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"A nation must think before it acts." - Robert Strausz-Hupé

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# CHINA'S ECONOMIC REFORMS AND THE COMMUNIST PARTY'S NEW LEFT

## By Felix K. Chang

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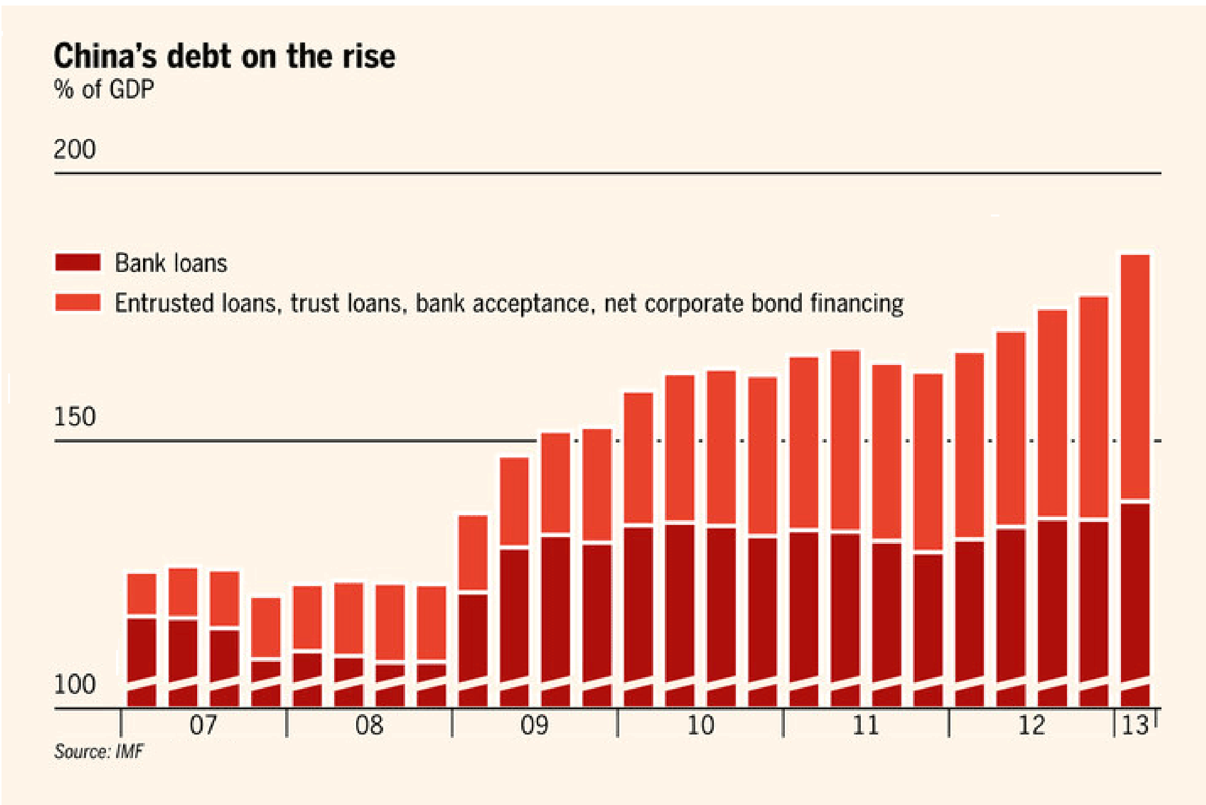
**At China's National People's Congress in early March 2014, the Chinese government rolled out a new set of economic reform measures—the basis of which were drawn up at the Chinese Communist Party's Third Plenum four months earlier. The reform measures are part of Beijing's broader plan to transform China's economy from one dependent on investment to a more sustainable one based on consumption (and, most importantly, to do so before over-investment in unproductive assets and infrastructure unhinges it). But as anyone who has ever served in government knows, the real challenge lies in implementation. In the past, the implementation of reform measures was left in the hands of line ministries and local governments. But since those organizations were often the ones that benefited the most from the existing economic structure, many of those reforms were ultimately watered down.**

**As things stand now, the Chinese government manages the pace of the country's economy through the control of loan issuances (and thus investment) from its large state-owned banks. By also restricting the investment options of its citizens, China has been able to ensure that its banks remain well capitalized. Interest rates on bank deposits are kept in the low single digits, even though the real inflation rate runs a few points higher. But without a solid social safety net, especially for China's hundreds of millions of migrant workers, it is little wonder that many Chinese still rather save (than consume).**

