POLITICS

New Reformists Emerging in China

More Centralization of Power Coming

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China's economy made headlines again in 2016. For the casual observer, slowing growth was the dominant storyline. Those who take a deeper look, however, will find a competing narrative: China's economy is moving in two different directions.

In industrial regions, China's "old economy" is showing signs of recession. Ailing state owned enterprises (SOEs) in sectors which had relied on a real estate boom – such as steel, mining and manufacturing – are grappling with massive overcapacity and inefficiencies. Millions of workers will eventually need to be laid off and trillions of yuan in non-performing loans (NPLs) managed. Excess lending to unprofitable SOEs has contributed to the rapid rise of corporate debt, which the IMF warned China in August 2016 is unsustainable.

Meanwhile, in China's Eastern and Southeastern coastal provinces and its megacities, innovative companies providing services and producing high-tech manufactured goods for middle class consumption are thriving despite decelerating GDP growth. These companies in China's "new economy" sectors grew profits by an average of 26 percent last year in contrast to flat rates for the country as a whole. By tapping into new technology and a growing middle-class, the new economy shows promise for becoming the engine for the next chapter of China's growth story.

To say that China's economic growth is slowing therefore is to miss the regional disparities and secular change that the economy is undergoing. China faces not a single challenge, but many: structural transition, reform, growth, and deleveraging. Understanding these dynamics can offer important insights for those trying to identify future opportunities in the Chinese market.

Chinese policymakers hope that strong performance in the new economy can offset losses in the old. Indeed, China's resilient services sector now accounts for the majority of economic output and job creation – a notable achievement. But, in order to ensure sustainable growth over the long term and avoid the middle-income trap, China's traditional sectors must also reform. This task has proved much more challenging in the face of intense pushback from vested interests.

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Several key reform initiatives faltered during implementation in 2015-2016 when China reverted to stability and growth at all costs amid panic in global markets. The debate over reform versus growth, and how much pain should be endured in order to implement reforms, underlies the difficulty policymakers have had in executing a coherent reform plan since the Third Plenum in November 2013. The emergence of "supply-side economics" is critical to understand in this context; it reveals the constraints under which reformers are operating and the shifting locus of economic policymaking.

President Xi Jinping has an opportunity to resolve this tension at the next five-yearly leadership transition, expected in October 2017. He has amassed exceptional power and clout, and has nearly twice the average number of Central Committee appointments to fill. The stakes are high – $5.6 trillion in GDP and $5.1 trillion in household income could be created from productivity gains in China's economic transition over the next decade. For businesses that depend on the success of China's reforms, understanding the political dynamics leading up to this changeover is essential. China's economy is top of mind for CEOs, but in 2017 the attention should be on Chinese politics.

The Emergence of Supply-side Reform

In May 2016, President Xi Jinping took to China's flagship newspaper, *People's Daily*, to clarify the central tenets of his latest hallmark economic policy, "supply-side structural reform." Despite his leadership's efforts to rein in credit growth and adapt to a "new normal," Chinese banks had issued a record $697 billion of credit in the first three months of the year, exceeding the 2009 stimulus during the depths of the financial crisis. There was a growing discrepancy between stated economic policy and its implementation in practice, and Xi appeared to feel a sense of urgency to ensure that his message was being understood.

Accordingly, *People's Daily* published the transcript of a long speech given by Xi to the Central Leading Group on Financial and Economic Affairs, a newly formed Party advisory body, which expounded on the main pillars of supply-side structural reform: 1) eliminating excess capacity through central government subsidies to local governments in order to facilitate the closing down of zombie companies and assist laid-off workers; 2) reducing the large stocks of unsold housing in second- and third-tier cities by making them affordable to migrants and other low-income residents; 3) de-leveraging, or restructuring debt by shutting down zombie firms and writing off their debts; and 4) helping firms reduce costs and increase competitiveness through policies such as tax cuts and deregulation.

