



Transcript

China's Third Plenum: Another Turning Point?

Professor Shaun Breslin

Associate Fellow, Asia Programme, Chatham House

Professor Jane Duckett

Edward Caird Chair of Politics; Director, Confucius Institute; Director, The Scottish Centre for China Research, University of Glasgow

Professor Christopher Hughes

Head, International Relations Department, LSE

Chair: Rob Gifford

China Editor, *The Economist*

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CHINA'S THIRD PLENUM: ANOTHER TURNING POINT?

Rob Gifford:

Good evening, everyone. Welcome to Chatham House. We are this evening going to be talking about China. I think seldom has any document with the word 'plenary' attached to it been so anticipated as the one issued last November, after the Third Plenum of the 18th Central Committee. Xi Jinping had been in power just a year and of course everyone was making comparisons with another document and another plenum back in 1978, presided over by a certain Deng Xiaoping. Everyone, it seems, knew that reform was needed. Everyone was looking for reform. Thirty-five years on, China had been transformed economically and socially – though not politically – and everyone was saying something's got to give. The model is outdated, the model cannot go on. We then had the document – 22,000 characters' worth – issuing what had been said at the meeting, what they had decided on. We even had a speech released of Xi Jinping's, in which it was revealed that he had presided personally over the shaping of the document.

So what we'd like to do this evening is to look at what came out in November, a few months on, under the title, 'China's Third Plenum: Another Turning Point?' One question being whether really 1978 seemed like a turning point at the moment – I think a lot of people, looking back, maybe didn't realize that it was going to be such a seminal moment in Chinese history, and perhaps history does move much more in China in longer sweeps than those short pivots and turning points as such. But I'm sure our three guests this evening will help us explore that issue and much more besides.

Before I introduce them, could I just announce that this event will be on the record. Comments can be made by Twitter, @CHEvents.

Let me introduce first, on my left, Shaun Breslin is an associate fellow of the Asia Programme here at Chatham House. He is professor of politics and international studies at the University of Warwick. He'll be speaking broadly about financial issues. Chris Hughes, on his left, is the head of the International Relations Department at the London School of Economics. On my far left, Professor Jane Duckett is the chair of politics and the director of the Scottish Centre for China Research at the University of Glasgow.

We're going to have each of the guests do seven or eight minutes looking at their particular focus – Shaun on the financial reforms, Chris looking at foreign policy especially, and Jane specifically looking at social reforms. Obviously there is a certain amount of cross-pollination within those areas. Once they've

presented their broad assessment of what happened and what was announced at the Third Plenum, we'll open it to the floor. Please do feel free to ask questions, and we'll have a broader discussion of some of these issues. Shaun, over to you.

Shaun Breslin:

Thank you very much indeed. I have to say, part of me thinks that we should ban ourselves from talking about events like this for at least two or three years, until we actually know what's happening. But that would make for a rather boring environment, so I'm going to speculate. I should say that I'm a very bad gambler; I've speculated in the past and been entirely wrong, so there's no reason to expect that I'll be right this time.

But I think when we're looking at financial reform, my gamble is that this is in fact about a control agenda. At the time there was a lot of talk about more markets, and yes, there's going to be more markets, I think. But I see this as part of a control agenda – a control agenda against the banks, the way that banks have been finding ways of expanding credit in ways that the central government doesn't want them to; and particularly a control agenda against the autonomy of local governments. So let's try and put a little bit of flesh on why I've come to that conclusion.

If you read through the documents of the Third Plenum, there are things that are said explicitly about financial reform, about new private banks, about moving towards interest rate liberalization. The key phrase was 'resources being allocated according to market forces', which doesn't really sound like a control agenda. These are important but I think if we're talking about the financial system as a whole, we need to look further than this, at other reforms that have been suggested that will have important collateral impact on the financial system. Strengthening property rights – very important, I think. Doesn't immediately sound perhaps as if it's a financial reform but has a big impact on local governments' ability to raise money through selling land use rights. Breaking down monopolies – I wonder whether this particularly means local monopolies rather than necessarily national monopolies; explicitly says ending local protectionism, which I think is one of the key targets of the reforms; readjusting centre-local financial relations and fiscal reforms.

