



# China

## AT THE

# Crossroads

**BY MARSHA  
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China's economic slowdown – three consecutive quarters of slowing expansion, with more forecast through the end of 2015 – has caught Beijing in a dilemma. Indeed, the below-target GDP growth is forcing the leadership to weigh the compatibility of policies for rekindling fast-paced expansion and the long list of institutional reforms that, just a few months ago, were widely seen as vital to keeping the maturing economy on track toward high-income status. At least on the surface, economic policymakers are opting for the former, declaring that growth and government-led development are now the priorities, even at the expense of delaying the structural reforms needed to support a huge and increasingly complex economy.



Xi Jinping, President of China and General Secretary of the Communist Party



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That choice is understandable. Without rapid growth, the tens of millions of unemployed and underemployed Chinese streaming into the country's megacities won't be able to find jobs, while the burgeoning middle class may fall victim to what development economists term the "middle-income trap." The catch – well, one catch, anyway – is that expansion may prove self-limiting if China remains dependent on export-led growth in an ever-more-competitive global manufacturing sector.

Some way, some day (preferably soon) China's economy must be rebalanced in ways that diversify output and put services in place as the lead driver. And that will require (among other things) more sophisticated regulation of an economy that now awkwardly mixes ebullient private markets with what might be called crony socialism.

In the meantime, a variety of developments suggest that despite the emerging preference for fast growth, China's leaders are trying to have it both ways. And this is giving legitimate hope to China's free-market champions, who want to believe that reforms will continue to be rolled out in parallel with efforts to juice up sagging demand.

### **JUGGLING AT THE APEX**

Recent pronouncements from the top underscore Beijing's focus on measures that arrest the growth slowdown. But reforms are clearly still on the table. Some are designed to rationalize fiscal management. Among them are a revised national budget law that makes budgeting more transparent; a broad-based

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value-added tax that replaces a hodgepodge of business taxes; and the refinancing of the massive debts of local governments that accumulated during the global financial crisis, when localities were ordered to pay for China's stimulus program. In the same vein, Beijing changed procedures to bring greater clarity to the relationship between central and local governments.

Moreover, the transition plan aimed at raising the growth rate is built for double duty. It anticipates the imperative for enhanced social-welfare programs in a better-balanced economy as well as the need for greater environmental protection and promotion of R&D to support China's move up the global pecking order of technology.

Commentary from the meetings of the National People's Congress on March 5, along with subsequent statements by the party leadership at the March 21-23 Economic Summit and annual China Development Forum in Beijing, supports the view that the government is hedging its bets. In his formal address to the nearly 3,000 delegates participating in the National People's Congress, Premier Li Keqiang affirmed that "reforms will be built around development and support of development rather than capital and financial market reform."

By the same token, Zhou Xiaochuan, head of the central bank, has not hidden his fear that domestic inflation was falling too fast. What's needed is to remain alert in the face of deflationary risks, he cautioned. And he acted on his view that the monetary authorities have considerable wiggle room to cut the banks' minimum reserve requirements in order to encourage lending.

Meanwhile, the deputy prime minister, Wang Yang, turned his sights on China's slowing trade growth, a crucial economic indicator for an export-led economy, calling on the government to act immediately to curb the



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downturn and prevent it from deteriorating into one continuous “speed loss.” (Something was lost in translation, but you get the point.)

The proceedings of the Economic Summit and subsequent China Development Forum, China’s highest-level meeting between foreigners (among them, me) and senior economic policymakers, provided a somewhat wider perspective on the leadership’s thinking. And while China’s policymakers’ public statements are always cautious, that doesn’t stop anybody from reading between the lines. Participants described China’s growing pains as

the “new normal,” a time when China’s increasing integration with the global economy makes it difficult to expand rapidly simply by increasing exports. “The government needs to change from being a strong government to being a smart government,” said Liu Shijin, vice president of the Development Research Council, the State Council’s research arm.

