

China: Restructuring and Reform Is there a new normal?

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Outline

1. China has been the most rapidly growing economy in world history; but that “miracle growth” phase is now over.
 - China’s growth is “miraculous,” but its rapid growth phase resembles that of Japan and Korea, and we can learn from their earlier experience.
2. China’s response to the end of miracle growth has been distinctive:
 - A. Xi Jinping’s authoritarian “revivalism.”
 - B. Economic policy: complex mix of ambitious reform proposals and shaky implementation. China has repeatedly “undershot.”
3. Restructuring and reform have not yet achieved qualitative success--we are not in the “new normal” yet, and we should expect further turbulence.

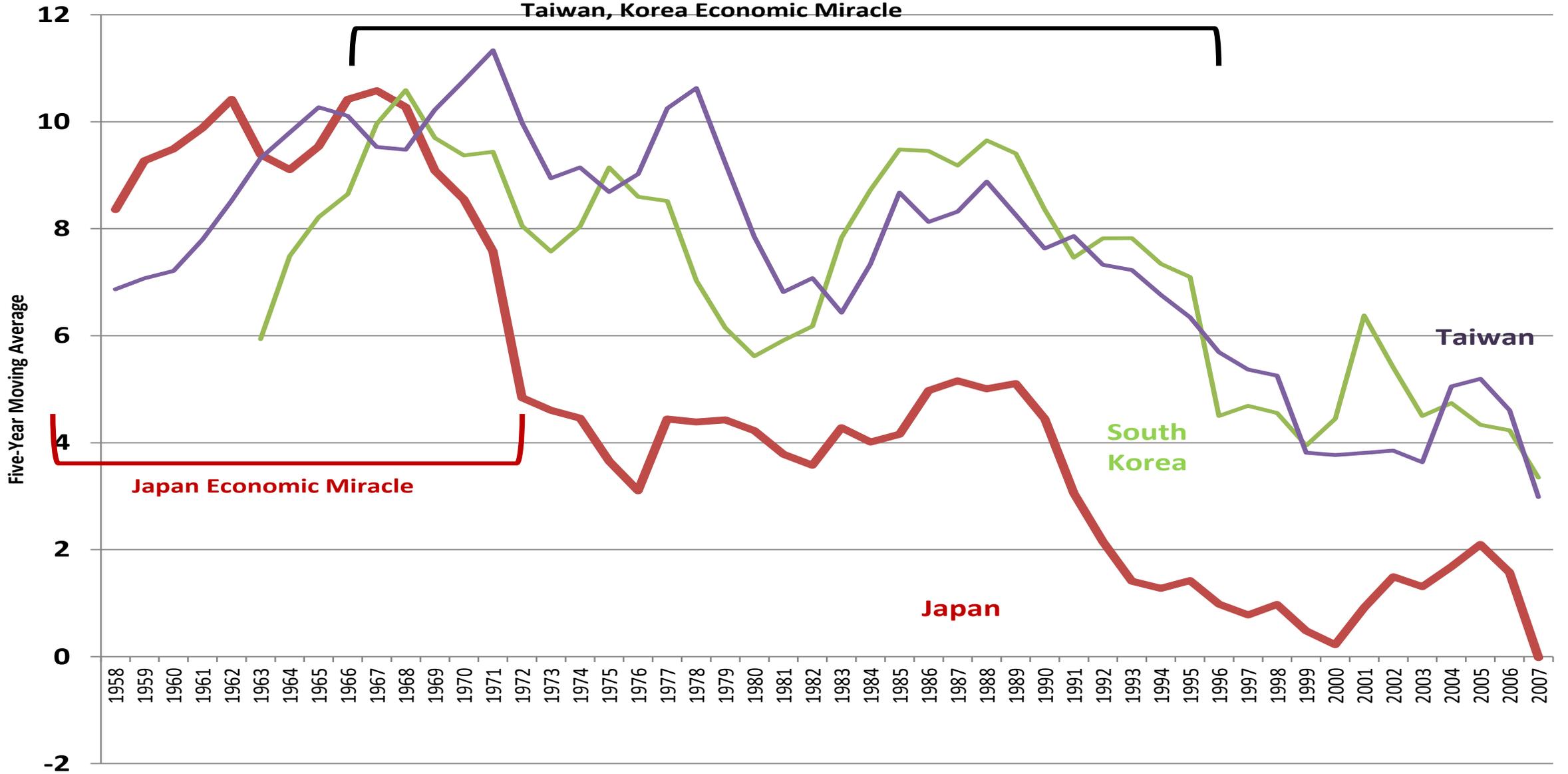
1. China is the most powerful “growth machine” ever seen

- China has experienced a 32 year period (1978-2010) during which GDP grew at over 8% per capita. All of the potential contributions to growth were high, and actual realized growth was very high.
- The 6th East Asian growth miracle, the biggest , the fastest, and the longest. Japan also grew above 8% per capita, but “only” for 18 years (1955-1973).
 - Demographic Dividend
 - Rapid Structural Change
 - Massive institutional and technological transfer
 - Huge gains from economic “openness” and successful system reforms.
 - High saving and investment make it possible and accelerate the pace of change.

