

PROBLEMS AND CHALLENGES

Kjeld Erik Brødsgaard & Paul Deng

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3rd Plenary Session

- The third plenary session adopted the "Decision on Major Issues Concerning Comprehensively Deepening Reform".
- Long document – 20,000 words, 16 chapters, 60 subsections.

Decision

- The Decision is not full of the usual long list of economic achievements.
- It is clearly a policy document which will be further specified by various working groups on the leadership of the newly formed leading small group for deepening comprehensive reform.
- It is specified that decisive results will have to be obtained by 2020 – i.e. when Xi Jinpings 10 year tenure is about to expire.

Comprehensive

- It is also extremely comprehensive covering reform within areas such as the financial system , land ownership, hukou and urbanization, education, health, environment, population control, economic restructuring, state-owned enterprises, taxation, government administration, etc.
- In fact it touches on all the major issues and problems facing China's current development trajectory.
- A blue-print for the new leadership's economic and social reform program.
- The most important document in a decade.

Market

- The market to play a much bigger role.
- The market will play a "decisive" (决定性) role – no longer just a basic role.
- Private capital will be allowed to invest in the state sector.
- Mixed economic forms will be encouraged.

Financial sector

- Private capital will be allowed to open small and medium-sized banks.
- Interest rates to be liberalized.
- The yuan to be fully convertible.
- Less rigorous capital control.

Real estate and property development

- Unified registration of property ownership under the Ministry of land and resources.
- Married couple can only buy two apartments.
- Limit the influence of property developers.
- Powerful interest groups block reform.
- Since 2005 45 major developers have not paid taxes amounting to 3,8 billioner RMB.

Hukou and urbanization

- More than 50% now live in the cities – only 28% have an urban hukou.
- In small cities farmers and migrant workers can now obtain urban hukou.
- In second tier cities rules will be relaxed, but some control will remain.
- In first tier cities – Beijing, Shanghai – urban hukou will still be restricted.

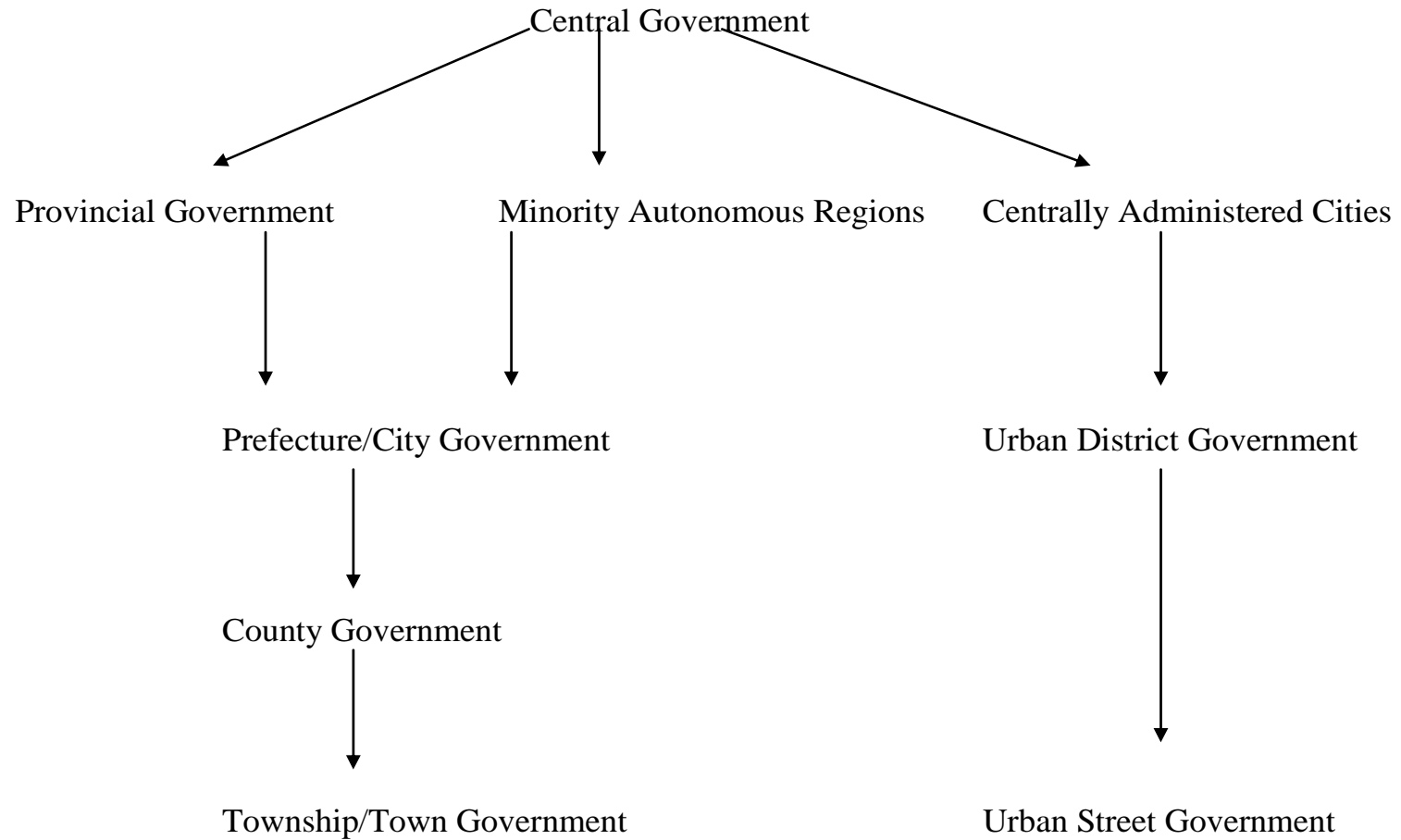
SOE Reform

- A distinction between "monopoly enterprises" and "competitive enterprises". The first needed in areas where the state needs to take care of public functions.
- The second category can experience with mixed ownership forms, including investment by private capital.
- By 2020 SOEs required to pay 30% in dividends – to be used for welfare systems.
- But no fundamental reform of this sector.

Administrative reform

- Continued streamlining of ministries and administrative agencies.
- New efforts to introduce a big ministerial reform creating superministries.
- New efforts to cut down on administrative agencies and personnel.
- Abolish the prefectural level administrative hierarchy. Provinces to directly manage counties and cities.

Structure of Chinese Government



Public service units

- Public sector consists of administrative organs and agencies, public service units, and SOEs.
- Public service units have had rankings and benefits similar to government agencies.
- Administrative ranking will be abolished.
- Some PSUs will be changed into enterprises and the employees will be hired on the basis of contracts.
- Some will be changed into social associations.
- In the future the government will buy services from these social associations – care for the elderly, basic health service, etc.
- A kind of outsourcing of public sector functions.

Other reforms

- Tax reform.
- Protection of peasants property rights.
- Free trade zones.
- Education.
- Environment.
- Legal affairs (abolish re-education through labour system).
- Cadres' work style and privileges.
- Appointment, promotion and evaluation systems (green GDP criteria).
- Social affairs – abolish one child policy.

Two new commissions

- Central leading group for comprehensively deepening reform (全面深化改革领导小组).
- Will cut across various bureaucracies and might be headed by Xi Jinping.
- National Security Commission (国家安全委员会).
- Will coordinate domestic security work as well as international issues.
- An attempt to sideline Zhou Yongkang's political legal system (xitong).

