Xi Jinping Regime Trying to Avert the “Two Traps” — Will the policy of “tilting leftward politically and rightward economically” be sustainable?

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Abstract

Since launching the reform and opening-up initiative, China has been aiming to achieve economic development and a transition to a market economy at the same time. During this process, there is the risk that China could be caught in two traps: a middle-income trap and a transition trap. Indeed, there are already signs that this risk is becoming a reality, including the widening income gap, environmental degradation, corruption among bureaucrats, a decline in the potential growth rate associated with a shortage of labor, and the stalling of the reform of state-owned enterprises.

To avoid being caught in these two traps, the government of Xi Jinping has set forth the policy of “tilting leftward politically and rightward economically,” which seeks to strengthen General Secretary Xi’s power base on the political front and to unleash the vitality of the market and companies by minimizing government intervention on the economic front. The details of economic reforms were decided at the Third Plenum of the Chinese Communist Party held in November 2013. With these reforms expected to meet resistance from vested interests, the government must obtain the people’s support for the economic reforms and undertake political reforms to promote democracy and the rule of law.

Keywords: Middle-income trap, transition trap, Third Plenum, Xi Jinping  
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I. Introduction

China is facing two traps: a middle-income trap and a transition trap. The common characteristics include a widening income gap, a deteriorating environment, and corruption of government officials. In addition, the middle-income trap is characterized by a shortage of labor accompanying the drying up of surplus labor in rural areas (the arrival of the Lewisian turning point), while the transition trap is characterized by stagnating market-oriented reform, such as the privatization of state-owned enterprises. Constrained by these factors, China’s potential growth rate has fallen sharply, and the economy has become unstable.

To avoid being stuck in these two traps, China’s leadership under General Secretary Xi Jinping has followed an agenda of “tilting leftward politically and rightward economically.”
The leftward tilt in the political realm seeks to strengthen the Communist Party’s one-party rule in general, and Xi Jinping’s power base in particular. On the other hand, the rightward tilt in the economic realm seeks to reduce government intervention in economic activities as much as possible so that both the market and enterprises (private sector companies in particular) can demonstrate their strengths. The overall aim is to speed up economic reform under an authoritarian regime. However, achieving this goal will require curbing resistance by vested interests through political reform centered on democratization and establishment of the rule of law.

II. China facing a middle-income trap and a transition trap

The reform and opening up process that China started in 1978 following the Third Plenum of the 11th Central Committee of the Chinese Communist Party can be interpreted as a dual process of economic development and marketization (Figure 1). Before setting out on this course, the Chinese economy consisted of an agricultural sector based on self-sufficient people’s communes and an industrial sector based on state-owned enterprises (known as “state-run enterprises” at that time) that produced according to the state plan. Reform and opening up has brought progress in economic development, with the economy’s core shifting from the agricultural sector to the industrial and service sectors. Meanwhile, the weight of state-owned enterprises has declined while that of foreign and private enterprises has increased as marketization has proceeded. China’s course of economic development has been similar to that of Japan’s since the Meiji Restoration, while its process of marketization has brought problems similar to those faced by Russia and East European countries after the collapse of the Berlin Wall in 1989. To become a modern market economy, China needs to overcome the two traps—the middle-income trap and the transition trap—that stand in the way of this dual transition.

II-1. The middle-income trap hypothesis advocated by the World Bank

The World Bank (Gill and Kharas 2007; World Bank 2012) introduced the concept of the middle-income trap to describe the situation in which an economy that has reached the global median per capita income then fails to find new drivers of growth and remains weak for a long time due to failure to adapt its development strategies or pattern. Countries in the middle-income trap typically experience a slowing growth rate and rising social instability as growth-inhibiting factors engendered during the early stage of economic development come to the surface. These include the drying up of surplus labor, stagnating industrial advancement, a widening income gap between rich and poor, a deteriorating environment, and corruption among government officials.

Generally speaking, in low-income countries, as the labor force moves from low-productivity agriculture to high-productivity manufacturing, exports of labor-intensive goods
increase and the overall productivity of the economy rises. Once these countries reach the middle-income stage, though, the pool of surplus labor in rural areas shrinks sharply, and by the time they pass the Lewisian turning point (i.e., reach the full employment stage of the development process), their growth becomes constrained by the availability of labor. They lose export competitiveness in labor-intensive goods, and economic growth will stagnate unless they increase productivity by becoming more innovative.

Latin American countries are a good example of economies that have fallen into the middle-income trap. These countries managed the transition from low-income to middle-income economies in the 1960s and 1970s, but since then they have experienced a long period of stagnation. Of the 101 countries and territories that were middle-income economies in 1960, only 13 (Equatorial Guinea, Greece, Hong Kong, Taiwan, Ireland, Israel, Japan, Mauritius, Portugal, Puerto Rico, Singapore, Korea, and Spain) became high-income economies by 2008 (World Bank, 2012).

In the more than three decades of the reform and opening-up initiative, China’s presence in the international community has increased, and the lives of its people have generally
improved. However, in recent years its growth rate has been declining, and social discontent 
has been increasing due to the widening income gap, worsening environmental problems, 
and corruption among government officials. These phenomena are regarded by some scholars 
as signs of the middle-income trap.

To overcome this middle-income trap, the Chinese government has tried to change the 
economic development pattern and move toward a harmonious society. Changing the pattern 
of development involves three transformations in the engines of growth: from investment 
and exports to consumption in terms of demand; from manufacturing to services in terms of 
industrial structure; and from expansion of inputs to productivity growth in terms of the 
mode of production. The primary objective is to improve the quality of the economy in 
addition to expanding it quantitatively. Also, to realize a harmonious society, the government 
has to narrow the gaps between urban and rural areas, between the eastern and western parts 
of the country, and between the rich and poor. To that end, the government has to eliminate 
the discrimination faced by farmers under the current household registration system and 
keep corruption in check.

II-2. The transition trap hypothesis proposed by researchers at Tsinghua University

While the middle-income trap focuses on the problems that occur in the process of 
economic development, the Tsinghua University Research Group (2012) introduced the 
concept of a transition trap to describe the problems that occur in the process of transition 
from a planned economy to a market economy. The transition trap refers to a situation 
whereby certain vested interests, such as state-owned enterprises that emerged during the 
transition from a planned to a market economy, resist further reform and try to maintain the 
mixed system of the transition. The consequence is distorted economic and social development 
and worsening associated problems, such as income gaps and environmental destruction. 
Moreover, the incremental approach to reform that China followed, dubbed “crossing the 
river while feeling the stones,” has provided a more favorable environment for the emergence 
of vested interests than the radical big bang transition made by Russia and East European 
countries.

In proposing the concept of a transition trap, the Tsinghua University Research Group 
identified five symptoms indicating that the Chinese economy has fallen into such a situation.

First, China’s economic development is distorted. Vested interests have been pursuing 
high growth in order to make money as quickly as possible, even if it means wasting vast 
resources. Also, they have been avoiding institutional reforms that might damage their 
interests, and instead have tried to moderate social contradictions by raising the people’s 
income through the pursuit of economic growth. With private-sector companies facing tough 
conditions, economic development has to be led by the public sector, and major construction 
projects and events have become important tools for boosting economic growth.