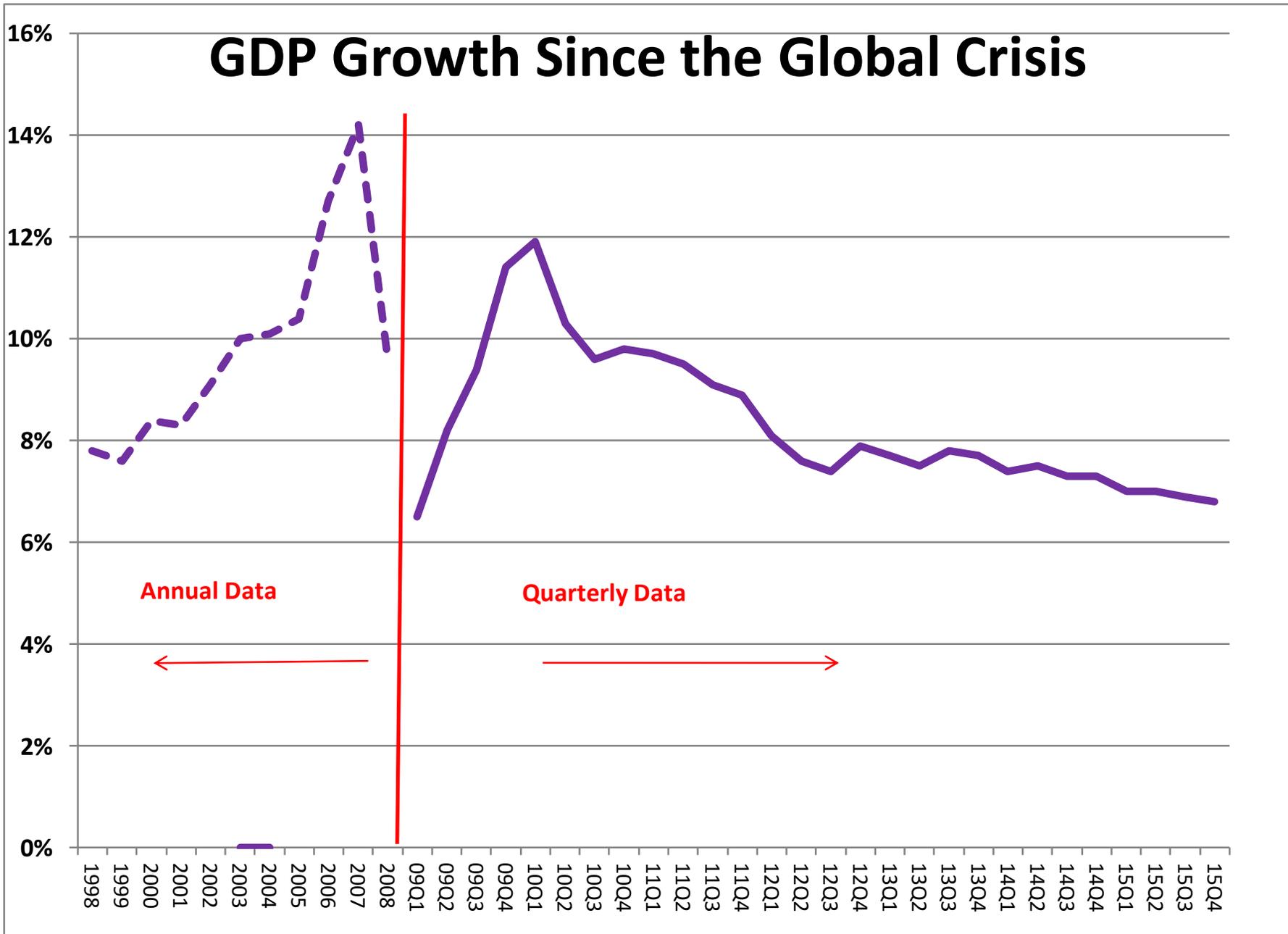
In forerunner economies (Japan and Korea, especially) the end of “hyper-growth” displayed four simple features:

- First, long-term structural changes began to signal the coming end of the hyper-growth period.
- Second, the government tried to sustain rapid growth through increasing investment and expansionary monetary (and fiscal) policy.
- Third, a sudden, sharp drop in growth was triggered by a seemingly unrelated exogenous event.
- Fourth, growth never fully “bounced back,” but instead recovered to a lower, more moderate long-term growth path.

Gross Domestic Product (GDP)--Growth Rates



GDP Growth Since the Global Crisis



Forerunners: The Response to Slowdown

1. The **economic** response is difficult:

Specific short-run problems turn out to be part of long-run, inter-related intractable problems.

Policy-makers take a long time to learn that the policies and institutions that worked so well during the miracle growth era no longer work.

Eventually, the economy responds more-or-less well, re-orienting to a larger domestic market, moving into a service economy (post-industrial), and becoming a higher-skilled and more innovative economy.