Challenges

- Reform stop (+)
- Corruption (+)
- Misuse of public funds (+)
- Vested interests (-)
- Inequality (-)
- Social unrest (-)
- Environment (-)

Vested interests

- Iron triangle of Party-state-big business.
- Prevent further privatization.
- SOEs occupy monopoly positions in strategic industries.
- The largest are on the central nomenklatura.
- SOE leaders enjoy high salaries and bureaucratic ranking.
- Source of cash for high-level leaders.
- Case of Ling Jihua and Jiang Jiemin.
- New leadership will protect these interests.

Inequality

- One million dollars millionaires.
- 64,000 super rich.
- 11, 000 super rich in Beijing, 55 in Qinghai.
- 150 million below the poverty line.
- Income opportunities linked to vested interests.

Social Unrest

- Mass incidents increased from 50,400 in 1993 to 180,000 in 2011.
- Caused by expropriation of land, environmental issues, local officials' abuse of power, etc.
- Latest Pew survey shows growing dissatisfaction with corruption and inequality.

Environment

- 16 out of 20 most polluted cities in China.
- Water pollution and lack of water.
- Shrinking farm land.
- No incentive to address the issues.

Will the System break down?

- Relates to the role of the CCP.
- Pessimists and optimists.
- Pessimists: The system is in a state of crisis and likely to collapse. The CCP is corrupt and has lost its legitimacy.
- Disagreement as to when it will collapse.
- Disagreement on how it will collapse and what will follow.

Optimists

- The Party has undergone a process of revitalization and re-institutionalization since 1989.
- Younger and better educated leaders.
- Move towards "inner-party democracy", regular personnel assessments, improvement of the CCP's control institutions, admittance of private entrepreneurs into the Party.
- The CCP enjoying "authoritarian resilience".
- The Party better qualified and more technical competent than at any other time post-Mao.
- Shambaugh was an optimist who is turning into a pessimist.

Three Schools

- The "evolution to democracy" school.
- The "fragile/collapse" school.
- The "resilient authoritarianism" school.
- Western analysts tend to have a linear perspective on history.
- Softening of authoritarianism does not always lead to democracy.

What China has not done right

Intro: Friedman on China, India and Egypt

According to Thomas Friedman,

- China has a muscular central government but a weak civil society
- India has a weak central government but a really strong civil society
- Egypt has a weak government and a very weak civil society

His conclusion:

India will only get a strong state when the best of society join the government, and China will only get a strong society when the best Mandarins go into the private sector.

The Major Challenge

- The inherent conflict within Chinese society today: one-party rule runs against people's democratic urge in an economy with fast rising income
 - Chinese-style “socialist democracy” is only allowed “within the Party”; Political reform is seriously lacking.
 - Even economic reform now calls for political reform in the sense that further and deeper economic reform requires government power to be seriously restrained. Hence, CCP's new slogan: Let market play a “decisive” role.
 - Yet, rather ironically, Chinese leadership still insists that public ownership occupy a major role in Chinese economy, while simultaneously emphasizing the importance of non-state ownership.
- ➔ Do you see the confusion in their recent policy initiatives?

Confusion? Political Compromise?

Letting market play a decisive role means market determines where capital should be allocated → capital allocation should go to the most efficient sectors and firms → private sector got more funding, SOEs will get less → but we know, due to SOE's fundamental problems, they're inherently less efficient → so without cheap financing or government subsidy, most SOEs will go under → less public or state ownership in Chinese economy

So tell me how to let market play a decisive role while still insisting public/state ownership be the major foundation of Chinese economy?

Main Challenges

- Chinese society will remain largely authoritarian in coming years. But CCP will find more and more difficult to achieve the “harmonious society” it wished for.
- As a result of CCP’s tight control, China will face daunting challenges in the long run:
 - establish rule of law
 - restrain government/party power under Constitution, with checks and balances (e.g., Denmark)
 - create an innovative economy and free society
- In the near term, China also faces huge macro risks:
 - rebalancing challenges
 - potential impact of a housing bubble burst

Government/Part above Rule of Law: Legal system with “Chinese characteristics”

“我保证忠实履行中国特色社会主义法律工作者的神圣使命，忠于祖国，忠于人民，拥护中国共产党的领导，拥护社会主义制度。”

China's new rule starting from March 2012: Lawyers have to swear they will remain loyal to the country, to the people and upheld socialism and the leadership of the Communist Party.

→ If lawyers cannot speak against Party, where are checks and balances in the system??



Long-term Consequence: The “Qian Puzzle”

In his meeting with Chinese Premier Wen Jiabao, Qian Xuesen (钱学森), raised a sobering question,

“Why have Chinese universities not produced a single world-class original thinker or innovative scientist after 1949?”

Ronald Coase: China needs to address the lack of a marketplace for ideas

- Recently, an equally puzzling question circulated widely in China's net-sphere, "Why don't we have Steve Jobs in China?"
- According to Coase (2012),

"An unrestricted flow of ideas is a precondition for the growth of knowledge, the most critical factor in any innovative and sustainable economy. "Made in China" is now found everywhere in the world. But few Western consumers remember any Chinese brand names. The British Industrial Revolution two centuries ago introduced many new products and created new industries. China's industrial revolution is far less innovative.... The active exchange of thoughts and information also offers an indispensable foundation for social harmony...the free flow of ideas engenders repeated criticism and continuous improvement. It also cultivates respect and tolerance, which are effective antidotes to the bigotry and false doctrines that can threaten the foundation of any society."
- The answer to these questions essentially will determine whether China can lead the innovation frontier in the 21st century and beyond

The Limits of Gradualism

- How far across the river?
- China's gradualist approach: crossing river by touching stone --
 - Policies often experimented locally, then spreaded out
- But now China's troubled water became too deep to feel the stone
 - Easy reforms were done, harder ones left untouched: SOEs, financial sector, ownership and property rights (especially on farmer's land rights)
 - Gradualism and stability often used by vested interest groups as excuse to stall deep structural reforms
- The logic of new policy initiative: *reforms with top-down design* (largely due to recommendation of Jinglian Wu, 吴敬琏)

Gradualism has served China's transition well in the past, but now reached its limit