The second symptom is that institutional reform has stagnated and the institutions of the 
transitional period have become permanent. By skillfully combining elements of both the old
system and the new one, vested interests have sought to maximize the benefits accrued to themselves. A good example of this is the monopolies enjoyed by state-owned enterprises. Reforms in important areas, notably politics, have been shelved. Vested interests have opposed reforms that would not be to their benefit and vigorously pursued reforms that are to their benefit. As a result, the general public has lost their enthusiasm for reform.

The third symptom of the transition trap in China is low social mobility and the ossification of social structures. Disconnects have formed between social classes, and society as a whole has lost some of its vigor. Social divisions have become acute, and some alienated sections of society have become desperate. As a result, social contradictions are growing.

The fourth symptom is that maintaining social stability has become the number one national priority. Many resources are devoted to achieving a harmonious society, and maintaining stability has become a pretext for shelving reform. Actions taken to maintain social stability have had the unintended effect of actually making society less stable.

The final symptom is growing signs of social disintegration. Particularly striking is the abuse of power by some regional governments. In the absence of proper curbs on power, the gulf between the people, in both urban and rural areas, and the government is widening, as symbolized by the conflicts over land appropriation that occur frequently. This has made it increasingly difficult for the government to maintain social equity and justice.

Based on this diagnosis, the Tsinghua University Research Group recommended three steps for China to take to break out of the transition trap.

First, China must join the mainstream of global civilization, which is based on universal values such as a market economy, a democratic government, and a society governed by laws. Rejection of universal values is the main reason why China has fallen into the transition trap, which at the same time has become an excuse for vested interest groups to maintain the status quo.

Second, China must also accelerate the reform of its political system. Widespread corruption has weakened the government’s authority as well as its ability to carry out policies effectively. Political reform must begin by creating mechanisms to constrain the government’s power, for example, through enhancing transparency.

Finally, decisions on how to implement reforms should be based on an overall plan (or grand design) formulated by the upper echelons of the central government, and not, as in the past, delegated to local governments and government ministries. When carrying out reforms, the government must listen to the people to gain public support and at the same time place basic value on equity and justice.

III. Emerging labor shortage leading to a fall in the potential growth rate

China’s potential growth rate has fallen sharply as a result of a shortage of labor, which is the focus of the middle-income trap hypothesis raised by the World Bank. Against this background, expansionary macroeconomic policies implemented by Chinese authorities to address the slowdown in growth have destabilized the economy.
III-1. Declining working-age population and drying up of surplus labor in rural areas

China’s once seemingly limitless supply of labor is turning into a shortage as the result of a decline in the size of the working age population and the drying up of surplus labor in rural areas. Thanks to the one-child policy put in place in the early 1980s, China’s working-age population (aged 15–59) started to decline in 2012 (Ma Jiantang, Commissioner of the National Bureau of Statistics of China, Press Conference on China’s Economic Performance in 2012, January 18, 2013) while the aging of the population is gathering momentum. In addition, the rapid pace of industrialization and urbanization has drained the rural areas of excess workers, and China seems to have passed through the Lewisian turning point into the full employment stage in its development process (Figure 2).

The shift from a growing to falling working-age population means that the earlier demographic bonus to the economy is turning into a demographic onus. The economy benefited from a large and expanding working-age population, which provided the labor and savings (and thus investment) needed to support high economic growth. Now, however, with the working-age population shrinking and the aging of the population gathering pace, economic growth will slow down as both the supply of labor and the savings rate decline.

Moreover, arrival at the Lewisian turning point will further constrain growth. The virtually unlimited supply of labor in the past supported economic growth in China through several channels. First, the absorption of excess workers from the agricultural sector by the

Figure 2. China Shifts from Labor Surplus to Labor Shortage

Source: Compiled by Nomura Institute of Capital Markets Research.
industrial and service sectors contributed directly to the expansion of GDP. Also, the shift of
the labor force from the inefficient agricultural sector to the industrial and service sectors,
where productivity was higher, improved productivity of the economy as a whole. Furthermore, by keeping wages at a low level, the labor surplus favored rich people with
high capital income, which in turn led to high savings and investment. With the achievement
of full employment, however, the supply of labor to the industrial and service sectors will
decrease. This, together with a decline in the savings rate, should result in a decline in the
potential growth rate.

Usually, developing countries experience the shift in the working-age population from an
upward to a downward trend and the shift from under employment to full employment at
different times. Japan, for example, is believed to have achieved full employment in the early
1960s (Minami, 1970), but its working-age population did not begin decreasing until around
1995 (World Population Prospects: The 2012 Revision, United Nations). In contrast, these
two turning points appear to have arrived at the same time in China, so the extent of the labor
shortage and the subsequent impact on the economy are greater than in other developing
countries.

Evidence of these changes in China’s labor market is found in the ratio of job offers to
job seekers in urban areas. In the second quarter of 2014 the ratio posted a record high of
1.11, despite the fact the economy was growing far more slowly than it had been in, for
example, 2006–08 (Figure 3). This is in sharp contrast to the situation in early 2009, when
the ratio plummeted at the same time as the economic growth rate fell. The fact that the
number of job offers exceeded that of job seekers suggests that China’s current potential
growth rate may have fallen below the 7.5% actual rate of growth in the second quarter of
2014.

To overcome the constraining effect of the labor shortage on economic growth, China
has started to relax its one-child policy. As the first step in that direction, in November 2013
the Third Plenum adopted a policy allowing the birth of a second child if at least one spouse
of a married couple is an only child.

However, the experience of many other countries suggests that easing the one-child
policy may not succeed in raising China’s birth rate significantly. Birth rates tend to fall as
economies develop and incomes rise, and China has already become a middle-income
country. Furthermore, any rise in the birth rate will be more pronounced in the less developed,
inland and rural areas of China than in the coastal and urban areas, where the economy is
more advanced and income is approaching the levels in developed nations. So, even if easing
the one-child policy leads to increases in labor supply in the medium and long-term, the
overall quality of the labor force in terms of workers’ education and health could be lower.

With the limitations of China’s growth strategy based on expanding inputs of labor and
capital becoming more and more apparent, it has become an urgent task to shift the engine of
growth on the supply side to raising productivity.
III-2. China showing clear signs of a bubble economy

With the potential economic growth rate falling sharply, any attempt to implement expansionary macroeconomic policies to achieve a growth target that exceeds the potential growth rate may destabilize the economy, as happened in Japan in the latter half of the 1980s. China is already showing at least three clear signs of instability, namely, soaring prices of real estate, the ballooning of local government debt, and the rapid growth of shadow banking (Figure 4).

One source of economic stability comes from the shadow banking system. In China, shadow banking refers to a system of credit intermediation that involves entities and activities outside the regular banking system, and raises systemic risk concerns, in particular by maturity/liquidity transformation, and regulatory arbitrage. The core of the shadow banking system consists of wealth management products sold by banks and trust products sold by trust companies. The combined size of these products is estimated to have reached 20.4 trillion yuan as of the end of 2013 (People’s Bank of China, “China Financial Stability Report 2014”).