In his speech, Xi noted that China's policy was distinct from the Western version of supply-side economics often associated with Ronald Reagan and Margaret Thatcher, which prescribes tax cuts and deregulation toward the goal of increasing the supply of goods and services. China's version stipulates similar policy prescriptions to promote economic growth and encourage innovation. However, the Chinese plan aims to reduce supply, especially industrial overcapacity, by shutting down unprofitable companies and reining in credit expansion. Xi said in his speech that pushing forward with supply-side structural reform was critical to the overall and long-term well-being of the Chinese economy. Yet, many in China were resistant to the policy, seeing it as a threat to their interests, and instead wanted the government to bail out troubled firms.

The publication of Xi's speech marked an important inflection point in China's efforts to reform its outdated economic model. Prompted by concerns that supply-side economics risked becoming derailed, Xi was stepping in to shape the outcome of the policy implementation. For the first time, the brewing internal debate over Chinese economic policy at the highest level was made visible to the public, though tensions had been apparent in the attempts to implement Third Plenum reforms in the years since the November 2013 meeting.

A clear example is the case of local government debt restructuring. An ambitious debt-for-bond swap program had been established by Finance Minister Lou Jiwei in 2014. But, when the time came for provinces to swap RMB 1 trillion debts in April 2015, banks did not want the bonds being offered; local governments wanted low interest rates, while the market wanted to be compensated for the risk with high interest rates. Following the Politburo's lead, a new program eliminated the market's role and instructed commercial banks to buy local bonds despite their low interest rates. The initial attempts at SOE restructuring and equity market reforms similarly gave the impression that China's economic policymaking was being pulled in contradictory directions. The introduction of supply-side structural reform was an indication that certain aspects of the Third Plenum reform agenda had been derailed during implementation, and that pro-reform policymakers needed a new vehicle with which to reinvigorate and advance initiatives such as SOE reform that had been met with resistance.

Authoritative Person: No Pain, No Gain

The publication of Xi's speech on supply side structural reforms in the People's Daily came just one day after the paper printed a notable interview with an "authoritative person" on the same topic. The authority, widely thought to be Xi Jinping's top economic advisor, Liu He, strongly criticized the credit surge during the first quarter and China's debt-fueled growth policies. The anonymous figure warned that China's economic trajectory would not rebound to previously high growth rate levels, but this would put the country on a more sustainable growth path.

The interview seemed to reflect the frustration of reform-minded economists like Liu He, who saw the use of stimulus and government spending in the first quarter as highly irresponsible. Taken together with the published transcript of Xi's speech, it was a clear indication that Xi had decided to insert himself further into economic policymaking. To many, it was also seen as a sidelining of Premier Li Keqiang and criticism of his ability to oversee economic policy. Only a month earlier, at China's National People's Congress, Li had sounded a reassuring note about the economy by highlighting the fact that growth and industry had been stabilized during the first months of the year. But the authoritative person pushed back, arguing that the Q1 credit binge, which had contributed to that stabilization, had only postponed necessary structural change and inevitable deleveraging. While a short-term panic had been avoided, the costs in the long-term for growth and reform could be even greater.

Official sources deny any suggestions of a rift between the Chinese president and premier, however, the growing disagreement more broadly over whether to continue resorting to stimulus to prop up growth, which has resulted in overproduction and high debt levels, or to undertake painful restructuring to reduce overcapacity and close down unprofitable and inefficient state firms, now seems undeniable. On one side of the debate are those who believe that stability and growth at all costs must be maintained. Based on China's experience of reform and opening over the past three decades, they suggest that structural reforms will be easier to achieve if the economy is growing at the same time. This camp therefore supports loose credit policies, government infrastructure investment, and increased fiscal deficits to sustain high growth. Included on this side of the debate is a minority who would rather not see reforms at all.

By contrast, a different group of reformists, thought to be championed by Xi Jinping, Liu He and other members of the Central Leading Group on Financial and Economic Affairs, believe that China must rein in credit expansion, impose budget constraints on SOEs, and end investment in unprofitable projects. While pursuing such reform would inevitably cause a growth slowdown in its initial phases, advocates of this approach believe the slowdown would be modest, and put China on a more sustainable path in the medium- and long-term. Economists who support this approach point out that framing the debate as reform versus growth presents a false choice. China's old economic model is no longer driving growth. The only way to ensure sustainable growth over the long-term is to reform.