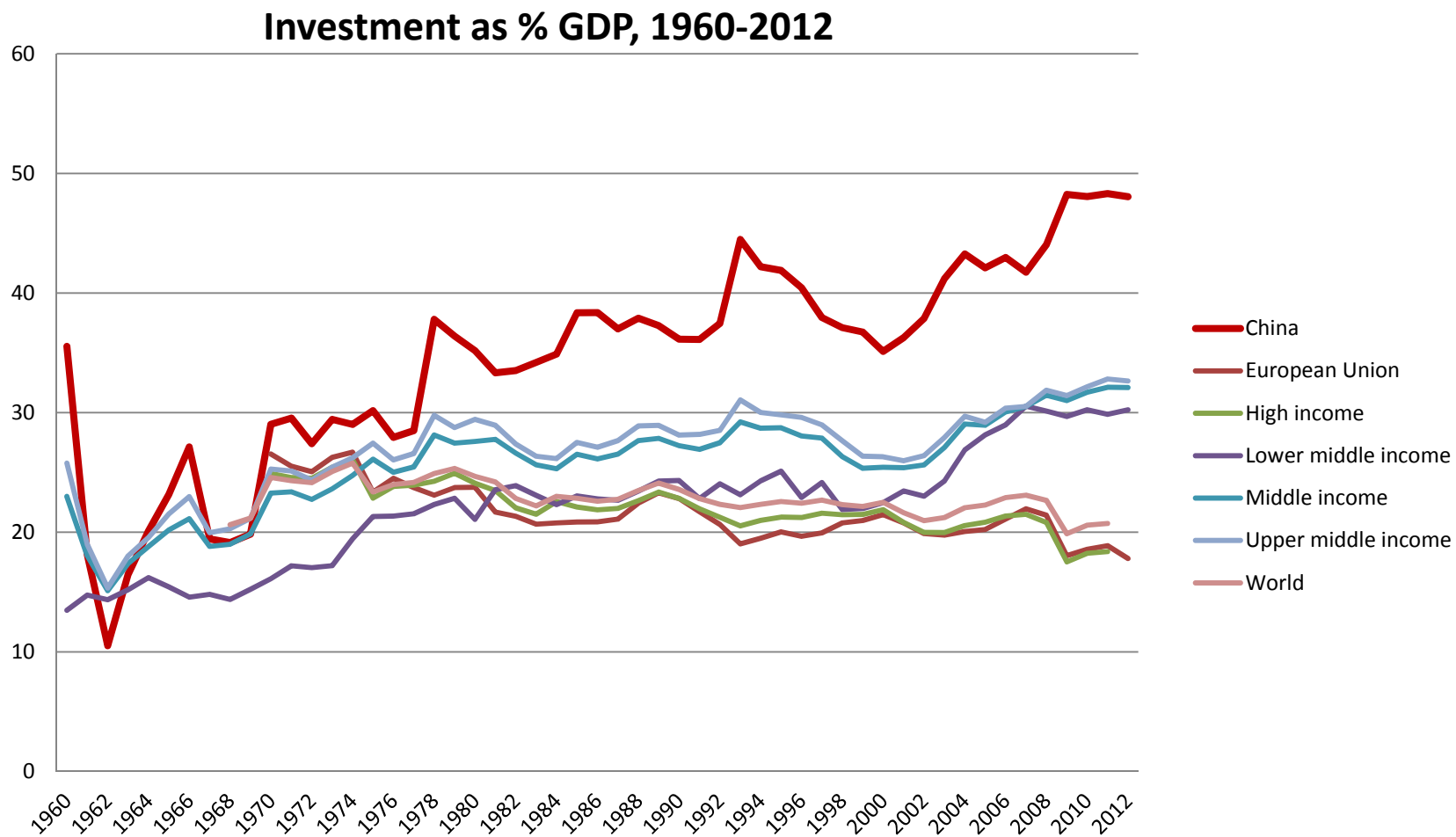
River got too deep to touch the stones



China's near-term risks

1. rebalancing challenges

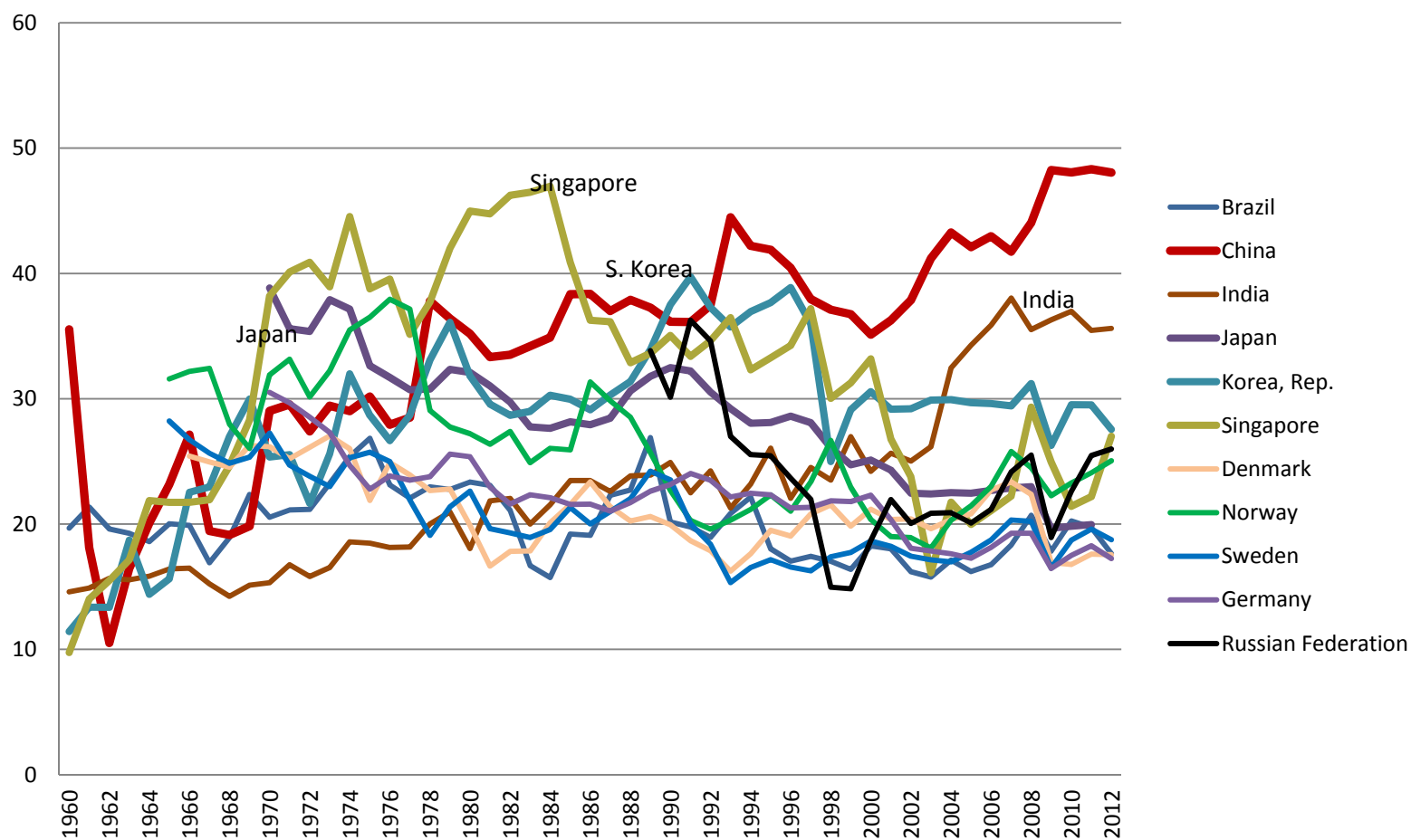
China's unusually high investment-GDP ratio



Source: Deng (2013) and WDI

The Rebalancing Challenge: History indicates China's high investment ratio is unsustainable