Figure 3. Ratio of Job Offers to Seekers Remains High Despite Slower Economic Growth
—Reflection of China’s Arrival at the Lewisian Turning Point—

Note: The ratio of job offers to seekers is calculated by dividing the number of job offers by the number of job seekers registered in public employment services organizations in approximately 100 cities in China. Source: Compiled by Nomura Institute of Capital Markets Research based on data provided by the National Bureau of Statistics of China and the Ministry of Human Resources and Social Security.
The shadow banking system uses financial innovation to circumvent supervisory and administrative regulations. The Chinese authorities have subjected banks to interest-rate regulations and relatively high reserve requirements (currently 20.0% for large banks), and are seeking to rein in bank lending through such measures as the loan-to-deposit ratio (75%) and window guidance. So, as market competition has intensified, banks have come to use shadow banking in lieu of traditional lending channels in order to avoid such regulations. In the absence of proper supervision by the authorities, shadow banking can lead to higher risk in the financial system. The sharply increasing volume of lending through the shadow banking system is flowing into the real estate market in particular, either directly or through financing platforms, and this is contributing to soaring housing prices.

A second source of instability is found in the real estate markets in major cities. Prices in these markets rose steeply following the monetary easing China adopted in response to the collapse of Lehman Brothers (Figure 5). In 2010, the government implemented a series of policies to keep the housing bubble from expanding further. Major steps to curb demand included restrictions on loans, limits on purchases, and a hike in real estate-related taxes, while the primary measure to increase supply was to accelerate the construction of public housing for low-income groups. These measures initially succeeded in dampening the real estate bubble, with the year-on-year rate of increase in sales prices of newly constructed residential buildings in 70 large and medium-sized cities turning negative temporarily. However, in January 2013, the increase in new house prices turned positive once again, following the authorities’ resumption of monetary easing. By December 2013, the average price of new residential buildings had risen by 9.7% above its level a year earlier to reach the level of a bubble. Housing prices have entered a phase of adjustment since early 2014, and there is rising concern that the banking sector and the macroeconomy may be hard hit if the...
In addition to the risks from the shadow banking system and the expansion of the housing bubble, the debt held by local governments and by financing platforms in particular is also considered a threat to macroeconomic stability. These financing platforms are economic entities with independent corporate status that local governments and their agencies established by investing fiscal funds, land, and stock holdings. Prohibited from issuing their own bonds under China’s current fiscal system, local governments continually suffer from a shortage of revenue, so they turned to financing platforms as a means to raise funds for infrastructure investments. The central government started to allow local governments to raise funds through financing platforms in conjunction with the post-Lehman economic stimulus package. Since then, the number of financing platforms increased rapidly along with their outstanding debt. The major sources of funds for these financing platforms, besides traditional bank loans, is shadow banking.

According to the National Audit Office (China’s equivalent of Japan’s Board of Audit), at the end of June 2013, local government debt in China totaled 17.9 trillion yuan, and of this amount, 7.0 trillion yuan was owed by financing platforms (“Audit Results of Nationwide Governmental Debt,” December 30, 2013). Moreover, total government debt outstanding reached 30.3 trillion yuan including 12.4 trillion owed by the central government. Total government debt includes debt owed directly by governments, debt owed by government-

Figure 5. Changes in Sales Prices of Newly Constructed Residential Buildings

![Graph showing changes in sales prices of newly constructed residential buildings over time.](image)


Source: Compiled by Nomura Institute of Capital Markets Research based on the CEIC Database.
related institutions with governmental guarantee responsibility, and debt owed by
government-related institutions with “with certain extent of possible governmental rescue
responsibility.” The slowdown in China’s economic growth has raised increasing concern
about the risk of government default on these debts, with the debt of financing platforms a
particular worry.

IV. Stagnating reform of state-owned enterprises

Meanwhile, little progress has been made in the reform of state-owned enterprises, the
major stumbling block of the transition trap.

IV-1. Advancing the state-owned sector and retreating the private sector

China has been encouraging the development of non-state owned enterprises, including
private enterprises, as part of the market-oriented reforms initiated in 1978 with the reform
and open-door policy. In the second half the 1990s, China also started to privatize state-owned enterprises (SOEs) in the name of “strategic realignment of the state-owned economy”
and “ownership reform.” In recent years, however, there has been a noticeable advance in the
state-owned sector and a retreat in the private sector in some quarters. Most of the four
trillion yuan of stimulus funds the government authorized in response to the Lehman Crisis went to infrastructure sectors that are monopolized by state-owned enterprises, including railways, roads, and airports. The advance of the state-owned sector and retreat of the private sector could limit the growth of the overall economy for the following reasons.

First, through lobbying activities, large SOEs seek to raise barriers to market entry in
order to maintain their monopoly profits. This hinders the introduction of the principle of
competition and further market opening. A typical example is that bank lending has been
concentrated in state-owned companies while private companies have difficulty raising
funds.

In addition, as monopoly enterprises can generate profits readily, they have no incentive
to improve efficiency and so cannot achieve competitiveness in international markets. In
fact, China’s emergence as the workshop of the world is largely attributable to foreign-affiliated companies, not SOEs. Those Chinese state-owned enterprises that rank in Fortune magazine’s annual Fortune Global 500 contribute little to the country’s exports.

Moreover, most earnings generated by state-owned enterprises are not submitted to the
government but are retained by the SOEs themselves (Note 1). In 2013, SOEs that are subject
to the budget for the operation of central state-owned capital paid less than ten percent (only
103.9 billion yuan) of their total recorded net income to the national treasury (Ministry of
Finance, “Explanation of the Budget for the Operation of Central State-owned Capital in
2014,” March 2014). In addition, until now, most net income that SOEs did turn over to
public finance flowed back to them as “spending for state-owned economy structural
adjustment,” “spending on priority items,” or “spending for industrial advancement and

Note 1: "Policy Research Institute, Ministry of Finance, Japan, Public Policy Review, Vol.11, No.1, March 2015"
development.” The retention of earnings by state-owned enterprises on one hand reduces the share of income going to labor, thereby suppressing consumption and on the other hand boosts wasteful investment by the SOEs.

**IV-2. The need to privatize state-owned enterprises**

Even in developed capitalist economies there is a risk that the separation of ownership and management may lead managers to infringe upon the rights of owners, but this risk is especially acute in China’s state-owned enterprises, which suffer from the absence of a real owner. Theoretically, each of China’s 1.3 billion citizens owns one 1.3-billionth of each of the country’s tens of thousands of SOEs, but in practice, these citizens are in no position to exercise effective control. As individuals they have neither the ability nor the incentive to monitor each of the enterprises which they are supposed to own, and it would be impossible for them to attend each shareholder meeting. Consequently, government agencies act on their behalf, but the government’s objectives in managing these assets may include not simply maximization of profit but also job creation and social stability. At the same time, the officials appointed by the government to carry out its policies may put their own interests before those of the state or of their fellow citizen-owners. Ensuring that state-owned enterprises serve the interests of the public is difficult in countries with well-established democratic institutions such as elections and parliamentary governments, and even more difficult under China’s one-party system. Since the failure of governance in state-owned enterprises arises from the absence of a real owner, the solution is privatization.

Based on this recognition, the Chinese government launched the idea of privatizing smaller business in the name of “keeping the large and releasing the small” in the mid-1990s. This was followed in 1997 by the policy of “strategic realignment of the state-owned economy,” announced in the Fifteenth National Congress of the Communist Party, which stipulated that state-ownership should be limited to sectors providing public goods and services, while state-owned enterprises, including large ones, should withdraw from areas that compete with the private sector. According to this decision, state-owned enterprises should continue to play a leading role only in the following four sectors, and those in other sectors should be privatized.

