

4. China's Political Economy into 2020: Pressures on Growth, Pressures on Reform

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Chinese President Xi Jinping applauds during the 40th anniversary of China's reform and opening-up at the Great Hall of the People in Beijing, China. Xie Huanchi. Xinhua. Getty Images. 2018.

TO UNDERSTAND WHERE CHINA'S ECONOMY IS HEADED IN THE 18 MONTHS AHEAD, leading up to the centennial of the Chinese Communist Party in 2021, it is important to understand the wider context in which China's current debates on the future of its political economy have been conducted in the period since Xi Jinping became China's paramount leader in 2012.

The year 2021 is the first weigh station for the Party and the country to evaluate progress in the realization of Xi Jinping's "China Dream." Xi promised in 2013 that by the centennial of the Party's founding, China will have eliminated poverty and achieved "moderate prosperity," usually interpreted in the official Chinese literature as middle-income status.

Whatever the actual numbers might be, let's be clear that the Party will proclaim that China has passed both these tests with flying colors. That is because it is central to Xi Jinping's legitimacy that China do so. But the truth is that the 2021 target does apply additional pressures in the meantime on China's economic managers not to allow the country's growth rate to slow too much, whatever the downside factors may be, either foreign or domestic.

There has been much discussion of why President Trump needs to bed down the U.S.-China trade war, as well as have accommodating monetary policy settings, to support his reelection campaign in 2020 with as robust an American economy as possible. But President Xi also faces his own reelection challenge at the 20th Party Congress in 2022, the year following the Party's centennial celebrations, where, despite constitutional change abolishing term limits for the Chinese presidency, he, too, will face political pressures of his own.

The most important of these pressures will be his government's ability to sustain economic growth above 6 percent in order to guarantee continuing increases in living standards and to avoid unemployment. To stumble on the economy, particularly at this most critical of political junctures, would be deeply problematic for Xi Jinping, and, indeed, potentially destabilizing.

The Enduring Dilemma of China's Political Economy

Against this background, my argument is that China is now at a crossroads in the history of its post-1978 political economy.

In part, this has to do with the U.S.-China trade war, together with the risk of a wider economic decoupling between the two countries, which is bringing new pressures to bear on China's domestic economic policy debate.

In part, however, and perhaps in larger part, it has to do with the type of China that Xi Jinping wants for the future, and how much he is prepared to allow market forces to shape that future at the cost of absolute Party control—in particular, the future role of private firms.

For China's post-Mao leadership, the central and continuing dilemma, or what the Party would describe as its "dialectic," has been there since the beginning. This is the tension within a Marxist-Leninist party, between a deep predilection for political control, on the one hand, and the need for a successful economy which increasingly must yield to the disciplines of a free market, on the other.

Indeed, for the Party to succeed in its national mission, it must achieve two fundamental economic objectives: first, to generate sufficient growth, increased living standards and employment opportunities to entrench the Party's long-term legitimacy in the eyes of its people, and second, through that growth, to enhance China's national economic capacity to enable the Chinese state to defend its core interests and increase its global power, influence, and international standing. Neither of these is possible without a fully functioning market economy. And virtually every single Chinese economist knows it.

The implementation of market economic reforms, therefore, has always been an uncomfortable process for the Chinese Communist Party.

That is because it has usually meant a relative loss of political control, as the Party's ideological apparatus has had to yield the political ground to a growing phalanx of professional economic and financial technocrats spawned across the various agencies of the Chinese state. Just as China's lumbering, Leviathan-like state-owned enterprises (SOEs) have had to yield market share to an army of nimble, entrepreneurial private firms. And, perhaps most critically of all, the Party has had to contend with the freer flow of information, ideas, and people as China has opened its economy to the world.

Over the first 35 years of the reform process, implementation, while uneven, has nonetheless produced spectacular economic results with which the world is now deeply familiar. It has also, however, produced a number of significant financial and economic vulnerabilities, of which the inefficiency and indebtedness of China's financial system has perhaps been the most problematic. This has occurred together with a Party that, until the rise of Xi Jinping, had become deeply, perhaps terminally, corrupt.

