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Xi's Real Test: Delivering on Reform and Maintaining Stability in 2014

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Germany and Asia
Building Bridges – Promoting Progress

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Emerging signs of economic difficulties have greatly compounded the tasks facing new Chinese leader Xi Jinping in the year of horse. After his government rolled out a surprisingly ambitious blueprint for systemic economic reform in November last year, Xi, the general secretary of the Chinese Communist Party (CCP), now finds his agenda complicated by the urgent need to stabilize the overleveraged financial sector while taking the first steps to implement enough of his promised reforms to gain credibility.

To the credit of his government, some of the reforms that are highly popular and face weak opposition have already been carried out. For instance, the modest relaxation of the draconian one-child policy has taken place. All of China's provinces have announced their timelines for allowing couples to have a second child if one of them is a single child. In a symbolic move of deregulation, China's Securities Regulatory Commission (CSRC) has lifted its ban on new stock market listings and several private companies were able to float their shares.

However, many of the more critical reforms still await. Although these reforms will affect different sectors, they share some common characteristics, such as the need for legislative action, detailed formulation, additional fiscal spending by the Central Government, and strong political opposition. Xi and his colleagues will need to overcome these obstacles soon, ideally during the upcoming National People's Congress (NPC) in mid-March, in order to maintain the momentum for reform.

Three Major Reforms to Watch

Of the reforms that will potentially have a significant positive impact on improving the livelihood of hundreds of millions of rural residents, the proposal to allow farmers to realize some cash income from their rights in leased farm land has become the litmus test of whether Xi's leadership team can actually deliver on his promised reforms. Indeed, if carried out, land reform would be the most radical rural change since the dismantling of collective agriculture thirty years ago. However, opposition runs strong

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Figure 1: Key Reform Measures and Their Prospects

Proposed Reform	Content	Status	Outlook
Land Reform	Giving farmers the ability to mortgage their land leases to obtain loans	Disagreements among various government departments. No specific measures announced.	Requires constitutional amendments and major legislative actions. No progress anticipated in the near term.
Hukou Reform	Giving 200 million rural migrants working in cities free access to public services	About 70 million will receive their urban residency rights, but no solution reached on funding expanded public services	Requires long-term fiscal reform to finance local governments' new expenditures. Uncertain near-term prospects
Deregulation	Abolishing most government approval of economic activities through "negative lists."	No specific actions yet. Intense discussion inside the government on the content of "negative lists."	Various regions may produce different negative lists. Uncertain as to the enforcement process.
Relaxing One-Child Policy	Allowing couples a second child if one of them is a single-child	Full implementation in 2014	2 million more children are likely to be born each year.

Source: Minxin Pei

in the Chinese bureaucracy. Conservatives see a major concession on full state ownership and control of land as a dangerous move that undermines the power of the state. Local government officials worry that, by granting more property rights to farmers, they would lose their ability to requisition land for lucrative commercial development and lose considerable revenues in the future.

Technically, this complex reform requires amending the constitution and passing relevant laws so that farmers' newly gained rights will be legally protected and procedures can be developed to mortgage farmers' land leasing rights. Senior Chinese leaders have remained silent on the issue of land reform since last November (a telltale sign that the proposed reform is stalled). One indicator of the Xi government's commitment to this reform is whether it succeeds in passing legislation related to land reform in the NPC's upcoming annual session.

Implementing *hukou* reform would be another test of Xi's ability to push his agenda forward. The Chinese *hukou* system, which effectively denies rural residents equal citizenship rights and access to publicly funded social services in urban areas (such as education and health insurance), is an obstacle to labor and social mobility. It is also a major cause of rural-urban disparities.

Reforming the *hukou* system can deliver many benefits. In the short-term, it will effectively raise the income of rural migrants working in the cities (by giving them access to free or subsidized social services). In the long run, the reform will contribute to a reduction in inequality and a consumption-based economy.