The details of the policy of strategic realignment of SOEs was fleshed out in September 1999 with a decision at the Fourth Plenum of the Fifteenth Central Committee of the Communist Party (“The Decision of the Central Committee of the Communist Party of China on Major Issues Concerning the Reform and Development of State-Owned Enterprises”). According to this decision, state-owned enterprises should continue to play a leading role in only four sectors of the economy, and those SOEs in other sectors should be privatized. The four sectors were: 1) industries crucial to national security (including arms production, other defense-related industries, coinage, and strategic reserves); 2) natural monopolies or oligopolies (including postal services, telecommunications, electric power, the railways and air transport); 3) suppliers of public goods and services such as water and gas supplies and
public transport, ports, airports, irrigation facilities and major forest reserve projects; and 4) “pillar industries and backbone enterprises in high and new technology sectors” such as oil, steel and automobiles and some advanced sectors of the electronics industry.

Since then, most of China’s small and medium-sized state-owned enterprises have been privatized through management buyouts, but little progress has been made in privatizing large state-owned enterprises mainly because of resistance from vested interests. China should fully implement the policy of “strategic realignment of the state-owned economy” in order to restore vitality to the economy.

V. The Third Plenum reform program centered on marketization

Since Xi Jinping became General Secretary, China’s leadership has been promoting market-oriented reforms as the means to break out of the middle-income and transition traps. The master plan for marketization going forward was revealed in the “Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform” (hereafter referred to as the “Decision”) which was adopted in November 2013 at the Third Plenum of the Eighteenth Central Committee. (Note 2) The Decision is the core document outlining Xi’s vision for the direction of the economy. Statements in the Decision, such as “let the market play the decisive role in allocating resources,” bring to mind the recommendations of the Washington Consensus, which is considered to be the policy agenda of neo-liberals, who advocate minimizing government intervention in the economy.

V-1. Market acknowledged as the major force in resource allocation

Since China shifted to the reform and opening up policies in 1978, much progress has been made in its transition from a planned economy to a market economy. In 1992, the Fourteenth National Congress of the Communist Party adopted the pursuit of a “socialist market economy” as the goal of economic system reform.

In the 2013 Third Plenum, General Secretary Xi Jinping pointed out:
“After 20 years of practice, a socialist market economy has been basically established in China, but there are still many problems. The market lacks order and many seek economic benefits through unjustified means; the market for factors of production lags behind in development, unable to allocate the factors of production to meet the effective demand; the lack of unified market rules means rampant protectionism initiated by departments or local governments; and market competition is not good enough to select the superior and eliminate the inferior, and thus slows down economic restructuring. If left unresolved, these problems will hinder the development of a sound socialist market economy.” (Explanatory Notes for the ‘Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform.’)
Based on the recognition that the transition to a socialist market economy will not be completed without solving these problems, the 2013 Decision of the Third Plenum makes market-oriented reforms its central organizing theme and raises the role of the market in resource allocation from “fundamental” to “decisive.” It describes the importance of market-oriented reform as follows:

“Economic system reform is the focus of deepening the reform comprehensively. The underlying issue is how to strike a balance between the role of the government and that of the market, and let the market play the decisive role in allocating resources and let the government play its functions better. It is a general rule of the market economy that the market decides the allocation of resources. We have to follow this rule when we improve the socialist market economy. We should work hard to address the problems of market imperfection, too much government interference and poor oversight.

We must actively and in an orderly manner promote market-oriented reform in width and in depth, greatly reducing the government’s role in the direct allocation of resources, and promote resource allocation according to market rules, market prices and market competition, so as to maximize the benefits and optimize the efficiency. The main responsibility and role of the government is to maintain the stability of the macro-economy, strengthen and improve public services, safeguard fair competition, strengthen oversight of the market, maintain market order, promote sustainable development and common prosperity, and intervene in situations where market failure occurs.” (Article 3)

To ensure that the market plays a “decisive” role in resource allocation, Article 10 stipulates that “We will improve the mechanism whereby prices are mainly determined by the market. Any price that can be determined by the market must be left to the market, and the government is not to carry out improper interventions. We will push ahead with pricing reforms for water, oil, natural gas, electricity, transportation, telecommunications and some other sectors while relaxing price control in competitive areas. Prices which are determined by the government will be limited to important public utilities, public-welfare services and network-based natural monopolies while raising transparency and accepting social supervision (Note 3). We will improve the pricing mechanism for agricultural products, and attach importance to the market’s role in determining prices.”

V-2. A reform program reminiscent of the Washington Consensus

The Decision, which aims to deepen market-oriented reforms, is reminiscent of the so-called Washington Consensus, a concept introduced by John Williamson of the Peterson Institute of International Economics. According to Williamson (1990), the basic prescriptions for developing countries made by Washington-based international institutions can be summarized in the form of ten policy recommendations.

1) Protection of property rights
2) Abolition of regulations restricting market entry and market exit
Here, we look at the content of the “Decision” using these ten policy recommendations as a guide.

1) Protection of property rights

Regarding the protection of property rights, Article 5 states: “Property rights are the core of ownership. We need to improve the modern property rights system with clear ownership, clear-cut rights and obligations, strict protection and smooth flow. The property rights of the public sector are inviolable, as are those of the non-public sector. The state protects the property rights and legitimate interests of all economic sectors, ensures that they have equal access to the factors of production according to the law, participate in market competition on an open, fair and just footing, and are accorded with equal protection and oversight according to the law.”

Article 21 adds: “We will safeguard the rights and interests of farmers as members of collective economic organizations, vigorously promote farmers’ joint-stock partnerships, grant farmers the rights to possess, profit from, pull out with compensation, mortgage, guarantee and inherit shares of collective assets. We will guarantee rural households’ legal rights to their homestead, and improve the rural homestead system through reform. We will select several pilot areas to steadily and prudently push forward the mortgage, guarantee and transfer of farmers’ residential property rights, and expand the channels for farmers to increase their property income. We will set up a rural property rights transfer market, and promote the open, fair and procedure-based operation of rural property rights transfer.”

In addition, in article 13 we find, “We will strengthen the application and protection of intellectual property rights (IPR), improve the technological innovation incentive mechanism, and explore ways to set up IPR courts.”

2) Abolition of regulations restricting market entry and market exit

The Decision addresses the abolition of regulations restricting market entry and market exit this way in Article 9: “We will implement a unified market access system. On the basis of making a negative list, all kinds of market players may enter areas not on the negative list on an equal basis and according to law. We will explore a management model for foreign investors with pre-entry national treatment plus the negative list.” . . . “We will reform the market oversight system, implement uniform market oversight, tidy up and annul all sorts of
regulations and methods that impede the national unified market and fair competition, strictly ban and punish all unlawful acts extending preferential policies, combat regional protection, and oppose monopoly and unfair competition.” “We will improve the market exit system in which the good eliminates the bad, and perfect the enterprise bankruptcy system.”