Nonetheless, the trend line was relatively clear, with an increasingly open economy producing a new generation of private firms at scale, gradually dominating the domestic market, and led by companies like Alibaba, beginning to take on the world.

The Economy under Xi Jinping

With Xi Jinping, the political economy compact between the Party and the market began to be rewritten. Once again, the process has been uneven, but the trend line has been observably different from what we have seen before. Driven by a range of ideological, political, and economic factors arising from China's stock market crash of 2015, the core organizing principle under Xi Jinping has been the reassertion of the centrality of the Party.

Over the last seven years since Xi's emergence as paramount leader in 2012, this process has gone through three complex and largely unplanned phases.

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The first phase, from 2012 to 2015, was marked by two core decisions. The first was launching the anticorruption campaign in 2013. This was the biggest in the Party's 100-year history and resulted in the incarceration and disciplining of hundreds of thousands of Party members, accompanied by the purge of Xi's principal political opponents.

The other was the Party's adoption of "The Decision" on the implementation of the next phase of China's economic reform program, defined as China's "new economic model." After ferocious internal debate, the market was, for the first time, explicitly nominated as the central organizing principle for the allocation of resources in the economy.

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The new model sought to accelerate the role of domestic consumption as the principal new engine of economic growth, driven almost exclusively by a rapidly expanding private sector, particularly in the services sector, and a more limited role for SOEs restricted to a defined list of critical industries, all tempered by new principles of environmental sustainability.

The 2013 "Decision" was accompanied by a detailed blueprint of 66 specific reforms across the entire economy. It was seen as Xi Jinping's answer to what had generally been called the "10 wasted years of economic reform" under his predecessors, Hu Jintao and Wen Jiabao.

The overall political and economic model that seemed to be emerging at the time was a Party strengthened though the restoration of its moral integrity but fully in sync with a bold program of next generation economic reform.

All this changed with the Chinese financial crisis of 2015, which marks the beginning of the second phase in China's unfolding political and economic debate in the Xi Jinping period. This was not just a crisis in the Chinese equities markets, as the authorities struggled with managing a stock market bubble driven by excessive liquidity and financially illiterate investors who saw investing in shares as the next best thing to the gambling tables in Macao. It also became a wider financial crisis given the proliferation of margin lending practices as consumers borrowed heavily from financial institutions to make investments in what was seen then as a permanently booming economy.

Both state and private institutions were directed, as part of what became known as the "national team," to invest heavily to try to stabilize the market, although this resulted in even further losses. Markets were finally stabilized at much lower prices early in 2016. But the damage had been done—the Shanghai

Composite Index collapsed 32 percent in less than three weeks in July 2015. At its 2015 high, market capitalization was \$10 trillion. By September 2018, it was still only half this high, at \$5.73 trillion.

The more important impact of these events during the second half of 2015 was to enrage the central leadership as millions of citizens lost their savings and blamed the Party and the government. As a result, the political appetite for the implementation of further broad-based market reforms, not just those in finance, was dulled considerably. A major casualty was the 2013 blueprint as the pace of reform ground to a virtual halt. Tight capital controls were implemented to prevent capital flight, which also made it more difficult for Chinese firms to expand abroad. Meanwhile, concern over China's debt-to-GDP ratio spiked, driven by a largely unregulated shadow banking sector and ballooning local government debt.

The strong regulatory clampdown on shadow lenders that followed, including a large-scale deleveraging campaign, had a suffocating effect on China's private firms. This was despite the fact that by this time, these firms had become the crucial, almost exclusive driver of economic growth.

Conversely, bloated and unproductive SOEs were given favorable access to credit, easing the impact of the broader deleveraging campaign on them, usually at the expense of the private sector. Indeed, many troubled private firms were either bought up by the state sector, in whole or in part, or went bust.

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The Party's Policy Response to Slowing Growth

The third phase in the evolution of Xi Jinping's political economy began to emerge in late 2018, after the Party center finally realized the extent of the radical slowing in Chinese growth numbers during the course of that year, driven by faltering private sector business confidence and growth. This was well before any actual or perceived effect from the trade war with the United States began to be felt.