The Chinese government has announced a three-step strategy to allow roughly 200 million migrants from rural areas to obtain urban residency rights in the coming years. According to this plan, rural migrants now working in towns and small cities (with population of 500,000 and under) will be granted full residency rights immediately. Urban residency rights will gradually be given to those living in mid-sized cities (with population between half a million to two million). Migrants in large cities (population over two million) will gain similar rights only after the impact of such reform is carefully studied.

Although this reform is more modest than it sounds, taking even the initial step could enable 70 – 80 million rural migrants now working in towns and small cities to receive valuable public services. The uncertainty at the moment comes from two sources. First, most local governments have not announced specific implementation rules or timetables for carrying out the first step. Second, the central government has not committed itself to paying for the costs of the reform (perhaps that is why few local governments have announced a timetable for reform). Since local governments, which have a narrow tax base (they collect only 40 percent of the taxes but are responsible for 80 percent of the total public spending) have no means to fund the additional services, Beijing will need to increase fiscal transfers to motivate local governments to implement the *hukou* reform as quickly as possible.

The third test of the Xi government's ability to force through change is deregulation. The CCP's reform plan set forth a bold plan for radical deregulation that, if implemented, would eliminate many, if not most, unnecessary bureaucratic approvals currently needed for starting businesses or making investments. One key provision of the deregulation reform is the idea of a "negative list" – a public list of commercial activities explicitly prohibited by the government. Activities not on the list will require no official approval.

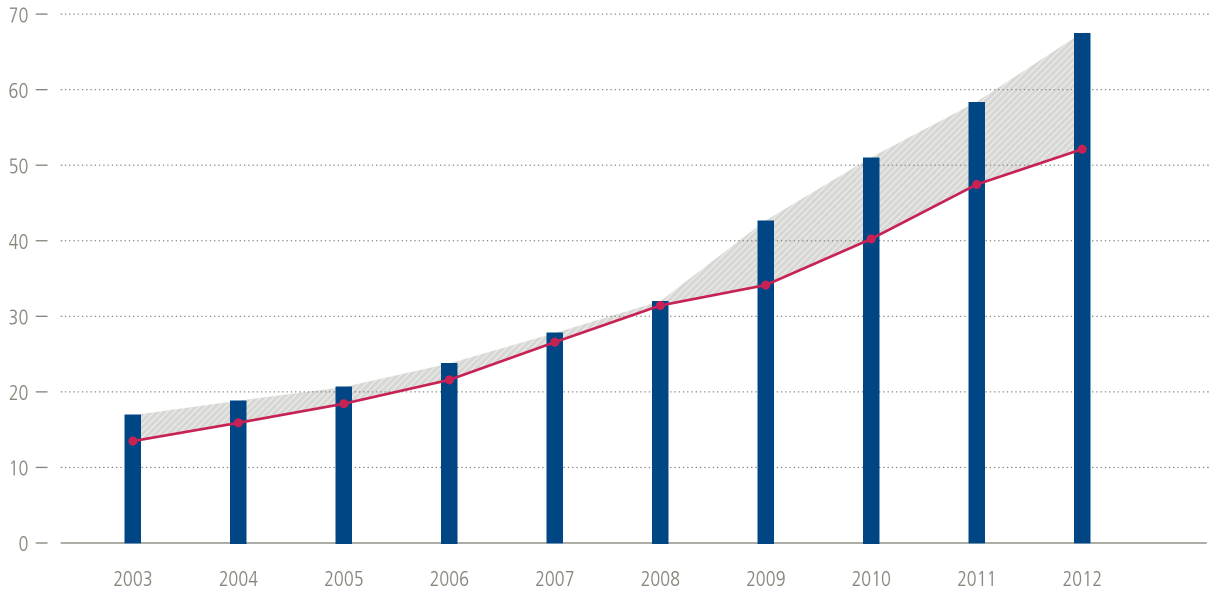
Evidently, such deregulation would free up enormous pent-up entrepreneurial energy in Chinese society. However, so far nothing of note has occurred on the deregulation front. The opposition from the Chinese bureaucracy is expected to be fierce because deregulation will reduce the power of many officials, who have traditionally used their approval authority to extract bribes. Another potential obstacle to deregulation is enforcement. Private entrepreneurs should be able to seek judicial relief when they encounter obstructionist bureaucrats who illegally interfere in their commercial activities. To instill confidence in Chinese private entrepreneurs, Xi and his colleagues must issue "negative lists" in most sectors soon and specify procedures that can help private entrepreneurs fight the bureaucracy.