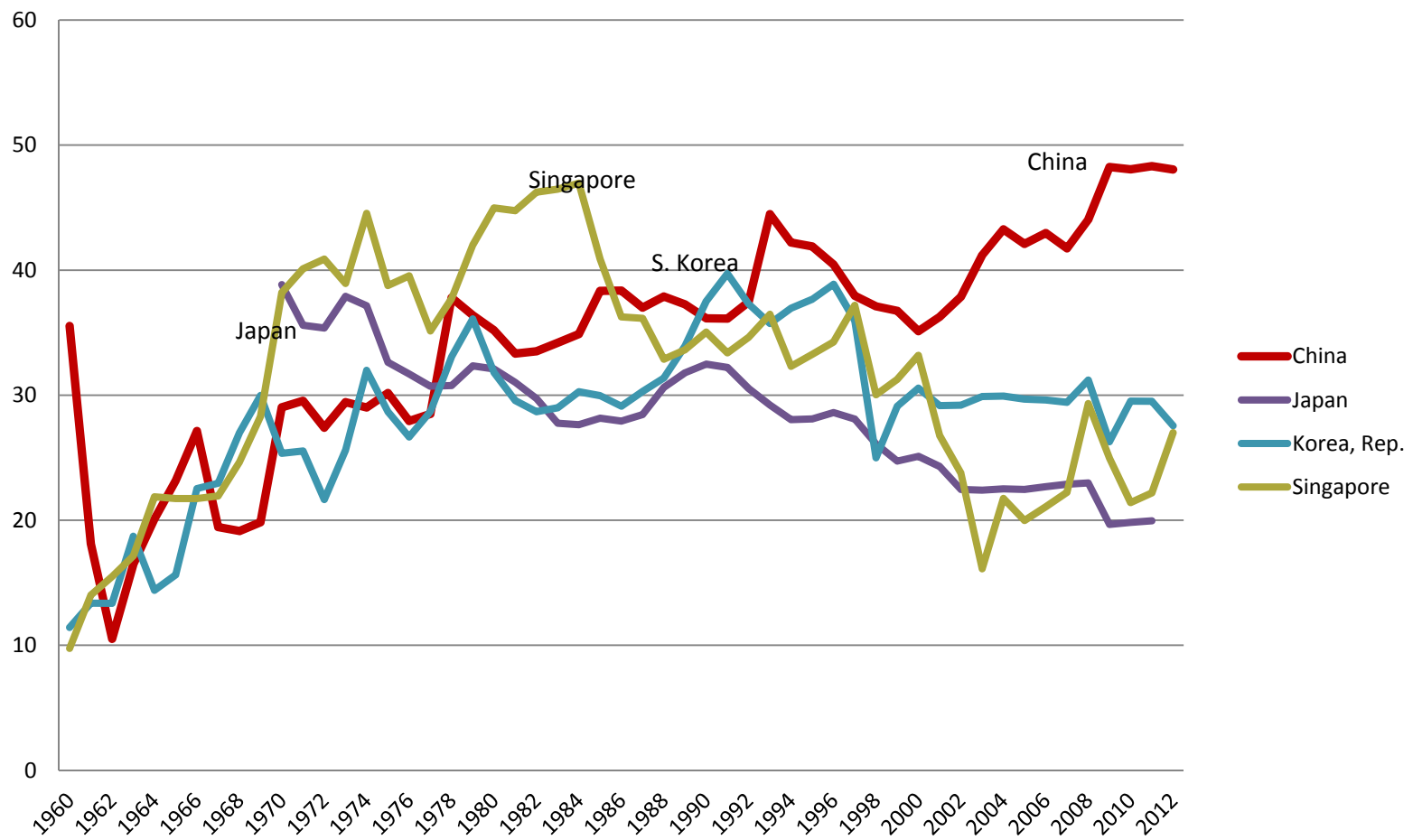
Investment as % GDP, 1960-2012

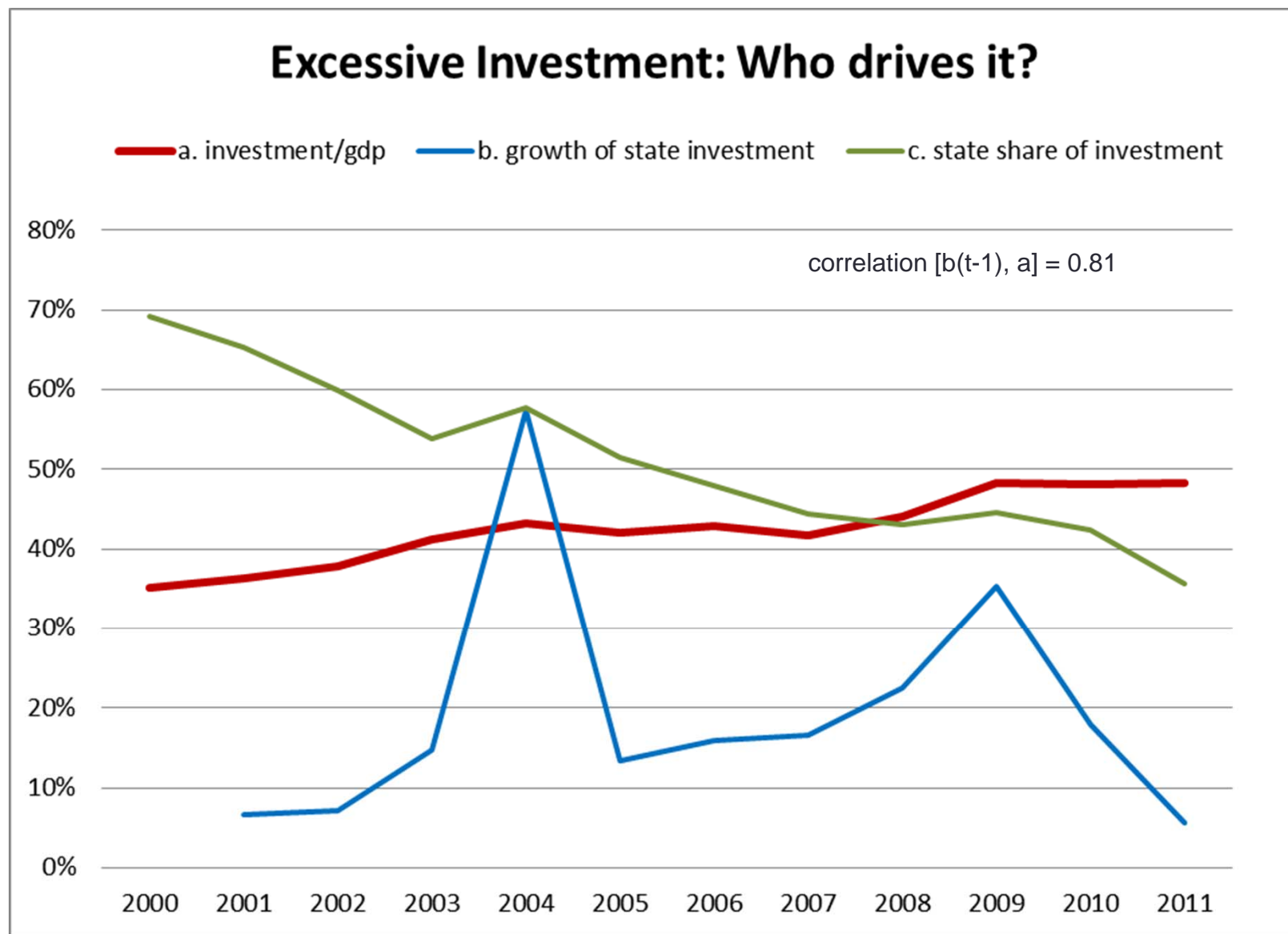


Source: Deng (2013) and WDI

A closer look: East Asian countries

Investment as % GDP, 1960-2012





Source: Deng (2013) and NBS

How governments drive excessive investments?