It’s all right if growth drops down to medium speed, explained Wu Jinglian, a widely respected China economist and DRC research fellow. The quality of growth, he suggested, was more important than the pace.



#### **TRANSLATIONS FROM THE CHINESE**

If all this still leaves you puzzled about what the leadership wants and expects to happen, that probably wouldn't bother them. This, after all, is a delicate moment in contemporary Chinese history, as the economy teeters on the edge of development and political power is being consolidated under Xi Jinping, the president and the Communist Party's general secretary. One must assume that it is an especially inauspicious time for officials to stick their heads out.

Also notable is what actually happened between November 2013 and now in the way of getting reforms into place – and what those reforms mean for the larger picture of China's economic success. Less than two years ago, China announced a bold commitment to letting Adam Smith's invisible hand replace the government's in guiding its economy. Many saw this as a commitment to liberalizing the financial sector and a step toward currency convertibility, market-determined interest

rates and more-liquid bond markets. Although there was no blueprint, the announced deadline was the end of this decade.

There are some who argue that this commitment remains intact, and they are supported by evidence that important reforms have been put into place, albeit at a deliberate pace. What appears different between then and now, however, is what lies at the heart of the current agenda to speed up growth, create enough jobs, meet demands for more equitable wealth distribution and keep public order.

One of the clearest explanations of both the quality and instance of the post-2013 reforms comes from outside the country. Barry Naughton, an economist who teaches in the Chinese Studies Program at the University of California, San Diego, divides reforms into three buckets: fiscal policy, property rights and foreign economic policy.

Fiscal policy reform spotlights the role of Lou Jiwei, the former head of the China Investment Corporation (China's sovereign wealth

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fund), who is now Xi's minister of finance. At the top of his agenda is a clever debt swap intended to help local governments ease the crushing debt they amassed as a result of the four trillion renminbi (about \$650 billion) stimulus in 2008-09 and a hyper-active housing market. The debt-swap plan provides local governments with a vehicle for issuing municipal bonds in the interbank market and then applying the proceeds to repay maturing debt over the course of this year.

The plan is labeled an interim liquidity measure and carries an implicit 1 trillion renminbi (about \$160 billion) subsidy. It will be helpful – but probably only modestly helpful, given the outsized debts that local governments now carry and the dearth of revenue generated by the infrastructure built with the borrowed funds.

Still, the swap plan is an important step toward putting local governments on a sounder fiscal footing and ultimately to positioning them as engines of growth and job creation. Moreover, the regulations governing the swap are expected to lend greater clarity to the divisions of responsibility between the two levels of government, and, with that, more effective central government oversight.

The second bucket of reforms is designed to clarify and defend farmers' property rights, which could become the prototype for a country-wide restructuring of the agricultural sector that increases productivity and growth. The reforms protect farmers against the uncompensated loss of property to developers

who, often in collusion with local governments, amass land for future construction projects. There will now be clear laws governing the rental of land and its use as loan collateral.

And none too soon, writes Naughton. He argues that "institutions must catch up with the changed rural reality, notably mass migration from China's rural to urban areas, and this new policy creates space for compromise and facilitates a consensus in support of the measure among urban elites."

The third bucket includes a series of initiatives designed to lengthen China's economic reach abroad (notably in Asia), to increase access to foreign capital and to employ global markets to help rebalance the domestic economy. Xi has been signaling his intentions on this front for some time. Last November's meeting of the Asia Pacific Economic Summit in Beijing featured his unveiling of China's plan to organize a multilateral credit facility, the Asia Infrastructure Investment Bank, and to invite some 30 countries to join as founding members. The initiative, opposed in part by the Obama administration because it could undermine efforts to set high standards for environmental impact on infrastructure loans, was applauded by potential recipients for the same reasons.

The announcement received scant international attention at the time, but ultimately contributed to catapulting Xi and China's economic diplomacy onto a wider international stage. Xi, by the way, has certainly won the first round in this contest with the United

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States: Australia, as well as South Korea and most EU countries, has signed on. (So far, Japan has not made a decision.)