All of these could have the consequence of strengthening the hand of the central government's ability to exercise macroeconomic control. It might sound a little bit odd – strengthening a control agenda for macroeconomic

control – but it's a way, I think, of allowing the central government to take a firmer control over the national economy as a whole and perhaps pulling a bit of autonomy back from local governments.

I think there are two short-term and three longer-term contexts that are drivers of this reform. The short-term – in the very short term – is the big growth in local government debt since 2009. The loans that Chinese local governments took out via their affiliated enterprises to fund the recovery from the collapse of exports have come due for repayment. They are not being repaid, they are being rolled over. There is a large amount of debt within the local government sector – dealable [sic]; if it's a debt crisis, it's a solvable debt crisis. But for some local governments there is a looming debt crisis.

The second short-term driver is the way that credit has expanded, and the central government hasn't really been able to control the expansion of that credit over the last two or three years. Shadow banking has always been an important part of the Chinese financial system. In fact, a recent report that was talking about regulation pointed to its good features. It said it was a good way of providing money to the real economy. But what we've seen since 2008 is a massive expansion of credit – according to Patrick Chovenek [indiscernible], equivalent to the entire size of the American financial system. We've also seen shadow banking moving slightly out of the shadows and becoming affiliated with the formal banking system, as many of the banks have been setting up innovative ways of getting money into the economy that bypass the government's attempt to restrict the expansion of credit. One of the consequences of this is that we've seen some quite risky projects. Just this week there was real concern that a three billion trust project was going to totally fail; in the end, it stepped in and was bailed out. According to some calculations, there have been around 20 major bailouts of these sort of shadowy banking activities over the last two years.

I think for the government the key thing is control. If you try and control the expansion of credit, that people keep finding ways of getting credit into the system, then they want to do something about it. It's interesting that when they have spoken so far about regulating the shadow banking system, it has really been this sort of quasi-official shadow banking that they've been targeting, not really the more shadowy shadow banking which leaves some people quite exposed. So I think that is one of the longer-term contexts, the attempt to try and pull back the control over the economy that in some ways was lost by the way in which China responded to the financial crisis. By allowing banks to lend, by allowing local governments to borrow, I think there was a little bit of a loss of control over the economic system.

The second longer-term context is something that I've hinted at and I think has significance for what Jane is going to talk about, and that's local government financing. One of the remarkable things that's happened in the last four or five years is the way that local governments have been using their ability to sell land use rights to raise finances. We've seen a huge amount of that. It's the single biggest source now of income that is actually controlled by local governments themselves. According to the 2000 budget, about 80 per cent of the income that local governments control themselves comes from selling land use rights. This seems to me to be a crazy way to be funding local governments. But the reality is that local governments have been given obligations to spend but not given the ability to raise finances to fund the spending. I think there's a real problem there that needs to be addressed. In this respect, for the government, a financial crisis of local governments might be a good thing, because it actually gives them an opportunity to perhaps let one or two trusts go bankrupt, to re-exert control.

But perhaps the most important long-term driver is what is seen as irrationalities in the banking system. The Chinese banks are very good at some things. They are very good at supporting state policy, for example. They are very good at getting money into the state-owned sector. They are very good at funding preferred enterprises. They are very good at sterilizing foreign currency inflows. They are also very good at providing protection for the economy in times of crisis, as we saw in 2008-2009.

But there are some things that the banks are very bad at. They are very bad at preventing moral hazard, because everybody is banking on the state. Everybody assumes that the state will step in if the banking system goes wrong, as it did in the 1990s. They're not very good at funding small and private-sector enterprises. They're not very good at rewarding savers, because savers have had very low interest rates, sometimes negative interest rates. So in some respects, the insecurity in the normal Chinese person has been funding the state's project or the state's preferred enterprises and industrial projects.

This seems to be at the core of what the suggestions of the Third Plenum were: to make sure that resources, including finance – it's a key resource – are more efficiently allocated by the market. If they do this though, if they really push through with this, it will be a fundamental change in the nature of the Chinese political economy. I actually think if they really do fundamentally change the banking system, it won't just be a huge financial reform – it will be a massive political reform.