- Central government's motivation: smooth business cycle's impact, so growth target can be achieved. Remember, CCP relies on economic growth to justify their non-democratic rule.
- Thus the puzzle, "Why China seemed not to have business cycles?"
- SOEs and public sector were used as the main vehicle to achieve the targeted growth
- At the same time, local government's huge moral hazard problem also leads to excessive investments – in what sense?
- More fundamentally, it's financial repression against both households and private sector that provided the funding for the massive and wasteful investments

Will China be able to rebalance its economy?

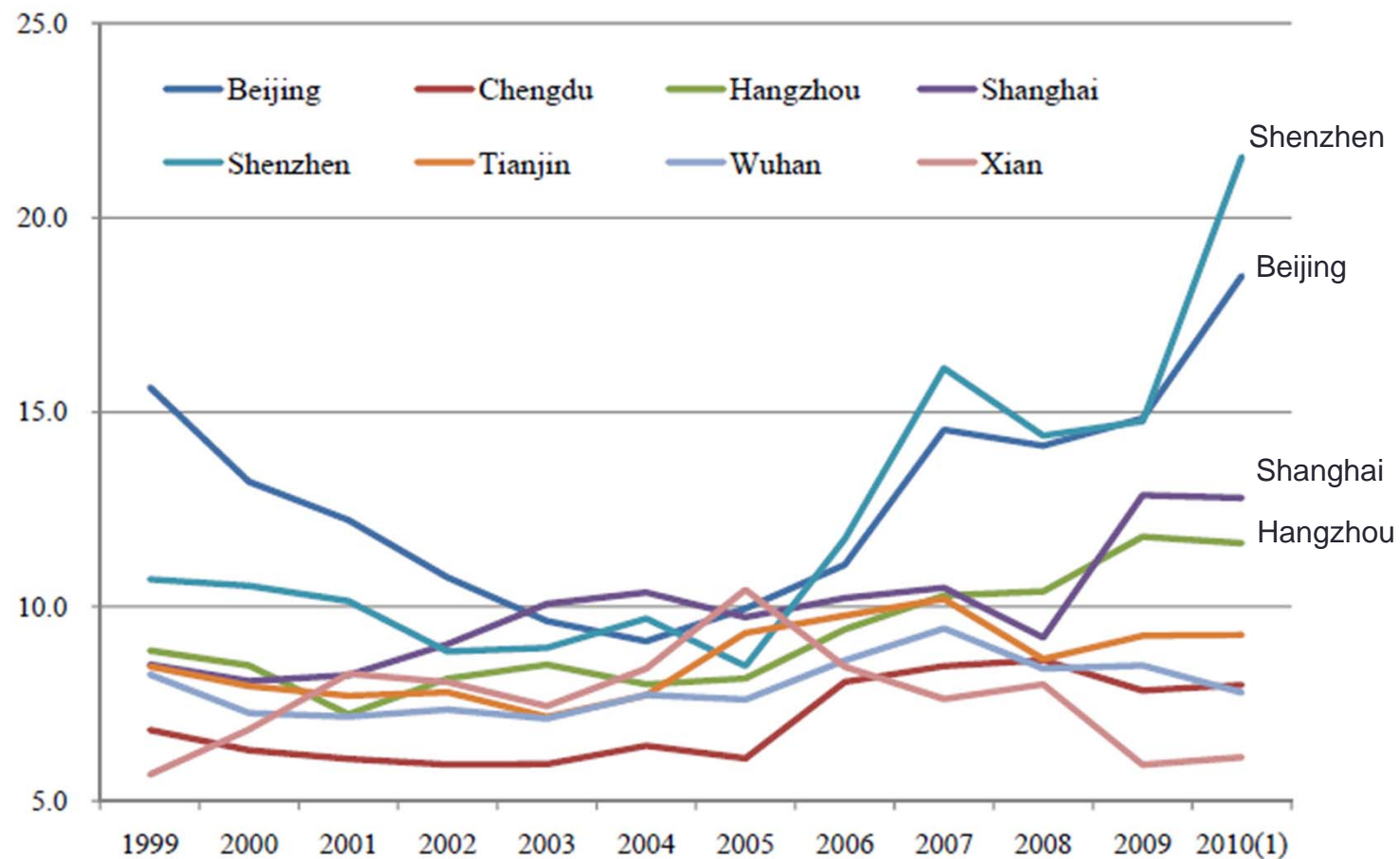
- In my view, China can have a better chance to sustain its high growth, should some of the following actions were taken:
 - nurture a more robust private sector via fair access to financing
 - further financial reforms and break the monopoly of state banks
 - solve the problem of huge capital mis-allocation
 - incentivize investments (incl. FDIs) to move to central and western regions, such as creating different tax incentives across regions
 - solve the problem of unequal regional development
 - poorer regions tend to grow faster (Solow)
 - *dramatically* increase investments in healthcare
 - solve the problem of too much precautionary saving
 - continue to improve and invest in infrastructure
 - enlarge the extent of the market (Adam Smith)
 - public goods create positive externalities