In particular, Article 8 states: “The non-public sector plays an important role in sustaining growth, stimulating innovation, increasing employment, increasing tax revenues and so on. We will persist in equality of rights, opportunities and rules, abolish all forms of irrational regulations for the non-public economy, remove all hidden barriers, and adopt specific measures for non-public enterprises to enter franchising fields (Note 4). We will encourage non-public enterprises to participate in state-owned enterprise (SOE) reform, foster mixed enterprises with non-public capital as the controlling shareholder, and encourage qualified private enterprises to establish the modern corporate system.”

The Decision also discusses opening entry in specific sectors. For example, “We will allow non-state-owned capital to hold shares in projects invested by state-owned capital.” (Article 6); and “We will open the financial industry wider, and allow qualified non-governmental capital to set up, in accordance with law, financial institutions such as small or medium-sized banks on the precondition that this comes under stronger oversight.” (Article 12)

3) Privatization of state-owned enterprises

The “Decision” does not mention privatization explicitly, but it does aim to reduce the weight of the state-owned sector by “vigorously developing a mixed economy” (Article 6) and “accurately defining the functions of different state-owned enterprises” (Article 7).

According to the Decision, “A mixed economy with cross holding by and mutual fusion between state-owned capital, collective capital and non-public capital is an important way to materialize the basic economic system of China. It is conducive to improving the amplification function of state-owned capital, ensuring the appreciation of its value and raising its competitiveness, and it is conducive to enabling capital with all kinds of ownership to draw on one another’s strong points to offset weaknesses, stimulate one another and develop together. We will allow more state-owned enterprises and enterprises of other types of ownership to develop into mixed enterprises.” (Article 6)

Also, “We will ensure state-owned capital increases its input into public-welfare enterprises and make greater contributions in the provision of public services. In natural monopoly industries in which state-owned capital continues to be the controlling shareholder, we will carry out reform focusing on separation of government administration from enterprise management, separation of government administration from state asset management, franchise operation, and government oversight, separate networks from operations and decontrol competitive businesses based on the characteristics of different industries, and make public resource allocation more market-oriented. We will continue to break up all forms of administrative monopoly.” (Article 7)
4) Liberalization of foreign direct investment

Regarding the liberalization of foreign direct investment, the Decision states in Article 24: “We will relax control over investment access. We will have the same laws and regulations on Chinese and foreign investment, and keep foreign investment policies stable, transparent and predictable. We will promote the orderly opening up of finance, education, culture, healthcare and other service sectors, lift limits on access for foreign investment in childcare, care for the elderly, architectural design, accounting and auditing, trade and logistics, electronic commerce and other such service sectors, and further liberalize general manufacturing. We will integrate and optimize customs special supervision zones at a faster pace.” Based on practices in the China (Shanghai) Pilot Free Trade Zone launched in September 2013, “we will select a number of qualified areas and build them into free trade park (port) areas.”

5) Liberalization of trade

The policy with respect to international trade is laid out in Article 25 of the Decision which states: “We will keep to the world trading system and rules, persist in bilateral, multilateral, regional and sub-regional openness and cooperation, seek more converging interests with other countries and regions, and carry out the free trade zone strategy at a faster pace with neighboring countries as the basis. We will reform the management systems of market access, customs oversight, inspection and quarantine, and others, and accelerate negotiations on environmental protection, investment protection, government procurement, e-commerce and other such new fields, so as to form a global, high-standard network of free trade zones.”

6) Liberalization of interest rates, and 7) maintaining competitive exchange rates

Article 12 addresses the issues of interest rate regulation and exchange rate controls with the statement: “We will improve the mechanism for market-based exchange rate formation, accelerate interest-rate liberalization, and improve the national debt yield curve that reflects the relationship between market supply and demand.”

In line with the Decision, China is implementing a three-pronged reform—shifting the yuan to a floating exchange rate system, liberalizing interest rates, and liberalizing capital transactions—in preparation for opening up the country’s financial markets. These moves should enhance the efficiency of the exchange rate and interest rates in allocating resources as well as the effectiveness of monetary policy through interest rate adjustment.

8) Strengthening fiscal discipline

Regarding strengthening fiscal discipline, in article 17 we find: “We will improve the budget management system.” “We will establish a standardized and reasonable debt management and risk early warning mechanism for both central and local governments.” “Local fiscal gaps caused by the central authority’s policy of increasing spending will be filled by general transfer payments in principle.” Then, Article 19 says: “We will maintain
the overall stability of the current financial pattern of the central and local governments, and
further rationalize the division of revenues between them through tax reform and taking into
consideration the tax categories.”

The current taxation system, known as the “tax sharing system”, was established as the
result of the fiscal and tax reform implemented in 1994. It has contributed to economic
growth on one hand, but also led to many problems on the other. First, with tax revenues
concentrated in the central government, local governments, which have large expenditures
but limited sources of revenues, have suffered large deficits. Also, how spending roles are to
be shared between the central government and local government as well as among local
governments are ambiguous and there are too many levels of governments. As a result, the
efficiency of fund use is low. Regional disparities have increased as local governments with
abundant revenues can provide good public services, while the others cannot. The adjustment
to how both revenues and expenditures are shared between the central government and local
governments, stipulated in the Decision, should help strengthen fiscal discipline by reducing
the fiscal deficits and debts of local governments.

9) Reducing public expenditures for redistributing income and raising expenditures for
public services

The Decision calls for redirecting public spending to benefit society at large. Article 2
states: “We should reform the income distribution system and promote common prosperity.
We should promote system innovation in the social sector, promote equal access to basic
public services, and step up efforts to form a scientific and effective social management
system so that our society is full of vigor, but also harmonious and orderly.” In addition,
Article 22 promises: “We will make overall plans for developing urban and rural infrastructure
and communities, and promote equitable access to basic public services in urban and rural
areas.” While Article 23 says: “We will steadily make basic urban public services available
to all permanent residents in cities, and incorporate farmers who have registered as urban
residents into the urban housing and social security network, and make sure their previous
subscription to old-age insurance and medical insurance in the countryside continues in the
urban social security system.”

10) Broadening the tax base

Regarding broadening the tax base, the Decision states that: “We will improve the
taxation system. We will deepen the reform of the taxation system, improve the local tax
system, and gradually increase the proportion of direct tax. We will promote the reform of
value-added tax, and simplify tax rates appropriately. We will adjust the collection scope,
procedures and rates of consumption tax, and impose this tax on products that consume too
much energy and cause serious pollution as well as some high-end consumer goods. We will
establish an individual income tax system in which taxable income is defined in both
comprehensive and categorized ways, accelerate real estate tax legislation and push the
related reform forward in a timely manner. We will accelerate resource tax reform, and
change the current environmental protection fee into an environment tax.” (Article 18) In addition, to increase fiscal revenues, “We will transfer part of the state-owned capital to social security funds. We will improve the budgeting system for the operation of state-owned capital, and increase the proportion of state-owned capital gains that are turned over to public finance to 30 percent by 2020, to be used to ensure and improve the people’s livelihood.” (Article 6)

VI. Post-Third Plenum Reform of State-Owned Enterprises

Among the reforms proposed in the Third Plenum Decision, the part related to state-owned enterprises has attracted the most attention, with the promotion of a mixed ownership economy, the development of a modern corporate system, and the improvement of the supervision and administration of state-owned assets garnering the most interest.