There were many reasons for declining private sector business investment beyond the blunt and brutal impact of the post 2015 deleveraging campaign. These included:

- the Communist Party's unclear policy signals on how big major private firms should be allowed to grow;
- the increased status of Party secretaries within the management of private firms; and
- the ongoing vagaries of China's legal system, which, when paired with the anticorruption campaign, caused increasing angst among Chinese entrepreneurs for their personal futures.

In response to this growing crisis in private sector growth, the Chinese Party launched a fivefold response.

Reembrace the Private Sector

The Party's first policy response has been to politically reembrace the private sector. This was outlined by Xi Jinping in a major speech in November 2018, when he stated that "private firms are an essential part of our economic system; private firms and private entrepreneurs are of our own."

Vice Premier Liu He also stressed the need to support the private sector a few weeks earlier in October, when he reminded the nation that the private sector was responsible for 90 percent of new employment growth, 80 percent of urban development, 70 percent of technological innovation, and 50 percent 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. Moves were made to channel credit to small private sector borrowers, by reducing the reserves banks are required to hold, along with a directive for large state-owned banks to increase their lending to small private sector borrowers by 30 percent.

In some cities such as Ningbo in eastern China, regulators also urged banks to expand their definition of collateral to cover a wider range of small businesses' assets, such as patents and trademarks, beyond typical assets such as real estate, which many lack access to. The State Council echoed these moves recently, calling for intellectual property to be more frequently used as collateral.

According to Chinese regulators, loans to small businesses from China's largest state-owned banks increased by nearly 17 percent in the first quarter of 2019. Yet according to other measures, loans to private firms only rose by 6.7 percent, compared to an overall growth in bank lending of 13.7 percent.

Meanwhile, in fiscal policy, the value-added tax for the manufacturing, agricultural, transport, construction, leasing, wholesale, retail, and real estate sectors was reduced. Beijing also reversed the implementation of social security reforms, easing the financial burden on private sector firms. Income tax was also reduced by increasing the personal tax threshold from 3,500 yuan to 5,000 yuan per year.

Accelerate Financial Sector Reform

A second line of policy response has been to embrace financial sector reform by liberalizing interest rates, changing the exchange rate setting mechanisms, and increasing foreign participation in China's financial services sector.

In March 2019, People's Bank of China (PBOC) Governor Yi Gang committed to the structural reform of interest rates, rather than further rate cuts, to support a slowing economy. Details were thin, yet his stated desire to increase competition in the banking sector and enforce price transparency was aimed at improving credit access to small and medium private firms by effectively lowering lending rates.

In May, the PBOC also issued plans to reform its exchange rate formation mechanism. Last month, Yi Gang appeared more open to having the renminbi fall below a rate of seven against the U.S. dollar amid

downward pressure on the renminbi. The stated policy objective here has been to make the currency more responsive to market disciplines rather than a simple administrative peg.

The most significant recent measures adopted by the Chinese authorities, however, has been to allow greater foreign participation in China's USD \$45 trillion financial services sector. In April 2018, time lines for allowing majority foreign ownership of Chinese securities companies and mutual funds were announced, along with similar policies for foreign insurance firms. Foreign ownership limits on banks were removed in August 2018. Foreign credit rating agencies were given full market access in January 2019, when S&P Global became the first wholly owned foreign 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 percent. 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 buy stock listed on the London Stock Exchange. The Bloomberg Barclays Global Aggregate Index also began introducing 364 Chinese fixed-income securities this April.

Superficially, this forms an impressive list of reforms. However, we need to be cautious about these announcements until we see how China's regulatory machinery adapts to these changes.

For example, conversations we have had with funds managers are replete with stories of overwhelming bureaucratic red tape. Another example is JPMorgan's ambitions to be the first foreign firm to have majority ownership of an asset management business. Recent reports revealed its bid for a controlling stake in their existing joint venture is at a 33 percent premium to an independent valuation. Yet this was the minimum bid price permitted by Chinese authorities. While the sale is not guaranteed, it serves as a further reminder that policy announcements need to be weighed with the ability of foreign firms to capitalize on them.