**But many Chinese have turned to real estate to earn higher returns. Because China's leaders believe that their citizens will eventually earn and consume more (and in the process transform the economy) if they move into cities, the government has encouraged urban migration. That has caused real estate prices in China's cities to climb almost 10% per year for over a decade. While that has benefited some, it has also bred problems and sometimes unrest. Since Chinese law concerning land ownership is vague (after all, the government nominally owns all the land), local governments have often chosen to interpret the law in a way that enables them to appropriate rural land from farmers with or without compensation and sell it to developers who then turn it into investable urban housing or industrial property. That has created a speculative spiral that has led local governments and developers to build ever more urban real estate, even erecting entirely new cities in some extreme cases.**[1]

[1] Bob Davis, "China's Leaders Push Urbanization as Engine for Growth," *Wall Street Journal*, Dec. 16, 2013.

**Another way Chinese have sought to earn higher returns is to put their money into wealth management products, one of the few investment options available to them. Today, these products are frequently used to provide the capital for short-term loans with interest rates as high as 10%. Unfortunately, a large number of such loans have been used to finance the long-term infrastructure projects of local governments. Since many of these projects were not well thought out, they might never produce any positive return. For the moment local governments can finance their old loans with new ones, but ultimately they will find it hard to repay all their loans. That raises the danger of defaults. While this sort of short-term financing enabled China's economy to power through the global recession, it also saddled the so-called shadow banking system with mountains of potentially unserviceable debt. Over the last two years, that debt has soared 70% while China's GDP growth has expanded at only half that rate—a sure sign of financial stress.[2]**




**Economic pitfalls such as these are what the National People's Congress' new economic reforms are intended to address. In the realm of real estate, the Chinese government revealed plans to introduce a nationwide real estate**

[2] The shadow banking system is sometimes not too deep in the shadows. In one case, China's largest bank, the Industrial & Commercial Bank of China (ICBC), sold $490 million in wealth management products to its customers. Those products are based on loans made by a shadow bank to a debt-laden coal mining company. The shadow bank warned in mid-January 2014 that it might be unable to repay ICBC's customers when the products mature at the end of the month. ICBC claims that it has no legal obligation to backstop the products, since it only acted as a sales agent. If ICBC did backstop the products, it would raise questions about how it treats all its other off-balance-sheet wealth management products, which amount to 5% of total assets and 80% of common equity. "Bringing all these risks onto the balance sheet would hurt the bank's otherwise healthy capital ratios." Some hope that a small default could curb the use of such products and gradually unwind the shadow banking system. But others fear that any default could rapidly erode investor confidence in wealth management products and make it harder for shadow banks to refinance loans to their risky borrowers. That credit contraction could trigger a wave of defaults. In the past, government and third-party entities have stepped in to guarantee loans, but in doing so they also weakened the incentive for caution among shadow lenders. Yuanyan Sophia Zhang and Steven Barnett, "Fiscal Vulnerabilities and Risks from Local Government Finance in China," International Monetary Fund Working Paper 14, Jan. 2014; "In three parts," *Economist*, Jan. 25, 2014; Aaron Back, "Dukes of Chinese Moral Hazard," *Wall Street Journal*, Jan. 22, 2014; Bob Davis and Dinny McMahon, "China Slows Pace of Lending, But Informal Loans Increase," *Wall Street Journal*, Jan. 16, 2014.

**registration system and levy a property tax to curb real estate speculation. Farmers may receive greater rights to their land, perhaps even the ability to mortgage it. Local governments will be allowed to issue bonds and hybrid securities so that they are not overly reliant on the shadow banking system. Moreover, they have been encouraged to set up local "bad banks" and debt exchanges so that they can offload their bad debt and sell it to private investors willing to accept the risk of default. And, finally, Beijing will attempt to ease the traditional *hukou* system, a household registration method that ties an individual's social benefits to where he or she is from, in order to ease the barriers to further urban migration.[3]**

**However, these reform measures have run up against the "new left" within the Communist Party. Those new leftists have been troubled by China's three-decade long shift toward a market economy and want a stronger hand for the state in economic planning. They harken back to the communist ideology of Mao Zedong, which advocated income equality and liberation from material desires (clearly not present-day China). That has clashed with those who are more reform-minded. Indeed, the 2012 downfall of former Communist Party highflier Bo Xilai, who the "new left" revered for his spending on public welfare and affection for state-owned enterprises, was seen as a sign of an internal party struggle. But perhaps to allay the fears of that wing of the party (or in recognition of its strength), China's leaders have allowed Maoist sentiments to be heard. Their recent speeches have even referred to Mao. Certainly, China has in the past downplayed Mao's collectivist failings, like those documented in Yang Jisheng's book *Tombstone: The Great Chinese Famine, 1958-1962*. But rarely has Mao been cited by China's reformist leaders until recently, demonstrating the influence that the "new left" may have on contemporary policy discussions.[4]**