VI-1. Promotion of a mixed ownership economy and development of a modern corporate system

Ownership of China’s SOEs has diversified in recent years with the introduction of non-state-owned capital through the shareholding system and other measures, and a so-called mixed ownership economy is gradually taking shape (Note 5). In the Decision, the mixed ownership economy is positioned as “an important way to materialize the basic economic system of China.” From now on, further development of the mixed ownership system, together with the development of a modern corporate system, will be the core of SOE reform. Huang Shuhe, Vice-Chairman of the State-owned Assets Supervision and Administration Commission of the State Council, explained the specific content of these reforms as follows (Huang, 2014).

When developing the mixed ownership economy, different policies will be applied, depending on the function of the enterprise. First, SOEs related to national security, state-owned capital investment companies, and state-owned capital operating companies will have 100% state ownership. Second, for SOEs in key industries and areas with deep involvement in the national economy, state capital will maintain absolute control. Third, for important SOEs in industries that are mainstays of the national economy and high-technology and technologically innovative industries, state-owned capital will maintain relative control. Fourth, for other SOEs, the ownership ratio of the state will be kept low and, in some cases, will be withdrawn completely. At the same time, the listing of qualified SOEs will be encouraged, and the shareholder structure of SOEs that have yet to fulfill listing requirements will be diversified by introducing a variety of investors. Furthermore, strategic investors with the necessary capital, technology, and management knowhow as well as institutional investors such as the National Social Security Fund, general insurance funds, and equity investment funds will be encouraged to participate in the reform of SOEs.

In order to develop a modern corporate system, the reform of SOEs will focus on five
areas.

First, corporate governance of SOEs will be improved. Shareholders, directors, auditors, and management will play their respective roles in aiming to bring about true corporate governance. SOEs will build an effective incentive mechanism over the long term and strengthen the pursuit of their management and investment responsibilities.

Second, SOEs will delegate management to professionals who will act as entrepreneurs. For that purpose, they will increase the number of managers recruited from the market.

Third, reforms related to human resources, labor, and distribution inside SOEs (the so-called three institutional reforms) will be promoted to enable them to compete freely in the market economy. At the same time, information disclosure will be strengthened, and the transparency of management will be improved.

Fourth, SOEs will standardize salary levels, benefits, welfare expenses, and business spending for management personnel and develop related rules. The compensation of managers and employees will be linked to company performance.

Finally, methods for employee shareholding in a mixed ownership company will be studied. SOEs will allow employee shareholding to create common interests between the owners of capital and workers.

VI-2. Improvement in the supervision and administration of state-owned assets

The Decision at the Third Plenum shifts the objective of the supervision and administration of state-owned assets from the previous one of managing enterprises to the new one of managing capital.

For a long time, SOEs in China were administered under different government departments and had no independent management, resulting in weak corporate governance and inefficiency. The creation of the State Asset Supervision and Administration Commission (SASAC) in 2003 addressed the problem of diverse control by concentrating responsibility for the supervision and administration of SOEs (except for banks and certain other SOEs) in the new entity. Since then, however, several problems related to the SASAC’s continued involvement in SOE management have become evident. First, the SASAC tends to formulate policies favorable to the business of certain SOEs in exchange for their carrying out administrative as well as business activities. Moreover, besides simply managing state-owned assets, the SASAC tends to engage in other functions—such as employee assignment, workplace safety, and environmental practices—that should be managed by the SOEs themselves. Finally, the SASAC may not be able to adequately supervise SOEs because it lacks sufficient information and specialized knowledge of the actual business conditions that pertain to their management.

To address these problems, the Decision at the Third Plenum adopts a policy of “improving the state-owned asset management system, strengthening state-owned asset oversight with capital management at the core, reforming the authorized operation mechanism for state-owned capital, establishing a number of state-owned capital operating companies,
and helping qualified SOEs to reorganize themselves into state-owned capital investment companies” (Article 6). The three-tiered structure that has already been introduced in cities such as Shanghai serves as a guide to how this policy will be implemented. That structure consists of the SASAC, state-owned capital operating (investment) companies, and SOEs (Figure 6).

To date, the SASAC has been directly administering the human resources, management, and finance of SOEs. In addition, as the principal-agent relationship over state-owned property rights has not been legally defined, the government intervenes excessively in SOEs and often compensates for their deficits. The resulting soft budget constraints create a serious threat of moral hazard. Moreover, the illiquidity of state-owned property rights hampers entry into new business areas and withdrawal from old areas and makes capital efficiency extremely low. Going forward, the top-tier SASAC will focus on the supervision and administration of state-owned capital operating (investment) companies, the middle tier.

The second-tier state-owned capital operating (investment) companies will manage capitalized and securitized state-owned assets, or state-owned capital, instead of managing SOEs directly. The main function of the middle tier entities is to serve as the shareholders of the state-owned enterprises with mixed ownership, that is, to exercise governance on these companies through the board of directors, to examine their business performance, to increase or decrease the number of state-owned shares, and to seek new investment. There are already several entities carrying out these functions including: the National Social Security Fund; asset management companies such as China Cinda Asset Management Co., Ltd. and China Huarong Asset Management Co.

![Figure 6. Three-tiered Structure for the Supervision and Administration of State-Owned Assets](image-url)
or decrease the number of state-owned shares, and to seek new investment. There are already several entities carrying out these functions including: the National Social Security Fund; asset management companies such as China Cinda Asset Management Co., Ltd. and China Huarong Asset Management Co. Ltd.; China Investment Corporation (CIC), which manages certain foreign currency reserves; and Central Huijin Investment Co., Ltd.

In the future, the treatment of SOEs will vary, depending on their nature. The Decision states: “State-owned capital investment operations must serve the strategic goals of the state, invest more in key industries and areas that are vital to national security and are the lifeblood of the economy, focusing on offering public services, developing important and forward-looking strategic industries, protecting the environment, supporting scientific and technological progress, and guaranteeing national security” (Article 6), and “We will ensure state-owned capital increases its input into public welfare enterprises and makes greater contributions in the provision of public services. In natural monopoly industries in which state-owned capital continues to be the controlling shareholder, we will carry out reform focusing on separating government administration from enterprise management, separating government administration from state asset management, franchise operation, and government oversight, separating maintenance departments from operations departments, and deregulating competitive businesses based on the industry’s characteristics, and we will make public resource allocation more market-oriented. We will continue to break up all forms of administrative monopoly.” (Article 7)

These reforms are anticipated to have the following effects. First, intervention by the SASAC into SOEs will be eliminated with the establishment of specialized organizations to manage state-owned capital. Second, as state-owned assets will be capitalized (physical assets and monetary assets of SOEs will be converted into shareholders’ equity), it will be easier for the state to manage its investment portfolio. In particular, as the liquidity of state-owned capital increases, it will be easier to enter into and withdraw from industries, so that resources will be allocated more efficiently. In addition, the capitalization of state-owned assets will facilitate the entry of other forms of capital, which will promote the diversification of the capital of SOEs.

VI-3. Remaining issues

While the Decision emphasizes the promotion of a mixed ownership economy, the development of a modern corporate system, and the improvement of the supervision and administration of state-owned assets, it also states: “We must unswervingly consolidate and develop the public economy, persist in the dominant position of public ownership, give full play to the leading role of the state-owned sector, and continuously increase its vitality, controlling force and influence” (Introduction to Section 2 - Adhering to and Improving the Basic Economic System). This means that the ideological barrier hindering the reform of SOEs has not yet been removed.