China's near-term risks

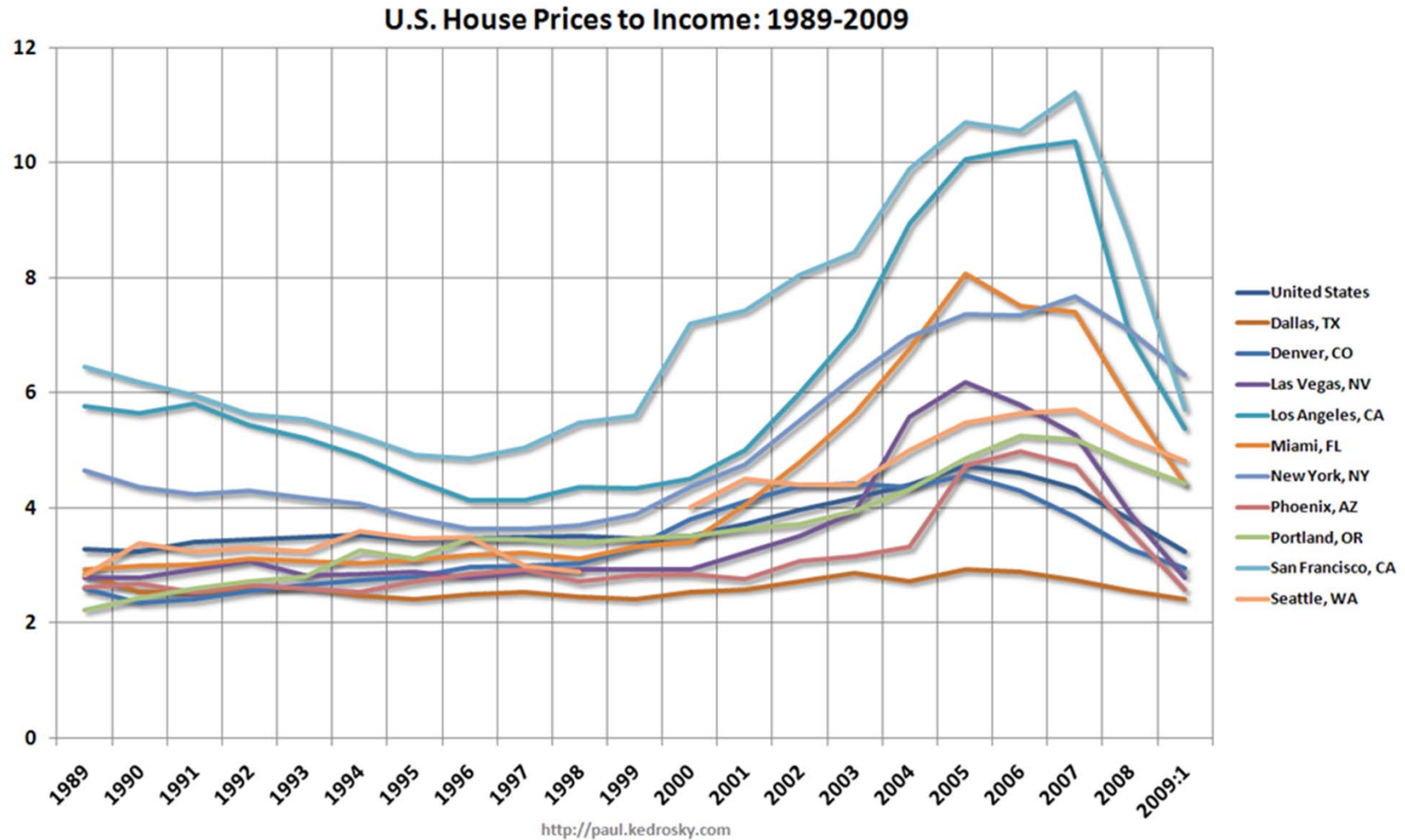
2. impact of housing bubble burst

China's bubbly housing market, but where is the bubble located?

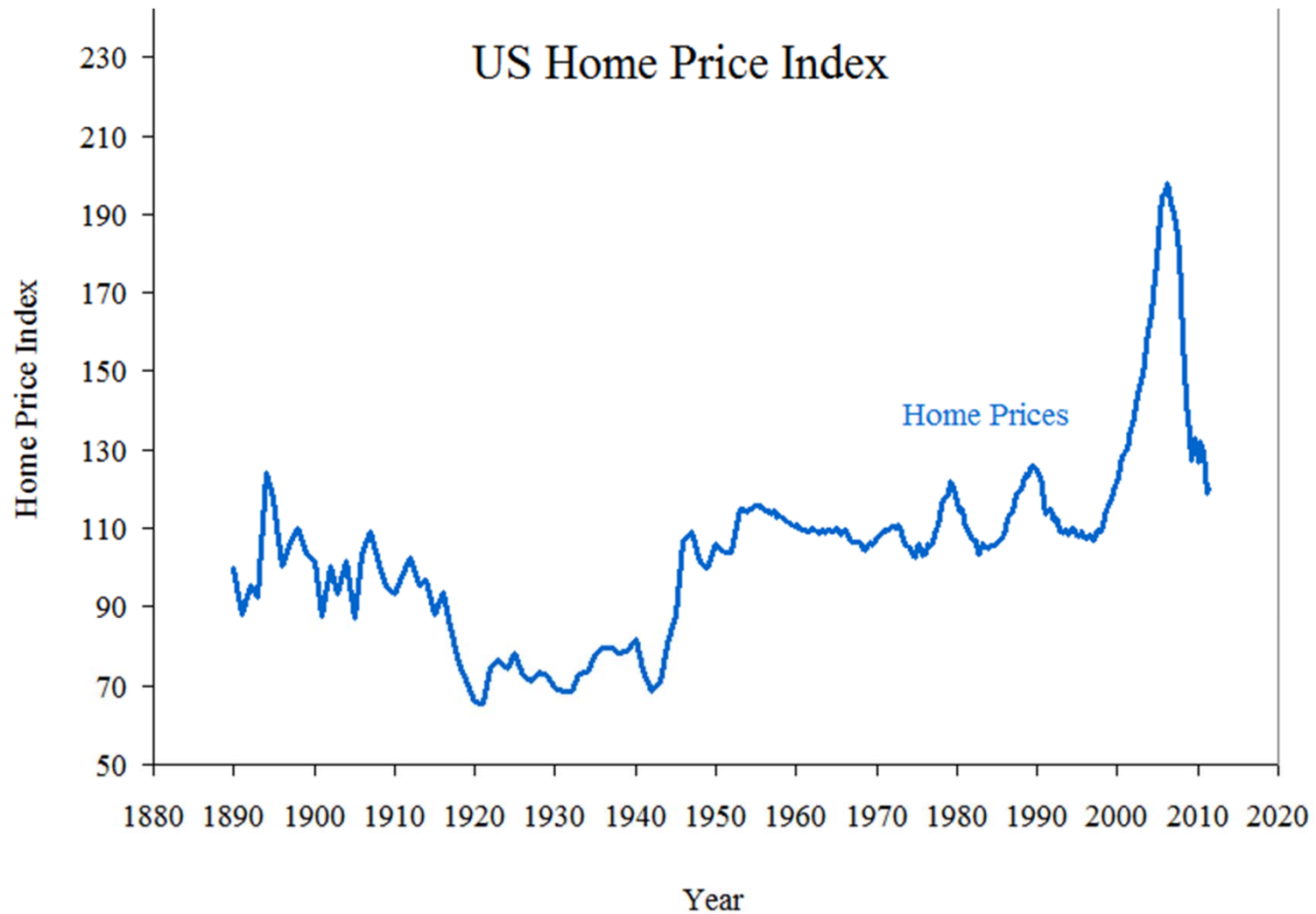
Figure 12: Price-to-Income Ratios in Eight Major Chinese Markets, 1999-2010(1)



How Chinese housing bubble compares to US bubble



The US bubble is unprecedented in history by itself



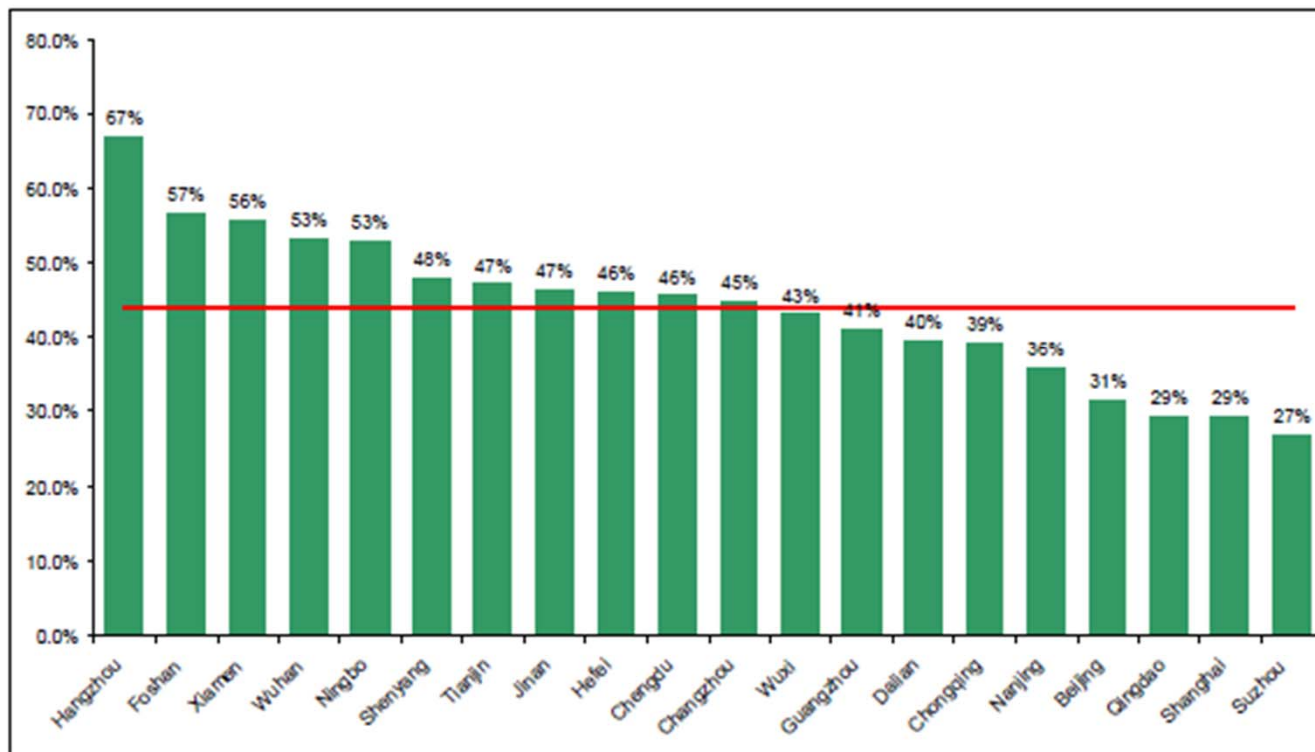
median apartment price, per sqm, US \$, 2013