China is not acting philanthropically with any of these changes. Chinese policymakers are driven by a number of clear policy objectives.

This first policy objective is to make the Chinese financial system more efficient in the allocation of credit. The current system is, at best, 50 percent as effective in wealth creation against international benchmarks.

The second is to spread the risks currently alive within the Chinese financial system where bad loans are still rife. For example, the recent high-profile public takeover of the privately held Baoshang bank highlighted ongoing risks that China's financial sector faces because of uncontrolled lending.

Beyond specific policy support for China's struggling private sector, as well as a fresh commitment to financial market liberalization, has come a broader policy response to a slowing economy—namely, the reembrace of “institutional” economic reforms.

Furthermore, Baoshang does not appear to be an isolated case, with a number of other small and medium banks, rumored to being recapitalized in a quieter fashion. Other areas of risk in China's financial system include the shadow banking sector's surging reliance on short-term interbank lending.

The political message from both Xi Jinping and Liu He was clear: adverse external events were now driving China in the direction of more vigorous internal market reforms. Once again, however, we must await the evidence that the systemic reform program first announced in 2013 is, in reality, back on the agenda. Or not.

A third policy objective underpinning China's financial reform efforts is the country's declining current account surplus, with some analysts predicting an imminent current account deficit. For around 25 years, China has consistently operated a current account surplus. However more recently, this surplus has been declining. Fueling this is rising domestic consumption, which is beginning to reverse a tradition of high savings rates among the Chinese population. Further erosion of Chinese savings is also expected as the aging population draws on retirement reserves. Whether China soon reports a current account deficit will be largely dependent on market prices of imported commodities. With a narrowing current account

comes the incentive to attract foreign capital to plug the gap, and therefore an even stronger argument for reformers for continued financial opening.

A Political Recombitment to Systemic Economic Reform

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This was explicitly announced by Xi Jinping at a Politburo meeting in April 2019. Importantly, this was the very same meeting that rejected the text of the draft trade agreement with the United States. This was the first time in many years that this language of systemic economic reform had been used by the country's most senior leadership.

It was reinforced by Vice Premier Liu He in June, when he candidly admitted that while China faced “some external pressures,” this would “help us improve innovation and self-development, speed up reform and opening up, and push forward with high quality growth.” Liu also noted that these pressures were spurring the creation of stronger domestic capital markets, and more innovative industrial supply chains, which were welcome trends in China's transition “from being big to being strong.”

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Universalizing Trade, Investment, and Intellectual Property Reforms

A fourth line of policy response to the slowing of the Chinese economy has been to universalize trade, investment, and other economic reforms being offered to the Americans bilaterally in the context of their ongoing trade negotiations.

This was on display most recently with President Xi Jinping at the G20 Summit, where he announced a range of reforms, including an updated negative list that permits foreign investment in the mining, manufacturing, services, and agriculture sectors. He also announced plans to implement penalties for intellectual property infringement as part of a new foreign investment law in 2020. Details of some of these plans were subsequently fleshed out by Premier Li Keqiang in July at the World Economic Forum in Dalian.

These general commitments to reform have been met with cautious optimism by the international business community having heard similar announcements by China's leaders before. There has long been skepticism that whatever China announces as a new commitment at the policy level can easily be undone at the level of administrative practice. Or as the Chinese say of their own system, "above there are policies; while below there are counter-policies."

A Return to Good Old Stimulus

Of course, the final response to slowing growth has been the reembrace of economic stimulus. As noted earlier, this has included cuts in the value-added tax, cuts to personal income taxes, but also targeted consumption stimulus packages toward 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 China's ability to handle the economic impact of the trade war. Central bank governor Yi Gang said ahead of the G20 that in his view, "the room for adjustment is tremendous" in China's fiscal and monetary policy toolkit, with "plenty of room in interest rates and in required reserve ratios."