While the development of a mixed ownership economy is expected to encourage the
privatization of SOEs, it could also be abused as a tool to expand the dominance of state-owned capital and strengthen the position of public ownership. In that case, the goal of breaking down the administrative monopoly cannot be realized.

In addition, China still has a rocky road ahead in installing professional corporate managers in place of the senior managers of SOEs who are drawn from cadres of the Communist Party or the government and also in pulling SOEs out of competitive sectors that could be left to private firms, as vested interests will exert strong resistance to such changes.

Finally, the supervision and administration of state-owned assets cannot be fair and disinterested under the SASAC. While the SASAC is supposed to be a disinterested impartial referee, it is also a player in the game of preserving state-owned assets. When guiding the overall operation of SOEs, the SASAC lacks strategic thinking and is not so concerned with the desired role and status of the SOEs in the national economy, but instead seeks to strengthen the state-owned economy alone. Furthermore, the issue of who should supervise the supervisory authorities, including the SASAC, remains unsolved.

Although it has headed in the right direction, the Decision has not yet provided fundamental solutions to the many difficult and long-standing problems regarding the reform of China’s SOEs, such as the ideological issue, dismantling the administrative monopoly, separating administration and corporate management, exiting of SOEs from competitive sectors, and improving the supervision and administration of state-owned assets. Therefore, whether the government will be able to achieve the desired effects remains an open question.

VII. Xi Jinping’s agenda: leftward political tilt and rightward economic tilt

Since becoming Secretary General in November 2012, Xi Jinping’s agenda has gradually come to be characterized by a leftward tilt politically and a rightward tilt economically. In the political realm it seeks to strengthen the Communist Party’s one-party rule, and Xi Jinping’s power base in particular. On the other hand, in the economic realm it seeks to reduce government intervention as much as possible to allow both the market and enterprises (private sector companies in particular) to demonstrate their strengths.

VII-1. Politics tilting leftward

In politics, observers have noted several leftward trends since Xi took office.

First, General Secretary Xi has tried to solidify the authority of the Communist Party and himself as the successor of Chairman Mao Zedong by praising Mao’s achievements. He has repeatedly commented, “People should not use the second 30 years (of the People’s Republic) to repudiate the first 30 years, or vice versa.” In July 2013, he visited Xibaipo and Mao’s former residence, which are considered holy places of the Chinese Revolution, and gave instructions to make Mao’s former residence an educational base to teach the traditions of nationalism and revolution. In December 2013, Xi and the other six members of the Central Politburo Standing Committee, the top leadership of the Communist Party attended a
roundtable discussion and visited the Chairman Mao Memorial Hall as part of the events commemorating the 120th anniversary of Mao’s birth.

The Communist Party has also stifled freedom of speech in the media to suppress criticism of the regime. Mini blogs of scholars with ideas or opinions in disagreement with those of the Communist Party have been shut down one after another since May 2013, and some well-known bloggers have been arrested. Over the same period, major news media such as the *Hongqi Wengao* (the Red-Flag Manuscript), the *People’s Daily*, and the *PLA Daily* have published a number of articles criticizing the constitutional government system while praising China’s current political system. Foreign news media have reported that universities in Beijing and Shanghai have issued an internal notice banning discussion of seven subjects—namely, universal values, freedom of the press, civil society, civil rights, the historical mistakes of the Communist Party of China, the powerful and wealthy privileged class, and the independence of the judiciary (Ming Pao Daily News, 2013).

In addition, the Communist Party is rectifying its disciplines and strengthening its anti-corruption campaign. Its aim is not only to gain popular support, but also to enhance the authority of the leadership and deliver a blow against conservative forces hampering reforms. Under the slogan “targeting both tigers and flies” (e.g., cracking down on corrupt leaders as well as low-level officials), many high-ranking officials have become subject to corruption investigations.

Lastly, the Communist Party has tried to concentrate power in the leadership, particularly in General Secretary Xi. The National Security Committee and the Leading Group on Comprehensive Deepening of Economic Reform, headed by Xi, were established following the Third Plenum in November 2013.

**VII-2. The authoritarian system has entered a new stage**

In fact, leaning leftward politically and rightward economically is the same basic agenda followed to some extent or another by all of China’s previous leaders since in 1978. Xi Jinping’s current agenda is simply to try to strengthen a format that is widely seen as characteristic of an authoritarian system.

An authoritarian system is positioned between a totalitarian system and a democratic system in terms of the extent to which political power is concentrated, the relationship between power and freedom, the governance method, ideology, and the legitimacy of the political regime (Table 1). In the wake of the reform and open-door policies adopted in 1978, China shifted to an authoritarian system from the totalitarian system that had existed since the establishment of the communist regime in 1949. Under an authoritarian system, China has aimed to maintain the Communist Party’s one-party rule and aims for economic development by promoting market-oriented reforms and opening up the country to the world.

Xiao Gongqin, a professor at Shanghai Normal University and a leading advocate of authoritarianism, regards the reform and open-door policy agenda adopted by Deng Xiaoping as Version 1.0 of China’s authoritarian system, and the agenda adopted by Xi Jinping as
Version 2.0 (Xiao, 2014). According to Xiao, in Version 1.0 of this authoritarian system, the government paved the way for market-oriented reforms, while in Version 2.0, in addition to developing a market economy, the government has to solve problems stemming from government-driven reforms, such as corruption and market monopolization by state-owned enterprises and the emergence of vested interest groups. With General Secretary Xi addressing these problems seriously, Xiao expects China to enter a golden age of authoritarian rule.

Wu Jiaxiang, who was a policy advisor to former General Secretaries Hu Yaobang and Zhao Ziyang in the 1980s, also believes that General Secretary Xi will become a strong, authoritarian leader (Wu, 2012). To support this view, he points out that Xi Jinping gained control of the military at the same time that he became General Secretary of the Communist Party, which is the first time this has happened in 30 years; that the premier of the State Council and the General Secretary of the Communist Party share similar viewpoints; and that political interference by former leaders has basically disappeared.

**VII-3. Political reforms have emerged as urgent issues**

Against this championship of authoritarianism, scholars outside of the regime, mainly neo-liberals, argue that democratization and the rule of law, rather than a stronger government, are necessary for China to solve the many problems it faces (Note 6). First, China’s one-party system tends to emphasize efficiency more than fairness in economic development. As a result, income disparity is growing, and it is becoming a threat
to social stability. Implementing fair and equal elections would reduce the disparity by giving a voice to the weak so that their demands will be reflected in economic policies.

Second, a government that stays in power for a long time will inevitably become corrupt, and the Communist Party of China is no exception. A political system that facilitates the orderly change of government through periodic democratic elections would reduce the tendency for corruption.

Third, China’s environmental problems have become more and more serious. However, its one-party system lacks the checks-and-balances, such as legal requirements, monitoring of companies by civilian groups and mass media, and unbiased court decisions that have enabled other countries to solve their environmental problems.

Lastly, China’s traditional communist ideology, which calls for class struggle, has lost its appeal to the people as economic development and an increasingly market-oriented economy have resulted in more diverse societal values and interests. Obtaining the people’s blessing through fair and open elections would be an effective way for the Communist Party to regain legitimacy.