Back to my gamble: my bet is that the commanding heights of the economy, the major state-owned enterprises, won't necessarily be subject to full competition and full market forces. My bet is that the focus and the target will be more those state-owned enterprises that are controlled at the local level, that often operate effective local monopolies – where local governments fund favoured companies and protect them from competition from other parts of the country. At last count, it's very difficult to actually get agreed figures for how many state-owned enterprises there are, but over 100,000: 117 controlled by the central government, 906 or so controlled at the provincial level – that leaves a huge amount of state-owned enterprises actually controlled at the lower levels of local government. My guess is that this is where the target of competition, this is where the target of 'market allocation of resources', and this is where the focus of reform is actually going to be.

In the 1990s, I was convinced there was going to be a financial crisis in China. I was wrong then; I might be wrong again. But that's my best bet at the moment.

Rob Gifford:

Thank you very much indeed, Shaun. Chris, looking at foreign policy – it's been a pretty busy time the last few months, in the East China Sea especially. Give us your take on what has come out of that document and perhaps some of the issues surrounding that in the foreign policy sphere.

Christopher Hughes:

It's actually not that hard to link in some of these foreign policy developments with a lot of the things Shaun was just saying, because one of the interesting things about this plenum – as was pointed out earlier, the Third Plenum normally focuses on economic reform – but one of the most significant things to come out of this one was that it also focused on security, with the establishment of a national security council for the first time (the Chinese call it a state security council in English, but I think we can call it either). What's significant about it is it shows that on the one hand, there are all those things going on that Shaun spoke about – economic reforms – which involve taking on some very big vested interests, and on the other hand this is balanced by a considerable tightening up of both domestic security but also foreign policy.

This makes it especially interesting that shortly after the Third Plenum, China announced its Air Defence Identification Zone (ADIZ), which I expect people

know what that is so I won't go into details here. But it's sort of marking out a large area in the East China Sea which includes the Senkaku Islands, some Japanese territory, and was seen very much – quite rightly, I think – as an escalation of the sort of salami-slicing tactics that China has been adopting in its foreign policy in these maritime territorial disputes in the South China Sea and the East China Sea. So we see this development which is kind of counterintuitive to a lot of people who assume that as economic reforms progressed then China's foreign policy would become more moderate in some ways, and become integrated into the global system, interdependence and so on. Instead what we see is a paradox of economic reforms speeding ahead but a hardening of domestic security and foreign policy.

But I think if we stand back a bit, it's not that surprising. This really goes to the whole heart of reform and opening itself, going right back to 1979 and the first Third Plenum which started all this. More recently, the Third Plenum is in the context of the new leadership of Xi Jinping coming in and inheriting a situation that has really accelerated some of those fundamental problems in reform and opening – this sort of contradiction between market reforms and social stability and foreign policy. Certainly since the global financial crisis in 2008, we saw this sort of post-financial-crisis hubris – Xi Jinping was in the leadership then, of course, in the Standing Committee of the Politburo. He wasn't the leader but he wasn't out of it. We saw this increasing assertiveness in Chinese foreign policy which has escalated ever since.

So we saw a kind of acceleration of some dynamics and we need to ask, why is this? It's puzzling a lot of people. What is pushing this assertiveness? I would suggest it's not that unusual, if we look at China as a late industrializing society and country. In international relations we tend to think in terms of analogies, which is a bit dangerous. We look at rising powers, we look back at the cases of Germany and Japan in particular. I'm very dubious of doing that for looking the system level, but if we look at the sort of disruption that occurs with late industrialization – and perhaps Jane will say more about the social effects of rapid economic change and modernization – then you do tend to see historically this resort to strengthening domestic security to take on vested interests but also accompanied by an adventurous, more assertive foreign policy. Bismarck, of course, Kaiser Wilhelm, are good examples of this. Even Japan in the early 20th century, where you see this tension where a society going through rapid change and possible disintegration in many ways, but reforming itself as the leadership has to take on vested interests. It's very tempting to resort to assertive foreign policy, to play on some of the old political myths – in this case, the whole issue of Japan and the century of

humiliation. I think if you look at it in that way, what's happening now makes a lot of sense with the Third Plenum – this balancing between economic reform and security.