Politics at the Fore, Xi at the Forefront

Which side will win out in this debate over China's structural reform direction? Admittedly, the odds are stacked against Xi Jinping. Nearly ten years ago, Premier Wen Jiabao warned that China's growth model was, "unstable, unbalanced, uncoordinated and unsustainable" and urged reform to address a similar set of threats to China's economy. Yet, progress in the years since has been piecemeal at best. During the 2008 global financial crisis that came shortly after Premier Wen's remarks, the Chinese government fell back to old ways, pumping half a trillion dollars of stimulus into the economy in order to sustain growth and stable employment. Since then, China's total debt has exploded to more than 200 percent of GDP.

Xi, however, has taken several extraordinary steps in his first term to consolidate his power and eliminate obstacles to reform that could allow him to break through longtime bureaucratic resistance. Much of his effort has been in preparation for the approaching five-yearly leadership transition, expected in October 2017, when Xi will have the opportunity to appoint his own people to key policymaking positions. If successful in doing so, it will vastly improve his odds of achieving his reform agenda in his second five-year term.

First, Xi has elevated the Party's position within the policymaking apparatus to new levels of predominance, even in spheres such as economic policy, which were previously handled by the State Council and its ministries. For foreign business executives, this development has several significant implications. First, it confirms that supply side structural reform has become the dominant policy orientation through at least 2017 and that Xi Jinping and his Party advisory group, the authors of the supply side structural reform plan, are now taking the helm of Chinese economic policymaking. Multinational corporations need to align their China government relations and communications strategies with the main pillars of supply side structural reform, because the policy has become the principal vehicle for advancing economic proposals in the near future.

Second, multinationals need to reassess and expand their strategic networks from government officials to strategic influencers. With so much policymaking occurring in the small Party leading groups, understanding the new circles of influence in China is essential, and building strong relationships with the key "influencers" in the Party is more important than ever.

Xi's extraordinary consolidation of power is also a consequence of his sweeping anti-corruption campaign, which has purged senior politicians who held authority over some of China's most powerful interest groups: Zhou Yongkang, the former security chief; Ling Jihua, former President Hu Jintao's top political aide; and General Xu Caihou, a former vice chairman on CPC's Central Military Commission; to name a few. Xi's anti-corruption drive has far exceeded those of his predecessors with its intensity, duration, and the seniority of its targets. The campaign enjoys enormous popularity among the Chinese public, who welcome the fact that it pierces all the way down the bureaucracy to notoriously corrupt local officials. Its success in crippling influential patronage networks has greatly contributed to Xi's concentration of power within his inner circle. However, it also has paralyzed risk-averse local leaders, slowing down decision-making, including the approval of new spending projects, which may be negatively impacting economic growth. For multinational corporations, this has manifested in local partners who are reluctant to take risks or make approvals, as well as a slowdown in luxury goods sectors.

A final factor in Xi's power consolidation is his effective silencing of dissent and tightening of control over the internet, media, and official conduct. In the past year, civil-society actors, human rights defenders, lawyers and activists in China have been arrested on charges of political subversion on an unprecedented scale. In February, Xi made a high-profile visit to three of China's leading state news organizations to announce that the media exists to serve the Party. Meanwhile, Xi has moved to tighten controls on information and the internet under a sweeping national security mandate. Finally, he has put in place new rules for official conduct of Party cadres. These steps have sent a chill across all areas of work in China. The upcoming plenary session in October 2016 will be focused on tightening the existing rules for party discipline, and is likely to further dismantle the collective governance model that has guided Party conduct for decades in favor of more centralization of decision-making with Xi and his closest advisors.

All told, these trends have contributed to an environment of fear that now permeates the atmosphere in China. And some observers have questioned whether Xi is over-centralizing and has the bandwidth to be in charge of everything.