But the infrastructure bank is only a part of the story. China has negotiated a new trade agreement with Australia that includes most-favored-nation status for Australia, and a similar agreement is in the offing with South Korea. An even-more-groundbreaking initiative involves the loosening of currency restrictions. That initiative, the Shanghai Free Trade Zone, which has long been in the planning stages, represents a major experiment in allowing the use of China's currency in international transactions without direct regulation.

During the early stages of the Shanghai Free Trade Zone's development, the port city of Tianjin was awarded the right to establish a similar zone focused on expanding trade and commercial relations with South Korea, which is just a few hundred miles away across the East China Sea. Other free-trade zones receiving approvals include a site in Guangdong province, the industrial heartland of southern China, which is intended to expand the region's already booming commerce with Hong Kong, and yet another in Fujian province, to build on its proximity to Taiwan.

Complementing the free-trade zones, China is dipping another toe in the waters of global securities trading. The Shanghai-Hong Kong Connect (soon to be joined by the Shenzhen-Hong Kong Connect) is a platform that allows investors on both sides of the China/Hong Kong border to trade stocks via registries in each of the respective markets. Buyers and sellers on the China side pay in renminbi, while their counterparts in Hong Kong settle transactions in Hong Kong dollars. The Connect platform also gives foreigners, including big institutional funds, access to so-called A-Market securities – shares in Chinese compa-

nies (many of them state-owned-enterprises in transition) that before November 2014 were only available to Chinese nationals and pre-approved foreign investors.

These experiments, it should be noted, may presage the breakthrough reform of allowing China's currency to be freely exchanged for others, and potentially giving the renminbi global reserve-currency status alongside the dollar and the euro. This shift, urged for years by China's big trade partners and foreign investors, would open the spigot for the foreign cash needed to modernize the nation's sluggish state-owned enterprises. A market-determined exchange rate would likely also signal the end of near-total dependence on manufacturing-export fueled growth – one crucial step in avoiding the much-feared middle-income trap.

Notable, too, is China's more recent announcement that it was about to implement an FDIC-like deposit insurance plan. But if the announcement's real significance turns out to represent a resolution of the long-standing debate about the effects and therefore the pace of capital-market reform, it also raises the more immediate question about the government's role in an economy that is increasingly driven by market forces.

The official response to China's dilemma – government-directed growth, reforms based on markets as drivers, or something in between – depends on Xi, who has amassed more power than any Chinese leader since Mao Zedong. Xi's authority, grounded on his hard-hitting drive against corruption in high places, has made him extremely popular. (He is affectionately referred to as Papa Xi.) But it is also raising questions about Xi's views on economic reform.

Early on, it was widely believed that the anticorruption drive's popularity would add to the president's political capital, allowing him





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to override the objections of special interests who were unhappy about reforms, especially those involving state-owned conglomerates. But some observers are now asking whether the investigations are being used to rationalize a slowdown in reform efforts, thereby giving Xi more flexibility in agenda-setting.

Either way, remarks attributed to Wang Qishan, a Politburo member and secretary of the nightmarishly named Central Commission for Discipline Inspection of the Communist Party, are apt: the anticorruption struggle is a “battle that cannot afford to be lost.”

Xi's core long-term goal, it is widely believed, is to sustain market-driven economic growth without opening the door to challenges to the Communist Party's monopoly on political power. Anticorruption efforts help to achieve this goal by allowing markets

to work more efficiently, even as they increase the political legitimacy of the party as the defender of the general welfare. But these efforts also have the potential to disrupt the symbiotic relationship between China's capitalists and their regulators. Indeed, it once again raises the question of whether authoritarian rule is fundamentally incompatible with the workings of a diversified, highly productive market economy.

We may soon know a lot more about Xi's reform inclinations. This year marks the conclusion of the 12th Five-Year Plan, which means Xi will need to come forward with the first Five-Year Plan of his own devising. It is this document that typically showcases the leadership's thinking about the economy. Thus, for Xi – and for China – this moment may be critical.