Unholy Trinity: Financial Stability, Growth, and Reform

If one thinks these structural reforms are hard enough, they are, in all likelihood, not the most pressing concerns on the minds of top Chinese leaders. Reality has an unpleasant habit of intruding on even the best-laid plans. In the Chinese case, Xi has the bad of luck of attempting the most challenging reforms when the most critical danger facing the Chinese economy is not long-term stagnation but a near-term financial crisis.

Indeed, worries that China could experience a financial sector meltdown have preoccupied the global business community. Such concerns have arisen mainly because of rapid credit growth in China since 2008. In response to the global financial crisis, the Chinese government unleashed a tidal wave of bank loans to support growth. Altogether, roughly $15 trillion in bank loans (nearly 200 percent of GDP) have been extended during this period. On average, loan growth averaged nearly 20 percent a year, more than double the GDP growth, in the last five years. Consequently, total debt to GDP now is estimated to be between 210 – 230 percent. Although the overall debt

Figure 2: Loans granted by banks in China from 2003 to 2012 in relation to GDP (in trillion yuan).



Sources: People's Bank of China, Xinhua

level in China is lower than in developed economies, it is the highest among emerging market economies.

What makes the Chinese situation unique and more worrisome is the breakdown of the debt. Sovereign debt level is relatively low, with explicit sovereign debt at 25 percent of GDP. Private consumer debt is similarly low, at around 20 percent of GDP. At the same time, local governments have seen their debt rise to about 20 – 25 percent of GDP. Chinese companies, both State-Owned Enterprises (SOEs) and private companies, have also piled up debt comparable to 145 – 160 percent of GDP (in most developing countries, corporate debt average between 40 – 70 percent of GDP).

Two facets of China's financial sector raise red flags about its stability. One is the rapidity of debt growth. The history of financial crisis shows that no country has avoided a banking crisis if credit grows at the pace recorded in China since 2008. The other salient feature is the poor repayment ability of the two largest groups of borrowers in China – local governments and Chinese companies. The narrow tax base of local governments generates little cash flow to service their debt. To make matters worse, much of the new debt borrowed by Chinese local governments appears to have gone into projects with dubious future returns (such as superfluous prestige infrastructure projects).

Among Chinese corporate borrowers, SOEs have engaged in reckless expansion, building new plants, speculating in real estate, and acquiring overseas assets at sky-high prices. Such expansion has resulted in excess capacity in most manufacturing industries (the average capacity utilization in steel, aluminum, copper, cement, and auto in China is about 70 percent). Private businesses, mostly real estate developers and mining companies, have loaded up on debt since 2008 to ride the property and commodities boom. As a result, they have constructed tens of millions of housing units that now sit empty or built unprofitable mines.

To be sure, the massive injection of credit enabled China to fund its fixed-asset investment (chiefly infrastructure) and maintain high growth during 2009 – 2013. But debt-fueled growth is not only risky but also ultimately unsustainable. Fitch Ratings, a credit rating agency, projected that, based on the experience of the last five years, China's debt will be 280 of GDP in 2017 and annual interest payment alone will exceed 20 percent of GDP.

Perhaps aware of the unsustainability of the trajectory of debt growth, the Chinese government, in particular the People's Bank of China (the central bank), has begun to tighten credit and reduce liquidity. But their initial efforts have produced no visible impact. While measures to curb loan growth through the (formal) banking sector are usually implemented more or less effectively (due to the strict loan quota system), borrowers can evade such curbs by tapping into the fast-growing shadow banking system – a network of trust companies, investment funds, credit brokers, and the bond market. Estimates place the size of the shadow banking sector, which was negligible before 2008, at roughly $5 – 6 trillion, or 30 percent of the entire financial system.

