

New Challenges for Chinese Government at Turning Point

By Long KE



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China changed track from communism to a liberalized open-door policy 34 years ago and announced a move towards a market-oriented economy 20 years ago. Looking back on Chinese history, Mao Zedong died in 1976, and Deng Xiaoping came back as a political leader in 1977. China has realized very rapid economic development over the past three decades through its gradual and realistic strategy. Deng Xiaoping was the designer and architect of the strategy, but I have to say the reform is not yet finished; it is still at a midway point.

At present, normal Chinese GDP in US dollar terms is the second biggest in the world. China has become the global manufacturing center, and it is going to be the market that drives the global market. Since the subprime loan crisis in America and the credit crunch in the euro-zone, American and European economies have been in serious recession. During this global credit crisis the world economy needs a new engine instead of the American economy. That new engine is the Chinese economy.

On the other hand, there are still some concerns about the sustainability of the Chinese economy. But there is no problem for policymakers to realize economic growth of about 8-9% under the circumstances because of the great potential of the domestic market. The problem here is how to sustain this growth for another decade while smoothing out its volatility. To realize this goal Chinese leaders need to undertake more reforms of the economic system, for example, privatizing state-owned enterprises (SOE) and state-owned commercial banks (SOCB). Another important task is to build a market-oriented system to guarantee the fairness of resource allocation and income reallocation. My conclusion here is that Chinese political leaders need to take risks to reform the political and economic system at a time when the economy is still growing rapidly. If China misses this opportunity, it will become much more difficult for it to reform its economic system.

Hu Jintao's Legacy & the Big Challenge Facing the Xi Jinping Administration

Over the past decade the economic growth ratio in China reached 10% annually, but most Chinese people are very critical of the Hu Jintao administration. The reason for this is that the low income class, comprising about 60% of Chinese people, did not enjoy the benefits of this economic growth. That means that the wealth in the country is concentrated within the upper class, comprising about 3% of the total population. During the past decade the Hu Jintao administration adopted policies to realize rapid economic growth. One of the more effective policies was the expenditure of 4 trillion yuan to support economic growth in 2009 and 2010 and overcome the impact of the global financial crisis. This policy contributed to sustainable economic growth, but most of the projects were taken by the SOEs, which may lower the efficiency of the economy and break the privatization of SOEs.

This year China will experience administration change. Vice Chairman Xi Jinping is expected to take Hu Jintao's place as the next chairman. As the new leader, Xi will face some difficulty in overcoming the legacy left by Hu. First of all, political reform was postponed under the Hu administration, but Xi cannot afford to postpone it any longer. Corruption is damaging social stability. The government can only solve this problem by reforming the political system.

As the new political leader, Xi Jinping must do the following. First, he must start to reform the political system as soon as possible in order to build a democratic system gradually. Secondly, he must build a real market-oriented economic system to guarantee fair and transparent market economic competition under the rule of law. Thirdly, he must privatize the SOEs and SOCBs.

According to a study by the World Bank, China's governance index of corruption control is still at a very low level compared to the rest of the world (*Chart*). Chairman Hu Jintao recommended building a harmonized society about 10 years ago. Chinese society has not been harmonized since then, despite the economy's unexpectedly rapid development. The Xi Jinping administration will need to control corruption and close the income gap. Such goals cannot be realized by the self-governance mechanism inside the communist party. China needs to create a transparent political governance system and accept monitoring by the citizenry.

How to Create a Harmonized Society under a Monopoly System?

What was the harmonized society recommended by Hu Jintao? The definition is still unclear, but at the very least, in a harmonized society most people should feel happy. In China it seems that most

people feel unhappy, including the government leaders, otherwise they wouldn't send their children abroad. China is creating a market-oriented economy, but the people are not allowed to monitor government officials. The large income gap and rampant corruption also damage social stability.

The income gap is currently very big, and it continues to expand. One reason for this is that the income allocation mechanism is not rational. For example, the rich class does not need to pay taxes for its fixed assets. As a result, the wealth in the country is concentrated within the rich class, which makes up about 3% of the total population.

To control corruption, an efficient monitoring system must be created, but under the Hu Jintao administration political reform was postponed, as mentioned above. It is unlikely that an efficient monitoring system would be created without a democratic political system first being built.