2. The **political** response is unambiguous:

Government policy becomes less intrusive, more “light touch.”

Society becomes more open and pluralistic.

In some cases, societies democratize.

They are wealthier, middle-income, better-educated and more diverse societies.

Korea is a good example where all these things happened simultaneously, as a response to short-run problems and long-run success.

2. China's Distinctive Response

- A. Politically: Xi Jinping has brought in a kind of revivalist, nationalist authoritarian system very different from the liberalization we should anticipate.
- B. Economically: Ambitious plans for system reform and structural transformation have been unevenly implemented.



2A. Politics: Xi Jinping's New System

- Xi Jinping has already completely upset expectations about change in the Chinese system. He has:
 - consolidated power more rapidly and established his own personal supremacy more thoroughly than most believed possible.
 - pushed for personalized, charismatic rule to a greater degree than anyone imagined.
 - advanced a more ambitious agenda many expected.
- As a result, the “collegial enlightened dictatorship” that was Deng Xiaoping’s legacy is over. It is becoming infused with more charismatic and authoritarian elements. This potentially gives the Chinese system more dynamism, but also makes it less predictable and potentially more dangerous.

Xi Jinping's "Revivalist" Agenda



2B. Economic Policy

- During the miracle growth years, Chinese economic policy was notably “smart.” It was adaptive, incremental and pragmatic.
(This—along with China’s entrepreneurial and relatively well-educated population—explains a lot about China’s success.)
- External conditions have changed: those policies don’t work today.
- Policy-makers were relatively quick to recognize that changes called for a new growth model—more balanced and sustainable—but did not have effective tools to achieve it.
- Xi Jinping came in promising radical economic reforms, and in the “Third Plenum” of November 2013, seemed to be delivering.

Implementation of the Reform Agenda: Mixed at Best

- Successes: Cutting red tape for small businesses; liberalizing interest rates; improving international access to Chinese capital markets.
- Progress, but disappointing: Improving land development rights for farmers; relaxing access to urban residence permits (*hukou*); stronger government transparency efforts.
- Ordinary failure: local government debt; local government fiscal reform; land system reform.
- Fiascos: Stock market liberalization; floating rate (depreciation) for the RMB.

State Enterprise Reform

The November 2013 Reform Document had exciting words about “Managing Capital,” “Mixed ownership,” and “Investment funds.” Instead, the positive achievement was to resume the stalled SOE Reform Agenda from a decade ago:

- A. Convert “virtually all” SOEs to Corporations under Company Law (which was passed in 1995, 21 years ago).
- B. Convert top-level holding companies into listed joint stock corporations gradually.
- C. Set up Boards of Directors at virtually all firms and strengthen their power.
- D. Strengthen the authority of the Communist Party over Boards of Directors and SOEs.
- E. Divide SOEs into “public service” and “commercial.” Divide Commercial SOEs further into those in competitive sectors and those in not purely competitive sectors or with special tasks.
- F. Private capital invited in whenever possible, and government stakes in competitive, commercial SOEs (only) could be converted to minority.

New Management Structure

Table: New State Capital Management System

Government

|

Asset Supervision Agency

|

State Capital Investment and/or Operation Company

|

State Enterprise

国有资本投资、运营公司

|

State Enterprise Subsidiaries

Commercial, Not-fully-competitive firms:

Any firm whose main business is in sectors that “relate to national security, or the commanding heights of the national economy or important sector or keypoint areas,” and should be incentivized to “better served important national strategies and macroeconomic control” and specifically “develop forward-looking strategic sectors and well as any specially assigned responsibilities.”

In other words, any firm that the government decides it wants to use as an instrument for anything. There is no dividing line. The government is instructed to maintain a controlling stake in every firm in this “not-fully-competitive” class.

Who decides what kind of firm it is?

- The owner.
- Currently the State Asset Regulatory Agency (SASAC and its local avatars).
- Ultimately, the SCIOs.
- SCIOs will have missions.
- SCIOs already have missions: for example, Gansu Province has already laid out a list of twenty-some objectives for its SOEs, drawn from its provincial plan. The implication is that a new SCIO will be set up to carry out these (unrealistic) objectives.

Part of the hi-tech push.

- Base level SOEs are *encouraged* to take stakes in private firms. They can expand and foster the government's agenda (implicitly, with cheaper capital).
- There are already hundreds of billions (USD) of new government “private equity” firms investing in high tech sectors. For integrated circuits, funds already announced total US \$150 billion. Beijing's fund is \$10 billion.
- SCIOs will join a crowded field investing in “forward-looking strategic industries.”

3. Reform and Restructuring Have Not Yet Achieved Qualitative Success

- Growth fears and ideological considerations have repeatedly undermined successful implementation of reforms.
 - GDP growth should not fall below 6.5% to reach target of doubling GDP by 2020.
- As a result, credit policy has been generally accommodative, and debt burdens have continued to grow.
- In fact, policy has been more accommodative than is apparent because of the way that, for instance, local government debt restructuring was carried out. \$3.2 trillion RMB in 2015—and \$5 trillion RMB projected for 2016—has been placed on the books of state banks (at low interest rates).