Because there is significant leakage from the formal banking system into the shadow banking system (much of the credit created through the shadow banking system is actually funded by deposits in state-owned banks), any attempt by Chinese monetary authorities to tighten credit will instantly freeze up the shadow banking sector, sending inter-bank lending rates through the roof. In June 2013, the central bank attempted to rein in the shadow banking sector and reduced liquidity. Within days China's interbank lending rates rose to double digits. Many desperate borrowers faced imminent default. This dire prospect forced Chinese policymakers to beat a hasty retreat. In December last year, the central bank tried again to send a message to the participants in the shadow banking sector by reducing liquidity. Again, interest rates shot up, and the central bank had to abandon its tightening attempt.

It appears that no task is more complex and delicate than guiding the Chinese financial system to a soft landing. The Xi government has to balance three competing objectives in 2014. The first objective is to stabilize the financial sector. The second objective is to maintain growth at a decent level (the new prime minister, Li Keqian, has said that 7 percent of GDP growth is needed to support employment). The third objective is implement structural reform. Obviously, these objectives are in conflict with each other. Maintaining financial sector stability will require reduction in credit growth, a step that will almost certainly dampen GDP growth. Forcing through some structural reforms (by raising the prices of natural resources, reducing subsidies to SOEs, and moving away from investment-led growth) will also likely hurt growth and even precipitate a financial crisis if zombie companies are pushed into bankruptcy. But if the Xi government values growth above long-term financial stability and sustainability and keeps loan growth at 20 percent, they may hit their target of 7 – 7.5 percent for 2014 (so far Beijing has not announced an official target), but such a course will dim the prospects of structural reform and raise the frightening specter of a full-blown financial crisis in the next four to five years.

Fighting a Two-Front Political War

For all the intractable economic challenges facing him, Xi has one advantage denied his predecessors: unrivaled personal authority since the passing of Deng Xiaoping

17 years ago. Since he ascended to the top position in November 2012, Xi has quickly asserted his institutional power as the head of the CCP and the commander-in-chief and largely broken the mode of collective leadership that has governed China since the end of the Deng era. Since the end of the CCP plenum last November, Xi has acquired additional power. He has been appointed the chairman of the newly established National Security Committee and the head of the Central Leading Group on Economic Reform.

Evidently, amassing power improves Xi's chances of pushing through tough reforms. But so far, Xi has exercised his personal authority in a way that has raised questions about the direction in which he is leading China.

Judging by the most consequential actions Xi has taken since November 2012, he seems to be following the example of the late Soviet leader Yuri Andropov. On the one hand, Xi has launched the most sweeping and sustained anti-corruption drive in recent memory. Dozens of senior officials have been arrested, and nearly 182,000 party members were punished in 2013. On the other hand, his government has also engineered the harshest crackdown on dissent and free speech. Several civic activists, including Mr. Xu Zhiyong, a well-known human rights lawyer, have been arrested and sentenced to jail terms. Outspoken academics were fired from universities. China's social media, once a vibrant arena for airing complaints against corruption and official misdeeds, has been tamed through an unrelenting campaign of censorship.

On the surface, Xi's political strategy of fighting a two-front war makes sense. By cracking down on corruption, Xi seeks to reassure the Chinese people that they can count on his personal authority to cleanse a government that has come to be identified with privilege and crony capitalism. If his anti-corruption campaign succeeds, it can gain Xi popular support and improve governance. By implication, such success will make genuine democratic reform unnecessary. At the same time, Xi also wants to demonstrate to the CCP that he will not allow pro-democracy forces to undermine the party's rule. Xi's personal authority is contingent upon the party's confidence in his intentions and ability to defend its political monopoly. And such confidence can be maintained only if Xi continues to adhere to a conservative political strategy.