	<u>city center</u>	<u>outside center</u>
Beijing	\$8,098	\$4,426
Shanghai	\$7,377	\$3,278
Shenzhen	\$6,721	\$3,278
Hangzhou	\$6,557	\$3,115
Hong Kong	\$17,357	\$11,108
Vancouver	\$7,004	\$4,844
Toronto	\$6,180	\$3,914
Boston	\$3,498	\$2,799
New York	\$9,015	\$4,922
San Francisco	\$6,696	\$5,533
Paris	\$13,495	\$9,447
London	\$12,860	\$7,394
Copenhagen	\$5,428	\$3,780

Source: Deng (2013)

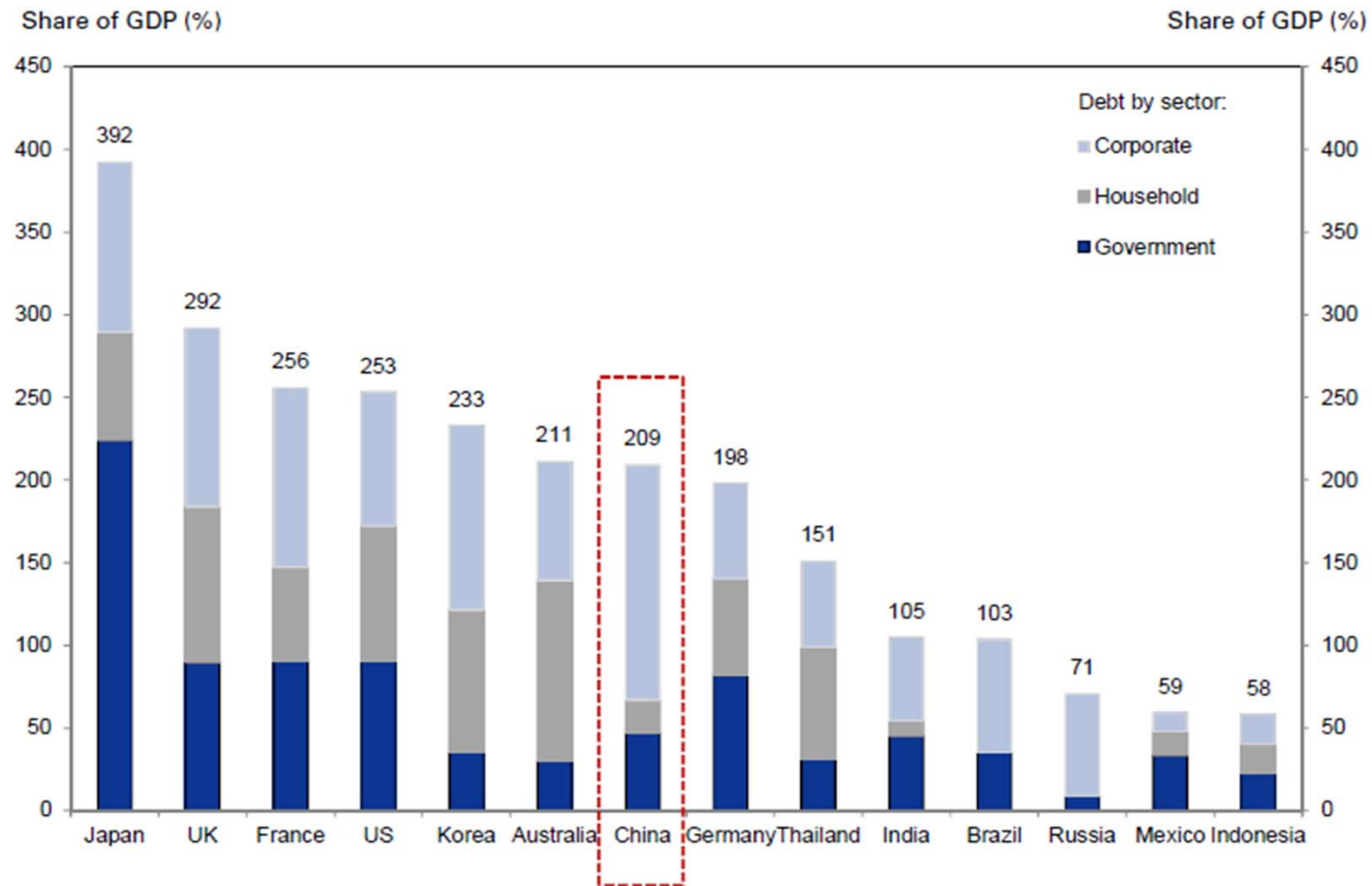
Local governments have huge incentives to see housing prices going up, not down

Figure 14. China Property — Land Premium as a Percentage of Government Revenue, 2009