Officially, the message is that the Chinese economy remains healthy, and there is no major risk to growth for the time being. Or, as Liu He put it, "No matter what happens temporarily, China's long-term growth remains positive, which won't change."

All that is code language that China will do what it takes to keep growth above 6 percent—including making up for the hit to growth that would come from a prolonged trade war. If that means adding further to China's budget deficit or debt-to-GDP ratios, so be it. China continues to take great confidence in the fact that practically all its debt is domestically denominated and that with a still relatively high domestic savings ratio, there is considerable flexibility at its disposal.

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The problem remains, however, despite the political assurances to the contrary over the last six months, that stimulus continues to become the continuing, easy alternative to substantive economic reform. In the end, such a course could prove lethal to China's long-term economic trajectory.

The Trade War, Technology War, and Wider Economic Decoupling

China's long-standing difficulties with private sector business confidence have been compounded by uncertainties arising from the trade war, the unfolding technology war, and the growing debate in the United States and China about a wider decoupling of their economies. I dealt with these factors in some detail last month in an address to the Lowy Institute in Sydney.

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It has long been my view that there will be a trade deal of some kind between the countries before the end of 2019. The reason is that both countries need a deal to stabilize their markets and economies going into the politically critical seasons that lie ahead—a presidential election year in the United States, and the lead-up to the Party centennial in China. There will be much debate about the intrinsic economic quality of the deal. But there will nonetheless be a deal that both sides can live with politically.

bring about an end to the technology war. Despite President Trump's ambiguous language in Osaka, it appears that Huawei will now remain listed. The United States has also listed five other entities. China has announced a retaliatory list for "hostile" foreign firms, although it has yet to nominate individual companies.

And beyond the trade and technology war, there is a growing expectation in Beijing that the United States is preparing for a much broader decoupling of the two economies. The next domain to be affected, at least in China's calculation, is the digital payment system, digital finance, and e-commerce, which China increasingly dominates through Alipay, WeChat Pay, and UnionPay.

There is a concern that the United States will then move on the finance sector in general, where U.S. institutions remain globally dominant, drawing on the formidable advantage afforded to the U.S. government through the continuing reserve currency status of the dollar. China has observed closely what it sees as the weaponization of the dollar and the international financial system more broadly against various strategic adversaries of the United States. Beijing anticipates the United States may be considering doing the same to China.

Finally, there is the unfolding impact of both the reality and the perception of decoupling on global supply chains as Chinese, American, and international firms seek to insulate themselves from a combination of tariffs, technology bans, and the longer-term possibility of financial sanctions. Companies that are part of global supply chains in sensitive industry sectors that are currently operating in China, whether they

are Chinese or foreign owned, have begun to offshore manufacturing facilities as a precautionary measure. Even if both the current trade and technology wars are resolved, it is unlikely that these decisions will be undone. The continuing geopolitical risk will still be significant in the eyes of corporate decision makers.

In summary, quite apart from the long-term consequences for the global economy of these uncertain decoupling scenarios, the bottom line for now is that all these factors, real or imagined, are further impacting business confidence in China and represent yet another contributing element to China's increasingly complex, near-term growth challenge.

Are China's Current Policy Responses Working?

The economic data in response to the Chinese government's policy actions to deal with the slowing economy so far has been mixed.

First-quarter 2019 Chinese economic growth was officially at 6.4 percent, stabilizing sliding economic growth from previous quarters, although independent analysts estimate growth to be closer to 6 percent. A significant portion of this growth is believed to be fueled by recent economic stimulus and remains dependent on it.

The most recent figures from May 2019 show industrial activity weaker than expected and fixed asset investment slowing slightly, although retail sales reportedly increased to 2.1 percent in May following a 0.6 percent decline in April. The official unemployment figure has remained steady at 3.8 percent in recent months.

It is concerning that almost half of Chinese exporters see the trade war as a permanent or long-term fixture of bilateral relations, according to a recent survey. This sentiment, and perceptions of its business impact, have steadily deteriorated over the past few months.