However, this strategy has its pitfalls. Xi's delicate balancing act – fighting corruption and tightening control simultaneously – is hard to maintain for an extended time. At the moment, Xi seems to be relying mostly on his personal authority and a top-down approach to fight corruption. His anti-graft campaign is marked by unprecedented intensity. However, intense campaigns are by nature unsustainable. They require the bureaucracy to do little else except carrying out the top leadership's wishes. Inevitably, such campaigns lose steam as top leadership has other priorities and the bureaucracy finds itself exhausted. Worse still, a sustained anti-corruption campaign could undermine leadership unity if it snares officials with close ties to senior leaders. If pursued with full commitment, a war on corruption will likely cause a paralysis in government activities. Corrupt activities are the proverbial grease that oils the machinery of the Chinese bureaucracy. Much official business is conducted in secluded private dining rooms in high-end restaurants. Gifts and bribes are expected simply to set up meetings with officials, who normally have little incentive to grant approval to anyone if they themselves cannot benefit personally from exercising the power of their office. As a result, an extended campaign against corruption will probably undermine Xi's most important power base – the party and the bureaucracy.

At the same time, tightening political control can risk a societal backlash. Moderates in Chinese society who hoped that the Xi administration would pursue limited liberalization could become disillusioned and radicalized. Re-imposing ideological restrictions reminiscent of the Maoist era could alienate a society that has become accustomed to expanding civic rights. A conservative political strategy also works against Xi's declared goal of improving governance because greater press censorship and political repression will stifle public opinion and make officials less accountable. In the worst case scenario, a majority of the public may lose hope in Xi as a true reformer.

Concluding Thoughts

The Xi government has embarked on an ambitious but high-risk strategy full of internal contradictions. At the moment, there are no signs that Xi and his colleagues have recognized these contradictions, let alone adjusted their policies to resolve them. At the heart of these contradictions is the conflict between the imperative to maintain the long-term survival of the CCP and the very reforms needed to revive Chinese economic growth and public confidence that are likely to endanger the party's hold on power. More specifically, the economic reform strategy Xi has unveiled is crucial to rebalancing the Chinese economy and increasing its efficiency. To be successfully implemented, this strategy requires a significant reduction of the power of the Chinese state and a dramatic empowerment of Chinese society. Clearly, this political outcome, a prerequisite of a market-based economy, could undermine the foundations of a one-party state. Tactically, the effective implementation of this strategy will require mobilization of societal forces to generate political pressure on interest groups currently embedded in the Chinese party-state. Apparently aware of the danger of appealing to the people for their support, Mr. Xi has so far opted for an entirely different course: centralizing power and relying on his personal authority to push reform.

Thus, Xi's long-term political prospects critically depend on his ability to manage the internal contradictions of his strategy. He will face his greatest test in 2017, when the CCP picks his successor. If Xi's strategy has delivered desired results by then, he will have accumulated enough political capital to nominate his own successor, a privilege denied his two predecessors.

At the moment, Xi's strategy faces two near-term challenges. Economically, his government must balance the competing goals of maintaining growth and achieving a soft landing of the over-leveraged financial system. Politically, he may have to stop waging a two-front war simultaneously. Confronting the economic challenge may be hard enough, but modifying his political strategy is even harder. The perception that he is the strongest leader since Deng Xiaoping may, counter-intuitively, work against Xi's long-term political interests. In a one-party state, political capital must be acquired and replenished continuously. Personal authority is often ephemeral. Political loyalty within the regime is practically non-existent. As someone who wants to emulate the late Deng, it is worth noting that Deng was a master coalition-builder and took care to cultivate major social groups for support. In the early days of his reform, he enlisted the intelligentsia in discrediting a moribund Maoist ideology, mobilized the peasantry in dismantling collective agriculture, and supported private entrepreneurs in reviving capitalism. The biggest missing piece in Xi's reform agenda is the role of China's dynamic and vibrant civil society. As the above analysis shows, Xi's real – and dependable – political allies are the progressive forces in Chinese society, not the apparatchiks whose interests and survival are the ultimate victims of the reforms announced by Xi's government – if such reforms ever succeed.

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Further reading:

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