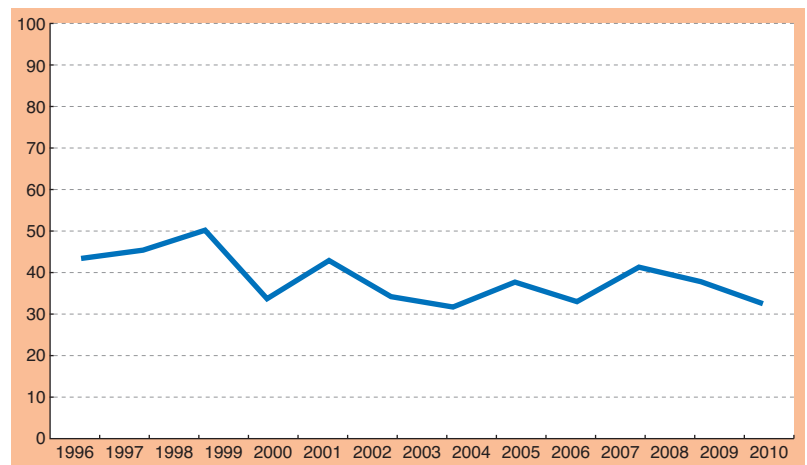
Before discussing the political system reform, I would like to make clear what kind of economic reform is necessary to build a harmonized society. First, the state-owned enterprise system must be reformed. SOEs take 60% of resources, but the ROE of SOEs is only about half that of the private sector and SOEs currently create only 20% of employment. But the government is still enacting a lot of policies to protect SOEs. In 2009 the government enacted a 4 trillion yuan stimulating policy to support economic development, but almost all of the public projects were taken by the SOEs. Just because the SOEs benefited from the public projects, they started to merge with private companies. This movement is called "Guo Jin Min Tui" (the State advances as the private sector retreats).

Secondly, China needs to reform its financial system more rapidly and in more depth. From 1994 to 2002 former Prime Minister Zhu Rongji improved financial reform and created a market-oriented financial structure. For example, the State banks have been reformed into commercial-based banks. The government's interference in the banks' management has been restricted. The People's Bank of China has become a real central bank. Such reforms have contributed to China's economic development since then. But I must point out that the financial reform has slowed since 2003 under the Hu Jintao administration. Four mega banks have been listed on the Shanghai and Hong Kong stock exchanges, but only 30% of their assets are traded on the markets. Corporate governance has not been strengthened at all. Another reform which needs to be undertaken is the liberalization of interest rate regulation. The Chinese government needs to widen the RMB foreign exchange trading band, but interest rate regulation is hindering such liberalization.

Thirdly, China needs to undertake the building of an efficient social safety net. In the era of a central planning economy, the public sector, including state-run enterprises, supplied social services such as medical care and pensions. In 1992 the government announced that it would build a market-oriented system and social services were separated from the SOEs, while local government took the lead in establishing public pension funds and a social medical care system. But the current social safety net is not strong enough. China now is at a very important stage

CHART

Governance index of corruption control in China



Note: This chart shows the governance index. 100 means corruption is controlled completely. 0 means corruption is not controlled.

Source: The World Bank

where it must strengthen domestic demand because its economy cannot sustain its own development by depending only on exports to the US and euro-zone. To achieve this goal, China needs to strengthen the coverage of its social safety net in order to allow households to consume freely without any unnecessary worries.

Big Challenges for the Xi Jinping Administration

Next spring the Xi Jinping administration will replace the Hu Jintao administration, but the legacy left by the Hu administration will be too heavy for the Xi administration to bear. First of all, Xi Jinping needs to provide strong leadership in reforming not only the economic system, but also the political system. More and more netizens (Internet users) are using social networking systems (SNSs) like Weibo (the Chinese version of Twitter) to criticize the corruption of government officials. SNSs are playing an important role in monitoring the behavior of the government. There are no other options for the Xi Jinping administration to maintain the government without reforming the political system.

Within the agenda for the Xi Jinping administration reforms, reform of the economic system is also very important. Thirty years ago Deng Xiaoping improved the open-door policy and strengthened the incentive for people to work hard. This incentive has allowed some people to become rich. The philosophy of Deng Xiaoping is completely different from Mao Zedong's ideas. Currently, a part of the Chinese population has become very rich, possibly one of the richest groups in the world, but the problem is how to raise the incomes of the low income class. The Xi Jinping administration must reform the taxation system to reallocate income between the rich and the poor.

Finally, I would like to reemphasize that the Xi Jinping administration must increase its efforts to improve the economic structure. China is now a main engine of the world economy. Although China is still an emerging economy, it will come to play an important global role in the future and must take more responsibility.

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