Still, Xi will continue to place consolidation of power and centralization of decision-making as top priorities through the 2017 leadership transition. The reasons why are clear: Xi's ambitious economic reform agenda has been met by intense resistance from various interest groups. Xi believes China's economy is at a "make-or-break" moment, and only he can steer it through the dangers ahead.

But very soon, Xi alone will face judgment as to whether he can effectively wield his tremendous authority to realize his stated reform ambitions. At the

19th Party Congress, Xi will have the opportunity to appoint his own people in key positions. Xi will have more places than usual to fill on the Party Central Committee – potentially close to 90 openings versus the normal 40-60. From now until then, politics will be the priority for the Xi administration. Xi Jinping's ability to appoint political allies into key positions of power in Beijing and throughout China's provinces will be critical to the cementing of his legacy. Already we are beginning to see shuffling at lower levels and speculation over the fates of senior officials like Premier Li Keqiang. The outcomes of the twice per decade Communist Party meeting could even foreshadow Xi's political ambitions beyond his second five-year term. CEOs need to be paying close attention to this key political shuffle.

The Promise of the "New Economy"

While the reform of the old economy faces substantial challenges ahead, China's new economy is already showing great promise and resilience. Consumption, services and higher-tech manufacturing have become the main engines of China's new growth despite the overall economic slowdown. Companies in industries such as accommodation, business services, information technology, transportation and retail sectors, and e-commerce are being buoyed by China's increasingly large and wealthy middle-class. By tapping into global talent, new technology, and investment, companies in new economy sectors registered strong positive earnings growth in 2015, in contrast with those in China's energy and materials sectors, which experienced negative growth over the same period.

Compared with just two million households with annual disposable incomes of at least $21,000 in 2000, today there are over one hundred million such middle-class families in China. Their changing consumer-spending patterns are fueling new business opportunities. Chinese consumers are spending more on discretionary items, for example, and showing a growing preference toward experiences rather than goods, which has led to growth in technology, health care, recreation and travel purchases. In addition, new opportunities abound in e-commerce thanks to China's young, highly educated, and tech-savvy consumer class. China's "Internet Plus" program aims to integrate digital infrastructure into other industries, as well as to the countryside to allow farmers to sell crops to the cities more easily.

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China's labor productivity is still relatively low – only 15-30 percent of the average in countries that are part of the OECD. Thus, there is enormous room for productivity growth by better meeting the needs and preferences of middle class consumers, advancing digitization of business processes, moving up the value chain through innovation, and partnering with multinational corporations to enhance efficiency and boost competitiveness. Rising wages, new technologies and innovation, and improving education should only accelerate the growth of new economy sectors going forward.

New growth drivers will also help with efforts to cut industrial overcapacity. The services sector employs more individuals and generates greater income potential per unit of growth than industrial development. In China's case, the services sector employs about 30 percent more jobs per unit of output than manufacturing and construction combined. Thus, the new economy's take-off has played an important role in limiting unemployment and preventing social instability during China's structural transition period.

Yet, replacing old drivers of growth with new ones is a painful process. The Chinese government has set a 6.5 percent growth target for 2017 despite downward pressures and calls to shift the focus away from growth toward reform. While policymakers hope the new economy can pick up the slack from the industrial sectors, both in employment and growth, the new economy may not be able to compensate fully for low growth in traditional sectors because of the geographic component to the issue: heavy industry and low-tech manufacturing are centered in North China, while Southeastern China is the hub of new economy sectors. Even if the new economy creates enough jobs to offset losses in manufacturing, they may not actually prevent large-scale unemployment concentrated in Northern regions.

If the new economy alone cannot offset the harms of supply-side reforms, this places greater pressure on Xi Jinping to achieve necessary structural reforms. Even if he prevails, there will likely be more missteps and obstacles in the future. Still, as China rebalances its economy from fixed-asset investment to services and consumption, newer industries should increasingly drive economic growth. Although difficult, this significant transition will continue to present long-term and rewarding opportunities in China for those willing to commit the time and energy to take advantage of them.