**The influence of the "new left" may make mending China's economic problems all the more difficult. Many of the policy communiqués that emanated from the Third Plenum seemed to temper the tenor of reform. Even as the government would seek to encourage private banks through the establishment of a deposit insurance scheme, it recognized the need for the state to guide their interest rates. And though a market-based economy would continue to be its goal, Beijing proclaimed "the dominance of the public sector" in that economy. "New left" priorities were also apparent in Third Plenum initiatives that focused on income inequality and kept state-owned enterprises firmly in the hands of the state.[5]**

**There is also the fact that the Communist Party is simply accustomed to being in control. Despite its interest in market reforms, the party still believes it knows what is best. At the moment, it thinks that urbanization is the best way for the country to create a consumer-led economy. But going a step further, the government wants to steer its rural population into smaller "second-tier" cities, rather than bigger "first-tier" ones (i.e., Tianjin, rather than Beijing), in order to avoid the over-development and crash that hit Japan in the 1980s. While that sort of policy fine-tuning may be judicious, a government used to such a high degree of control often finds it hard to step aside to allow markets to function.[6]**

**So even though the Communist Party openly endorsed the "decisive" role of the market in China's economy, it clearly still wants a big say in how that economy is run.[7] That was again evident in February 2014, when China's central bank began to push reforms to make the yuan more responsive to market forces. Ironically, it did so by directly intervening in the market—directing China's state-run banks to buy U.S. dollars in order to devalue the**

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[3] "China to accelerate 'hukou' system reform: document," Xinhua, Nov. 15, 2013, http://news.xinhuanet.com/english/china/2013-11/15/c_132892030.htm; Yinqiu Lu and Tao Sun, "Local Government Financing Platforms in China: A Fortune or Misfortune?" International Monetary Fund Working Paper 243, Oct. 2013.

[4] Carlos Barria, "In rural China, teacher upholds Mao Thought to save the world," Reuters, Dec. 16, 2013; "The party's new blueprint," *Economist*, Nov. 16, 2013; Brian Spegele, "China's 'New Left' Grows Louder," *Wall Street Journal*, Oct. 6, 2012, p. A9.

[5] Victoria Bi and Kevin Yao, "China approves pilot plan to set up 3-5 private banks," Reuters, Jan. 6, 2014; "China to hone income distribution: CPC decision," Xinhua, Nov. 15, 2013, http://news.xinhuanet.com/english/china/2013-11/15/c_132892022.htm; "China advances diverse forms of ownership: communiqué," Xinhua, Nov. 12, 2013, http://news.xinhuanet.com/english/china/2013-11/12/c_132882338.htm.

[6] Xiaoyi Shao and Kevin Yao, "China can avoid Japan-style property bubble: official," Reuters, Jan. 13, 2014; Bob Davis, "China's Leaders Push Urbanization as Engine for Growth," *Wall Street Journal*, Dec. 16, 2013; "China to balance urban, rural development," Xinhua, Nov. 15, 2013, http://news.xinhuanet.com/english/china/2013-11/15/c_132892185.htm.

[7] "CPC acknowledges market's 'decisive' role," Xinhua, Nov. 12, 2013, http://news.xinhuanet.com/english/china/2013-11/12/c_132882359.htm.

**yuan and flush out those that the government considers to be market speculators.[8]**

**Such episodes leave some to wonder how effective China's new reform measures will be. No doubt the National People's Congress will approve the measures. But the influence of the "new left" within the Communist Party may not make implementing them any easier. Over the next year, that may not be much of a concern. China's central bank has sufficient reserves to backstop the debt that the country currently has on its books (now that it made the effort to account for all the debt). But if the growth of new bad loans goes unchecked, that may not always be the case. Chinese banks will need roughly $320 billion in capital over the next five years to stay afloat.[9] China already experienced two brief credit crises in 2013, the first in June and then in December, and one in January 2014, when interbank interest rates suddenly spiked higher. Clearly, economic waters can quickly turn choppy. Letting go of old ways of doing things was always going to be hard, but if the economic waters get choppier, the Communist Party might find holding on to be even harder.**

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[8] Pete Sweeney and Lu Jianxin, "China's central bank opens liquidity front in hot money war," Reuters, Feb. 28, 2014.
[9] Dinny McMahon, "Beijing Tests Tools to Tackle Bad Debt," *Wall Street Journal*, Jan. 10, 2014.