Since the mid-1970s, more and more countries around the world have made the transition from authoritarian systems to democratic ones, a phenomenon which has come to be known as the “third wave” (Huntington, 1991). In Asia, for example, authoritarian systems (or “developmental dictatorships”) in the Philippines, Taiwan, South Korea, Thailand, and Indonesia, have all given way to more democratic ones. China’s current difficulty ensuring continued economic development while maintaining social stability is calling its authoritarian system into question and generating pressure to shift to a democratic system. It seems inevitable that the Xi Jinping government will have to pursue political reforms in that direction.

Appendix

Two Bubbles—Comparing China today with Japan in the late 1980s

The Japanese economy experienced an asset bubble in the late 1980s, which was followed by a decades-long slump once it burst in 1990. A bubble is also forming in China’s real estate market today, and whether China’s economy will follow the same course as Japan’s is attracting wide attention. Here we try to figure out the similarities and differences between the two episodes.

Similar factors leading to the two bubbles

Some of the factors that led to the emergence of each bubble are similar.

First, in both cases the government responded to an increasing shortage of labor by adopting expansionary macroeconomic policies to stimulate the economy above its potential growth rate. This was a cause of the asset bubble.

Also, in both countries, liquidity expanded as a result of the authorities actively intervening in the foreign exchange market to curb a rise in exchange rates. In Japan, the yen appreciated sharply following the Plaza Accord of 1985, and the Bank of Japan began to
conduct a large-scale dollar buying intervention in February 1987 in the wake of the conclusion of the Louvre Accord, which sought to stabilize the U.S. dollar among the G7 member countries based on the recognition that the goal of correcting the strong dollar had been achieved. Together with monetary easing, this boosted liquidity, which in turn fueled the asset bubble. In China, the market intervention undertaken to curb the rise in the yuan also has become a factor in expanding liquidity and triggering rising real estate prices.

Moreover, in both countries, shadow banking has been used as a way to get around regulations on lending funded by bank deposits. In Japan during the bubble period, significant property-related lending was provided through non-banks, such as jusen, or housing loan companies, that were beyond the reach of supervising authorities. This accelerated the ballooning of the real estate bubble and aggravated the bad debt problem after the bubble burst. In today’s China, banks and trust companies are also pouring some of the funds they have raised by selling wealth management products and trust products into the real estate market.

Lastly, although the prices of assets (real estate and stocks in the case of Japan, real estate only in the case of China) rose significantly during the bubble, inflation remained relatively low. This delayed the shift to a tighter monetary policy which would have helped deflate the bubble.

Differences from Japan that are expected to attenuate the risks

In a number of ways, however, China’s situation today is significantly different from Japan in the 1980s.

First, in Japan, since lending by banks to non-banks such as housing loan companies was a balance sheet item, it showed up in the form of non-performing loans if it went sour. In contrast, in today’s China, most shadow banking products are separated from banks’ balance sheets, and banks are not obliged, in principle, to compensate their customers for losses even if these products default.

Also, while most banks in Japan are private-sector companies, banks in China are mostly state-owned. Therefore, Chinese banks are expected to have the support of the government in times of emergency.

In addition, by the time of its asset bubble, Japan had already moved to a floating exchange rate system and capital movements had been liberalized to a large extent. In contrast, in China the authorities still strictly manage the yuan exchange rate and capital movements are tightly restricted. As a result, the yuan is unlikely to become a target of speculation, and the destabilization of the financial market through major capital movements can be avoided.

Lastly, the two countries are at very different stages of economic development. Japan was already a mature, developed economy in 1990 at the time its bubble burst. China, on the other hand, is still an emerging industrial nation. Even though China’s potential growth rate has fallen, it is likely to be able to maintain moderate growth of 6–7% for the foreseeable future by making use of the latecomer advantage. In particular, the expected advance of
urbanization will underpin not only real estate investment but also overall economic growth. These differences provide favorable conditions for China to avert an economic crisis and a long-term economic slump that could result from the bursting of the bubble.

Notes:
1. As of 2013, the share of net income after taxes (subtracting the previous fiscal year’s losses and legal reserves from net income) paid to the national treasury by SOEs under direct control of the central government is classified into five categories (Ministry of Finance, “Explanation of the Budget for the Operation of Central State-owned Capital in 2013,” March 2013).

   Category I: Tobacco enterprises, 20%
   Category II: Resource monopoly enterprises such as petrochemical, utilities, telecommunications, and coal, 15%
   Category III: Enterprises in general competitive industries, such as steel, transportation, electronics, foreign trade, and construction, 10%
   Category IV: Defense enterprises, scientific research institutes that have been incorporated, China Post Group, and enterprises that became subject to the budget for the operation of central state-owned capital in 2011 and 2012, 5%
   Category V: Policy-related enterprises including China Grain Reserves Corporation (Sinograin) and China National Cotton Reserves Corporation (CNCRC), 0%

   Small and micro SOEs with net income of 100,000 yuan or less are exempt from payments to the national treasury under the intent of Category V.

2. The Decision is composed of 16 sections and 60 articles (excluding the introduction and closing remarks) covering economic, political, cultural, social, ecological and national defense issues. Economic issues are mainly discussed in Section 2 (Adhering to and Improving the Basic Economic System), Section 3 (Accelerating the Improvement of the Modern Market System), Section 4 (Accelerating the Transformation of Government Functions), Section 5 (Deepening the Reform of the Fiscal and Taxation Systems), Section 6 (Improving Mechanisms and Institutions for Integrated Development of Urban and Rural Areas), Section 7 (Building a New Open Economic System).

3. Network-based natural monopolies refer to such sectors as electricity, railway and telecommunications.

4. Franchising business refers to areas such as public services and infrastructure, where companies involved need to receive permission from the government.

5. “Mixed ownership economy” is not a new concept. The Decision of the Central Committee of the Communist Party of China on Several Major Issues Concerning the
Reform and Development of State-Owned Enterprises made at the Fourth Plenum of the Fifteenth Central Committee of the Communist Party of China in 1999 stipulated that “State-owned capital can attract and organize social capital through the shareholding system, expand the function of state-owned capital and increase the control, influence, and driving power of the state-owned economy. State-owned large and medium enterprises, particularly those which have an advantage, are suited for the implementation of the shareholding system, and we will change them to shareholding companies and develop the mixed ownership economy in forms such as listing according to rules, joint ventures with foreign companies, and mutual investment. In the case of important enterprises, the state will be the controlling shareholder.” The Decision of the Central Committee of the Communist Party of China on Several Issues Concerning the Development of the Socialist Market Economy made at the Third Plenum of the Sixteenth Central Committee of the Communist Party of China in 2003 also stated: “We will greatly advance the mixed ownership economy in which state-owned capital, collective capital, and non-publicly-owned capital are jointly invested and make the shareholding system the main form to realize the public ownership system.”

6. Authoritarians also believe, as neoliberals do, that China should aim eventually to establish a democratic system. However, authoritarians recommend that China should carry forward the process of democratization by moving in an orderly way from a totalitarian system to an authoritarian system and then to a democratic system. They claim that society could be destabilized if China ignores this order and tries to shift to a democratic system all at once. Thus, China should aim to make a democratic system a long-term objective, instead of a short-term objective. Toward that end, under an authoritarian system, the government must not only promote economic development, but also develop preconditions for a democratic system, such as a market economy, private property, civil society, and the rule of law.

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