So I think in many ways Xi Jinping inherited this from his predecessor, Hu Jintao, who most of us think sort of lost a lot of control over many of the domestic actors who were pushing this more assertive foreign policy, especially the military. So one of the interesting questions about Xi Jinping and the Third Plenum is: what's he going to do about this, with this national security council? Is he going to reassert control over all those actors who are shaping foreign policy? We think that a lot of this assertiveness in the South China Sea, East China Sea, is driven by elements of the military and so on, who Hu Jintao really lost control of. So in some ways, Xi Jinping may be trying to get a more rational foreign policy. That would be an optimistic view, if that means his intention then is to move back to a more moderate policy, the kind of thing we saw with Deng Xiaoping – a very cautious, conservative foreign policy. But this is why the ADIZ issue is troubling, because if that was the intention, why announce this ADIZ so soon after the Third Plenum? What is the message that is being sent here? It doesn't seem to be that part of this national security council's job will be to rein in this assertive foreign policy.

So the messages are sort of very contradictory. I would suggest it's not all bad. Xi Jinping was last year trying to push forwards more constructive issues in foreign policy, in particular this idea of a new model of a great power relationship with the United States. He had a diplomatic offensive in Southeast Asia to try and calm nerves down. But at the same time we see this constant assertiveness, salami-slicing in the maritime issues, territorial disputes. How do we make sense, how do we put these things together?

I would suggest, as I said, it's not that unusual if we think about Xi Jinping having to take on those vested interests that Shaun is talking about. This will be a very difficult fight for Xi and he needs support. Where is he going to get it? Does he need the support of the military, for example? Well, one view of Xi Jinping is he has a military background, he has the support of the military. I don't think it's so simple. It's always an issue of bargaining in the Chinese system. If he wants the support of the military, he needs to give them something too. So in that sense, we can expect the military to continue playing a role, defence spending to keep rising and more assertiveness.

Equally, does the leadership really want to reduce the tension? There's no signs at all of China engaging in any confidence-building measures, any sort of crisis management mechanisms that have been suggested by Japan and

the US and Southeast Asia. No sign of going to arbitration over these issues at all. What we do see is a continuation of a longstanding policy that really began around WTO entry in 2001, of creating a crisis mentality in China – that we are about to have a war. This is done through the education system, the media system, national defence mobilization laws, all these things which deliberately create a crisis mentality. So I think this is typical of a late industrializing society, I'm afraid. So when Shinzo Abe at Davos talked about a return to 1914, I think this is worrying. Increasingly you hear from both sides, Japan and China, talk about war. I haven't really heard before so many people saying we're in this gray area now between war and peace. We're not quite sure of China's intentions. But my suggestion here is it's driven very much by these domestic issues of reform and opening and this fundamental problem of maintaining domestic solidarity and legitimacy.

Rob Gifford:

Fantastic. Speaking of which, Jane, obviously two of the issues that get the headlines after the Plenum were the abolition of reform through labour and the reform to the one child policy. To what extent were these new issues or is this again part of a continuation of something that's going on? Perhaps you can give us your summary of the social side of things.

Jane Duckett:

On the social side, there were these new announcements of the one child policy, so that now – it's implemented from now. It's going to be allowed for people in a couple, one of whom is an only child, to have two children. In the past you had to have – the previous policy and the previous relaxation of the one child policy was that both parents had to have been an only child for them to be able to have two children, and now it's only one parent, one of the couple, who needs to have been an only child. This was something that had been talked about, it's been discussed, it's been experimented with, so it wasn't a big surprise. Similarly, the reform through labour had been mooted at least a year – almost a year in advance of the plenum, as something that was going to happen. Abolition of those camps which were set up in the 1950s, in which – those of you who recall the anti-rightist movement of the late 1950s, where people were imprisoned, several hundreds of thousands of people were imprisoned, sometimes for 20 years. They are now being abolished. That, again, wasn't a surprise, and does show a continuation in these trends of legal institutionalization in that case, and again a slight continuation, a

slight trend for the one child policy in liberalization of those population controls.