Conversations with business owners in second- and third-tier cities continue to reflect anxiety and uncertainty over the private sector business environment. Private entrepreneurs still do not trust Beijing. Many are still sitting on their hands, not taking new investment decisions.

All this is before the full wash-through effect of any future collapse of business confidence in the event of a nonresolution of the trade war.

China's Strategic Economic Choices for the Future

China's political economy therefore finds itself at a policy crossroads: Between the competing demands of Party control and the market. Between the competing demands of sustainable economic reform and continuing recourse to stimulus. Between an economy that over the last 40 years has integrated itself with global supply chains, technology markets, and finance, and a country that now fears it may progressively be cut off from all three if decoupling becomes a reality. The question, then, is what strategic response is China under Xi Jinping now likely to adopt.

One possibility is that China, in response to its internal pressures on growth, as well as the external pressures on trade, technology, and finance, accelerates the liberalization of the Chinese domestic economy

as per 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 could take many forms.

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In Asia, China could use the Regional Comprehensive Economic Partnership (RCEP), which includes 16 Asia-Pacific economies, to advance regional economic integration if that agreement is signed in 2020. China is also debating internally the desirability of seeking membership in the Trans-Pacific Partnership (now known as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership), a far more ambitious free trade agreement than RCEP involving 11 regional economies, from which the United States has withdrawn. Meanwhile, in Northeast Asia, China is seeking to accelerate the negotiation of a Northeast Asian Free Trade Agreement with Japan and South Korea.

In Europe, the European Union-China Investment Agreement is likely to come into force in 2020. China could use this agreement to turbocharge its wider economic engagement with the 28—soon to be 27—member states. China sees Europe as an important strategic economic partner in the future. This is not just because of the size and technological sophistication of much of the European economy. It is also because China sees Europe as being much less energized by the security concerns of the United States and its allies in Asia.

On technology in particular, China will also seek to advance its engagement with Japan, Germany, and Israel, where it has already sought to become a significant investor.

Globally, China may also seek to become a substantive champion of the World Trade Organization (WTO) and the global free trading system it underpins, particularly given the systematic assault on the WTO by the United States.

There is, however, a second script available to Xi Jinping's China. That is for the country to increasingly turn inward toward even greater Party control, economic self-reliance, and more mercantilist practices abroad.

If Chinese leaders conclude that a strategy of systematic economic decoupling has been embraced by the United States, and is indeed under way, then China may adopt a more radically conservative response to its circumstances. The Party may double down domestically against what it increasingly fears to be hostile forces operating within. China may seek to accelerate the expansion of domestic demand in the hope that domestic consumption can offset some of the impact of a much more adversarial international economic environment. And, rather than open its markets more to the world, or even the non-American world, it may seek instead to expand its selective economic engagement with friendlier Belt and Road Initiative states where Chinese goods, services, and technology standards are more welcome.

A third and more likely response from China would be an untidy combination of both of these approaches.

Given China's uncertainty about the precise contours of future American strategy on trade, investment, finance, tech, and broader decoupling, whether under Trump or any replacement Democratic

administration, as well as the additional uncertainty of whether U.S. friends and allies will cooperate with an American strategy of this type, China may well proceed cautiously until the strategic landscape is clearer.

China is now in a formal process of deep strategic review internally on the extent to which its external circumstances have changed and what China should do in response. Xi Jinping's recent reported remarks are nonetheless telling when he said in an internal speech that China now needs to expect another "30 years of containment and provocation from the United States" through until 2049.

The bottom line for all of us that the global strategic and economic landscape is now in a period of fundamental change. The open question for us all is how the Chinese political economy will respond to its own domestic growth challenges and to both the reality and the perception of economic decoupling from the United States.

As a McKinsey report warned recently, not only has the world changed China over the last 40 years, China, through the sheer size of its economy, its impact on global consumer prices, and the significance of its markets, has also changed the world. Therefore, how China now responds to these dual yet mutually reinforcing challenges will profoundly affect us all.

Global geopolitical risk is now back with a vengeance. We should all fasten our seatbelts for a rocky road ahead.