As a result, restructuring has been slow

- We know that the “old economy” indicators for China showed close to zero growth last year.
- Electricity production +0.3%; Coal -3.3%; Steel -2.2%; Cement -5.3%
- Consumer durables Autos +3.3%; Refrigerators -9.1%

- The question is, how much have “new economy” grown?
- E-commerce is exploding: the number of customers surpassed the US in 2013, *China Mobile* data traffic is up 152%; international air travel +34%; medicine and medical device sales +14-18%.

Fig 1. Composition of GDP

Production Side: Current Prices

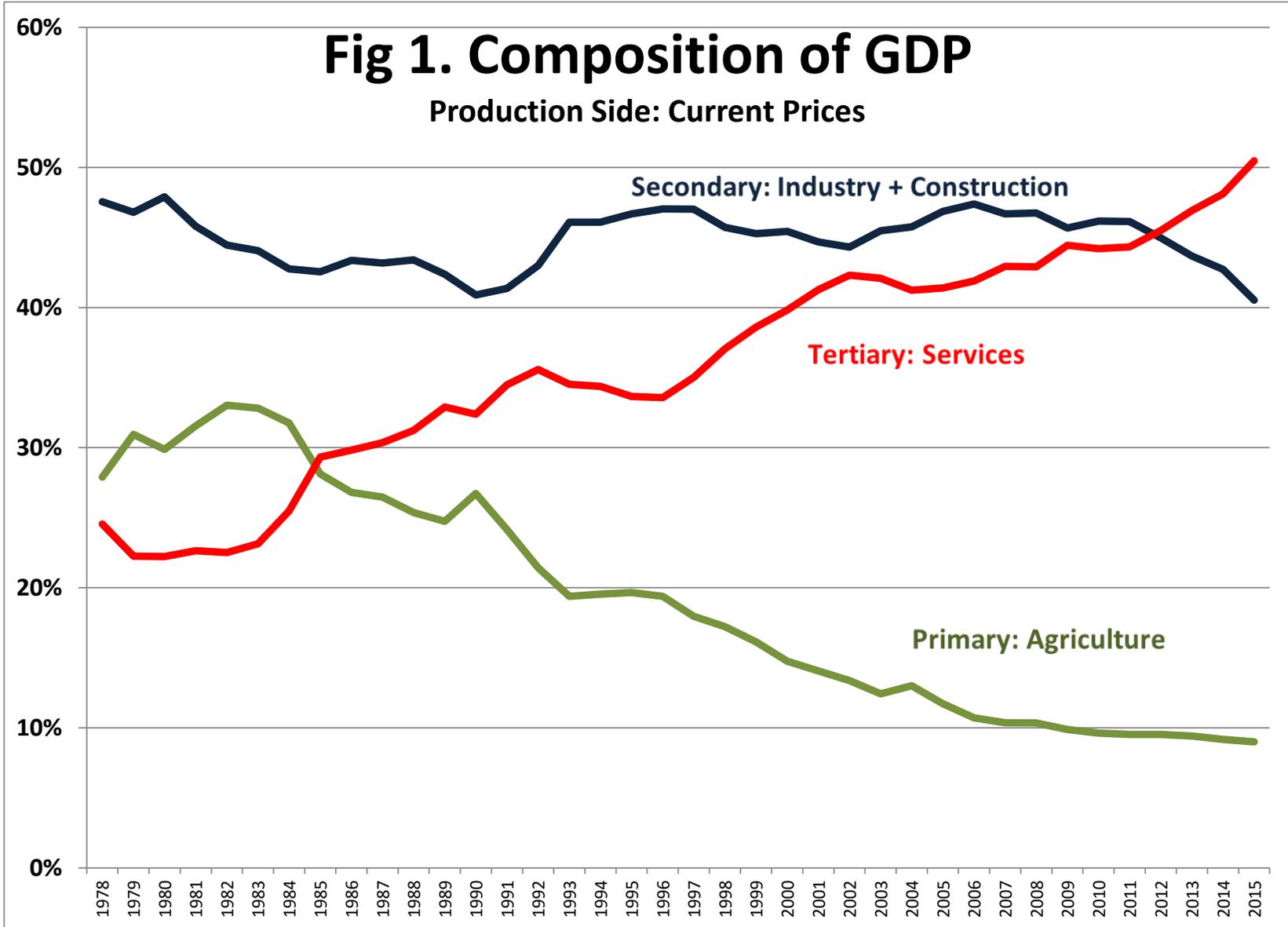
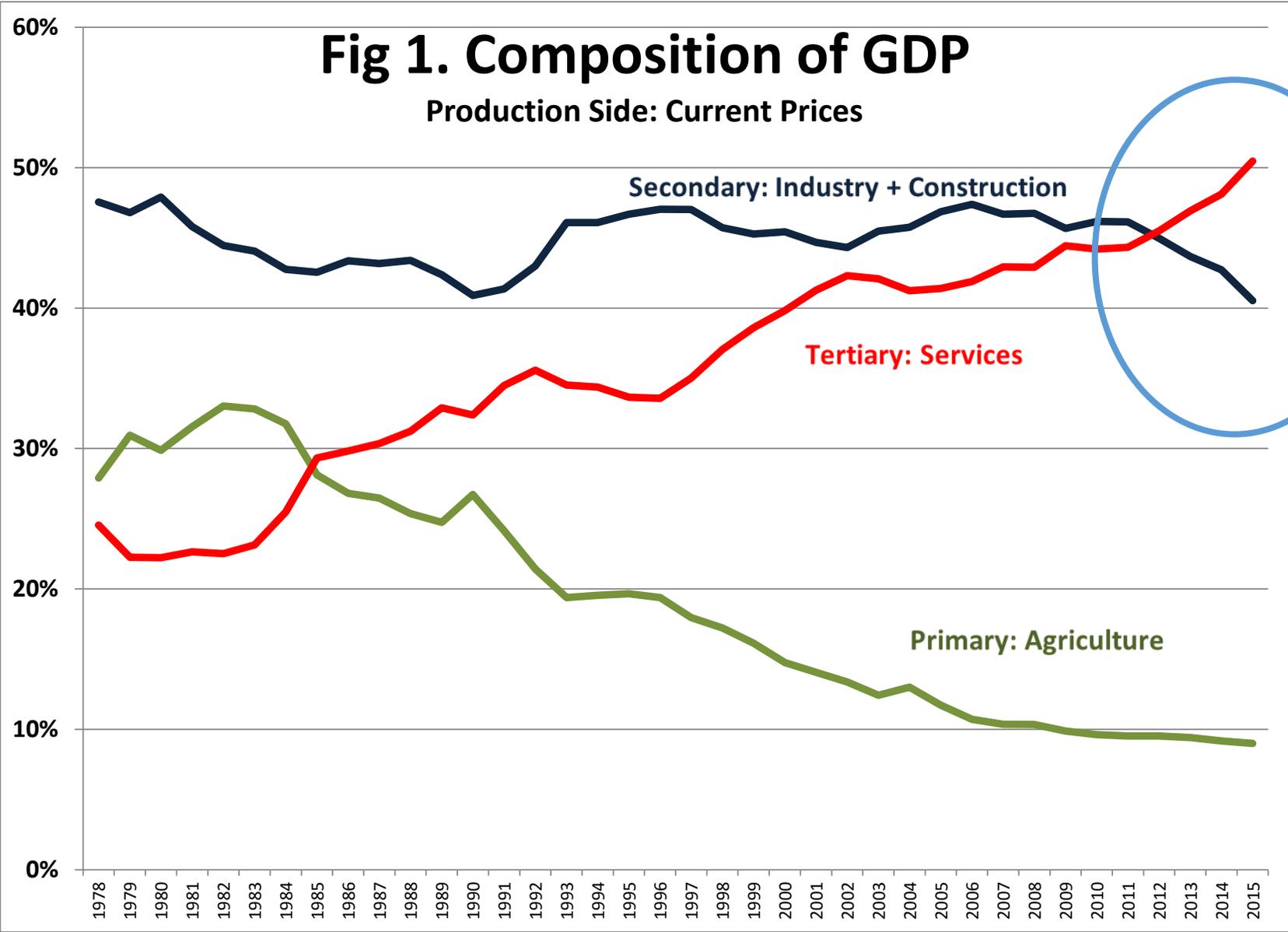