But the liberalization of the one child policy – they're not completely giving up on population controls. There's still a concern about maintaining and controlling growth in the population. Apparently it's estimated that relaxing the population controls at the moment is likely to lead to an additional – something like 2 million more births per year as a result. That's taking the number of births per year from about 7 million to about 9 million as a result.

So there were those kind of announcements. If you look at the decision document overall – looking through it for me, I've been researching quite a lot lately the whole Hu Jintao and Jiabao periods and their social policies. For me, what I can see in the decision is really very much a continuation of what Hu and Wen were doing. Hu and Wen – some people have talked about them as the lost decade, and I think in terms of economic policy and economic reform that's what people feel, that they failed to grasp certain nettles. But in social policy actually quite a lot was going on that tends not to be given as much prominence. Everyone focuses on the economy obviously, on the banking system and this kind of thing. But in terms of social policy, Hu and Wen did quite a lot.

I think partly they were dealing with what they perceived as a lot of political problems, a lot of simmering unrest which they felt they had to tackle, and they kind of shifted to that. So they abolished rural taxes, which created problems for local governments by taking away some of their revenue. So they abolished local taxes. They introduced health care – kind of insurance, kind of cooperative medical schemes in rural areas. They extended pensions. They introduced rural pensions latterly. Then also in urban areas they've extended the systems of social security. What we've seen in the decision document is an indication that the new leaders, or the new administration, is simply wanting to carry on with that: extending the population coverage of these schemes, trying to integrate the rural and urban as part of this process of urbanization (which, again, was well flagged and sort of planned under Hu and Wen). So I don't see a lot of change there. The same rhetoric of social fairness and equity is kind of coming through the document for me, talking about the provision of basic services, the equalization of basic services for people as part of this trying to bring the rural areas up with the urban.

Within that, there are some interesting twists, things that we didn't see in the previous administration. One of them, as Shaun alluded to, is the reform of the tax system. To provide these basic services for all, they need to make the

tax system – the balance between central and local – more rational. There's been a perception that really what tends to happen is the central government gives orders about the extension of the social security system and it's left to the local governments to do it, but they don't have the fiscal capacity. And that in fact to make it happen what tends to happen is the central government has to make specific transfers to support these policies. So it's interesting that they've put this in the document and it will be interesting to see how they think they're going to do it, because as Shaun indicated it's very difficult, in a very decentralized fiscal system (as it is now), to redistribute. How they're going to tackle that and take away from the richer provinces and richer local governments – which are cities – has been one of the real nubs and one of the obstacles to social reform for quite a long time.

The other thing that is worth mentioning, because I don't think it's going to come up today: interestingly, none of us has actually been asked to talk about politics and political reform and democratization, which is kind of what we usually get in these things. It may come up; maybe everyone's given up on democratization. One of the interesting things about Xi and Li is that they've been tackling corruption. We have seen in the last year or so – I think in the year running up to the Third Plenum – 18 provincial and ministerial-level officials being punished for corruption, and 182,000 officials across the country. This has obviously made the headlines, we all know about this. One of the reasons that seems to be going on – it does seem to be something different than before – is it's tied in with this notion of social fairness and equity as well. So they're not just about redistributing wealth, which they do talk about in the decision, but there's also this problem of this perception of the unfairness that goes along with officials being seen to be feathering their own nests.

So there are some small, interesting new ideas in the decision, but ones which might be difficult to implement. But a lot of the fundamentals – they don't seem to have a lot of new big ideas in there, in terms of social policy. My sense is that the economic is going to be more important, whereas under Hu and Wen the social was more prominent. Thank you.

Rob Gifford:

Great, thank you very much. Yeah, very interesting that we haven't got anyone talking about politics, but that says a lot, especially bearing in mind the events of the last few days. Xu Zhiyong, a man who really was trying to work within the system as best he could – not setting up a political party in

any way, trying to work with the system, with the constitution – locked up for four years. I think it's pretty clear that the social and economic and the foreign policy reforms are where the action is. On that note, I'd like to open it up to the floor.