support of political reform, the current balance of power makes any political changes implausible.

Hence, the president has, presumably, taken the route of economic reforms first and political changes later. By strengthening his control within the Party, through cracking down on corruption, government opponents, and critics in the media and even academia, he seeks to increase his ability to impose economic reforms while minimizing the risk of being challenged by the reactionary forces. By not clashing with the vested interests before his power base is solidified, Xi is trying to avoid giving his opponents the opportunity to build a critical mass of resistance. This alliance of resistance was what toppled previous reform-minded leaders Hu Yaobang and Zhao Ziyang before the Tiananmen incident, when they were seen as jeopardizing Party control.

Because of implementation difficulty, no completion timetables have been given out for most of the reforms outlined in the Decision. Political reforms in the short-term will be limited to reorganizing government agencies, cracking down on extravagant public spending, and fighting against corruption. Hopes for genuine political reforms to deepen and speed up structural changes rest in Xi's second term, when the five other members of the Politburo's Standing Committee apart from Xi and Premier Li Kequiang will retire and be replaced—hopefully by reformers. In the meantime, what is likely is another wave of "low-hanging fruit" economic reforms boosting market expectations. ◆

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