Fig 1. Composition of GDP

Production Side: Current Prices

Optimists
Focus Here



Deflate properly and the effect almost disappears

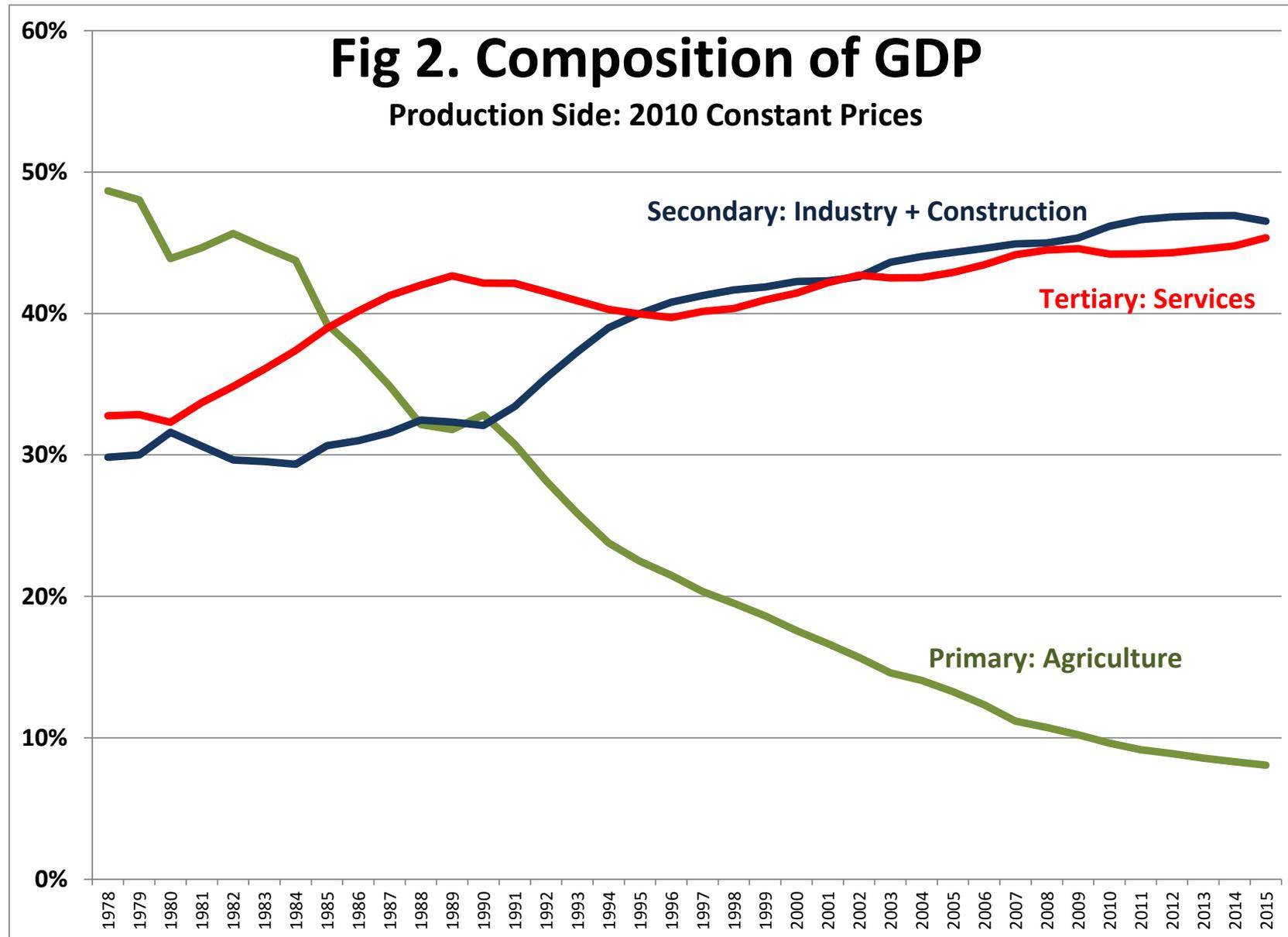
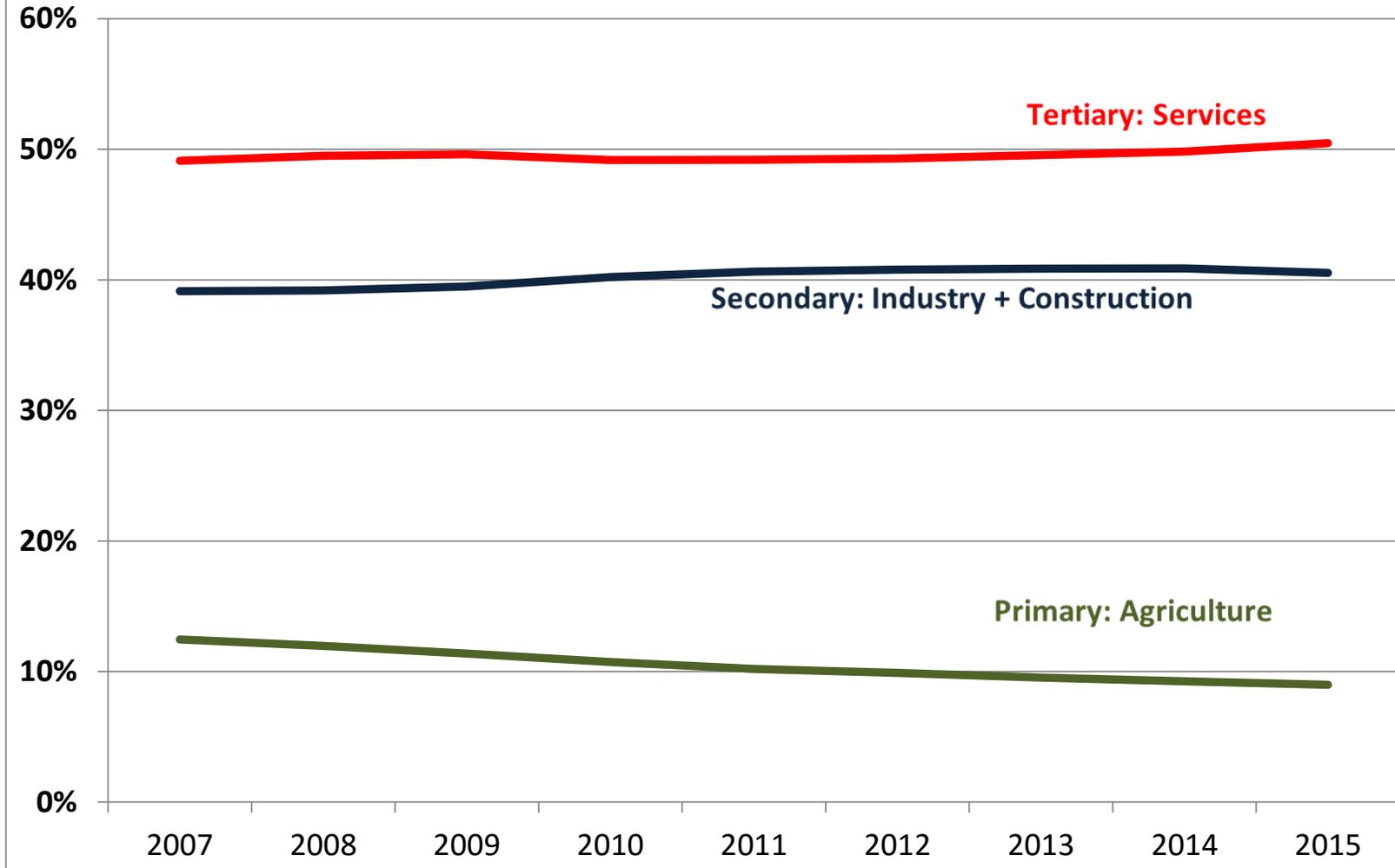