Source: Soufun; CEIC; Citi Investment Research and Analysis

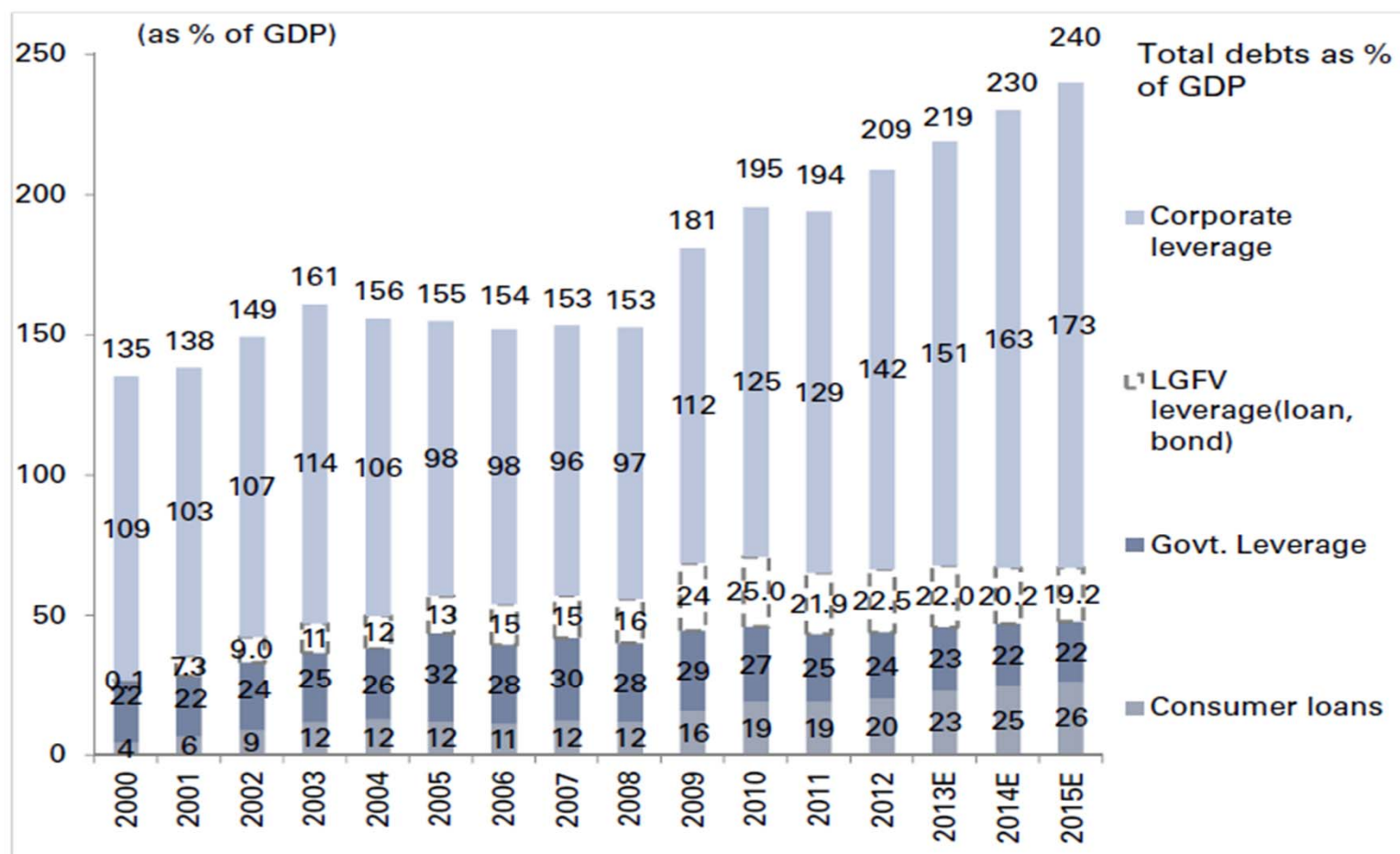
Total debt-to-GDP ratio, 2012



Note: "Corporate" includes all private debt for Brazil and Russia.

Source: BIS, IMF, National statistical offices, World Bank.

Chinese debt by type (percent of GDP)



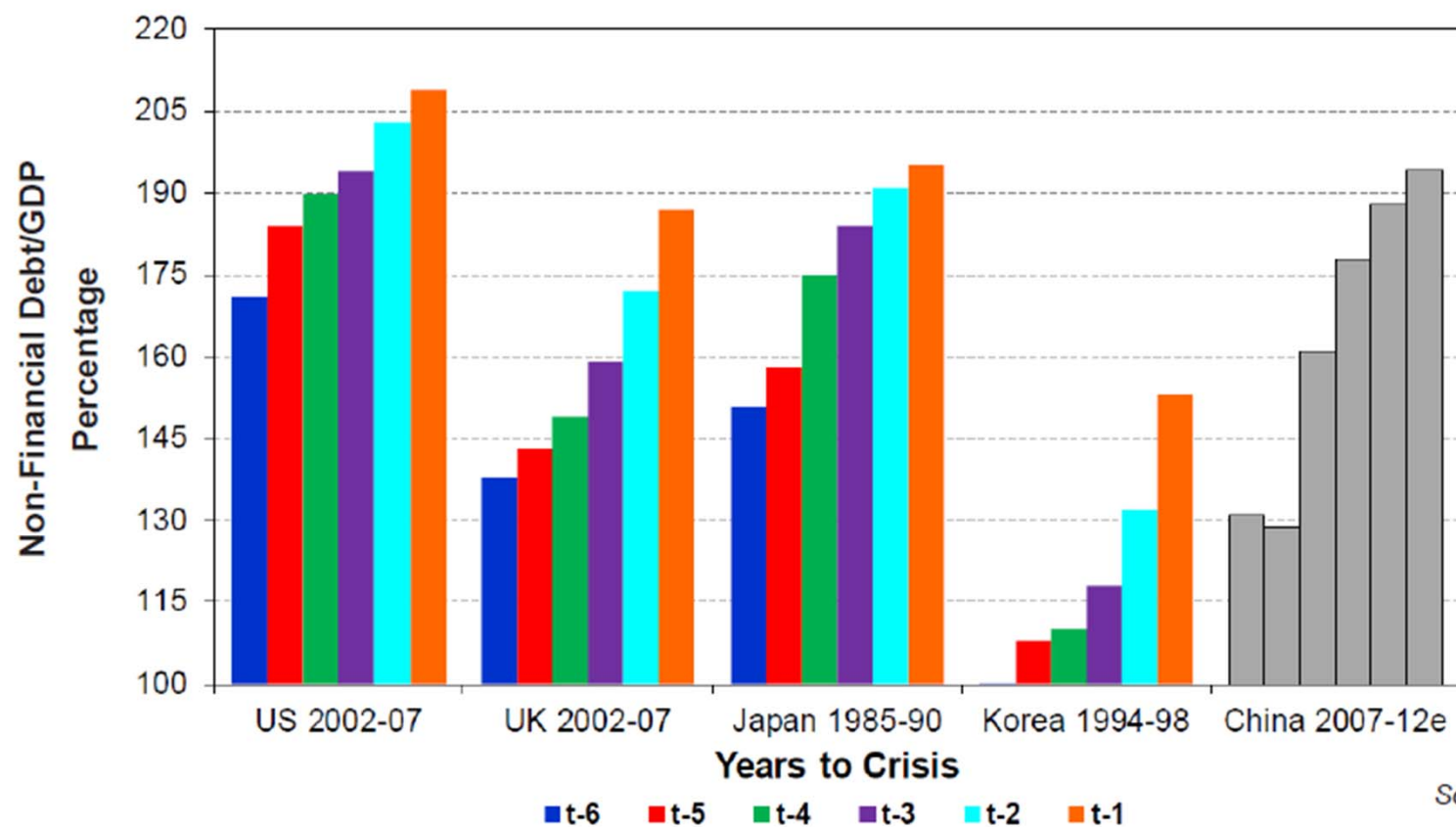
Note: 1) financial institutions credit is excluded from this calculation 2) only half of entrust loans outstanding is tallied to avoid double counting 3) trust loan are wholly classified to corporate loans category.

Source: People's Bank of China, GS Global ECS Research estimates.

China may be at the brink of a major crisis

Five Credit Bubbles

Rapid Credit Growth Precedes the Busts



Source: Fitch