Fig 3. Composition of GDP

Production Side: 2015 Constant Prices



Employment Data Contains two Anomalies

Changes in Labor Force and Employment (Millions)

	Working Age	Employed	Primary	Secondary	Tertiary
Avg. 2011-2014	-8.3	2.8	-12.7	1.9	13.6
2015	-4.9	2.0	-8.7	-4.1	14.8

1. Many workers drawn from outside core working age employment.
2. Very rapid movement of people out of agriculture, not consistent with anecdotal evidence or other data.

Fig. 4. Growth of Non-Agricultural Labor Force

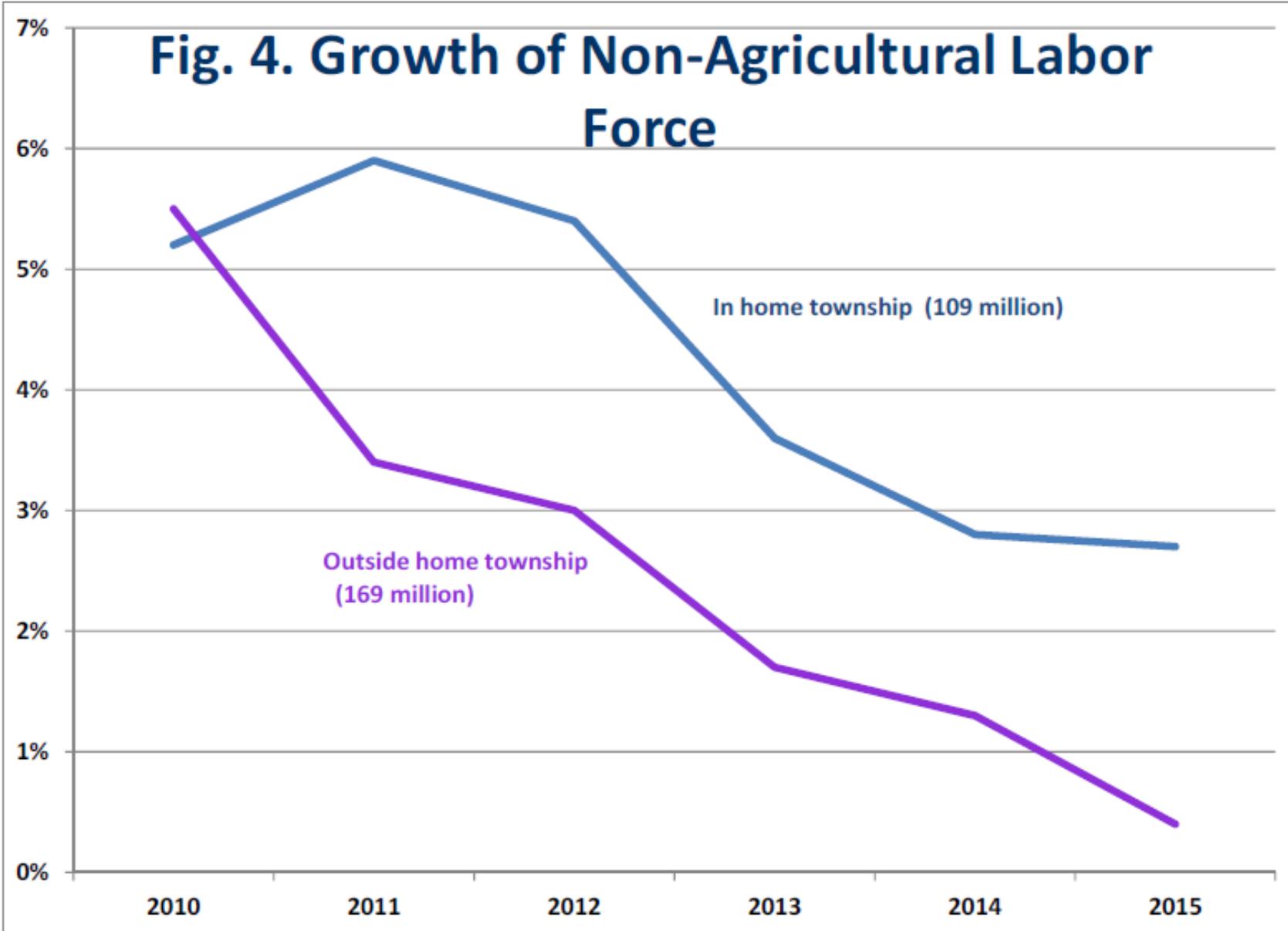


Table 1 Increment to Non-farm Workforce (Million)							
	2009	2010	2011	2012	2013	2014	2015
Out-Migrant	4.92	8.02	5.28	4.73	2.74	2.11	0.63
Local	-0.56	4.43	5.27	5.1	3.59	2.9	2.89
Total	4.36	12.45	10.55	9.83	6.33	5.01	3.52

The quality of the aggregate labor data is poor. The picture the labor data paint is at best anomalous.

This data is derived from a household survey, the methodology of which we understand, and which is not linked to the success indicator of any bureaucrat. Which is right?

A Final Piece of Evidence: Supply-side Structural Reforms

- Announced fall 2015; clearly coming out of the Party Leadership Small Group system (i.e., not the government).
- NOT part of the Third Plenum economic reform program, nor is it related to it in any way. NOT part of the existing playbook. (Of course, this was not emphasized in Chinese media.)
- Seeks to accelerate the restructuring process, starting with closing down excess capacity in coal and steel.
- Seeks to carry out restructuring in accord with market forces, but also clearly seeks to assert Party leadership and control, to keep the process from spinning out of control.

Supply-Side Structural Reforms

供给侧结构性改革

Sudden new emphasis on aggressively restructuring the “supply side”:

1. Close down excess capacity;
2. Get rid of unsold housing inventories;
3. De-leverage (write down debt);
4. Lower costs;
5. Fill in missing pieces.

Elaborated in a long, long piece in January 4, 2016 People’s Daily by an “Authoritative Personage.” (权威人士). Given the provenance of the ideas, this must be a writing group closely working for Liu He (财经领导小组办公室主任) .

Ideally, supply-side reforms are driven by regulatory decisions, plus political pressure.

- Five regulatory standards:
 1. Pollution
 2. Energy consumption
 3. Output quality
 4. Occupational safety
 5. Technology (effectively a minimum size requirement).
- The objective is to get rid of “zombie firms” 僵尸
- Pressure local governments not to prop up these firms; provide them with subsidies conditional on shutting them down.
- Coal and Steel first: 29 Feb., announce expected lay-offs:
 - 1.2 million coal workers
 - 0.5 million steel workers

Challenges to Supply-side Reforms

- Lacks clear implementation paths for many of its crucial components.
- Built-in tensions:
 - between the way closing excess capacity depends on stronger regulatory and market forces, and the fact that its implementation is pushed down onto local governments and Party secretaries;
 - between desire to accelerate restructuring and desire to protect workers and ensure that their voice is heard;
 - between drive to get the government out of excess capacity sectors and the desire to have government lead newly emerging sectors.
- No defined process for handling debt.
- Scope of Supply side reform is undefined and open to change as conditions change. It will undoubtedly go through many changes and different versions as implementation proceeds.

Conclusions 1

- In early 2016, Chinese policy-makers seem to have successfully stabilized the economy.
 - Careful management—combined with USD depreciation—has allowed the RMB to stabilize.
 - Shanghai stock market has shrugged off year-beginning volatility, stabilized around 3,000.
 - Increased credit creation has supported a rebound in infrastructure investment.
- If nothing else, it appears that the quality of Chinese economic policy-making has improved dramatically.
- However, these have been achieved through accommodative macroeconomic policies that are essentially “more of the same,” and through limiting reforms, e.g., in capital accounting opening.
- There is still an “overhang” of debt, capacity, and institutional features. So far, these are getting worse, not better. Economic stresses have only barely begun penetrating into labor market conditions and household expectations, so there is a kind of expectations overhang as well.

Conclusions 2

There is a heightened risk that the Chinese government is backing into a *more* intrusive role in the economy. Direct government action is now approved in order to achieve:

- Investment in new high-tech sectors funded by government money;
- Government initiatives to shut down capacity in traditional industrial sectors;
- A government insistence on maintaining annual GDP growth rates at 6.5% or above.

The long-run dynamism of the Chinese economy is extraordinary. However, in the short run, reform and restructuring are still running behind the needs of the economy. We are far from achieving a “new normal,” and we should expect further rounds of turbulence to emerge from China late this year or next.