Economic Risks under the Xi Jinping Administration

Author Long Ke

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Market Economy Key to Success

China has realized miraculous development over the past decades, taking over from Japan as the second-largest economy in the world in 2010. Before that China had started playing an important role as a global manufacturing center, which has not only driven its economy but has also contributed to world economic development. As some analysts have said, the slowing Chinese economy is a big risk to the global economy, as there is no other economy that could drive it.

The Chinese government has defined the slowing economy as the "new normal" — meaning it has decided to accept this new situation as normal. For a long time the Chinese government has recognized that speedy economic development could prove that a dictatorial political system could have advantages over a democratic system such as those in the United States or Japan. Actually, 38 years ago the Chinese government decided to reform the economic system by installing a market-oriented system instead of a centrally-planned one. It is this which has been the driving force behind the economic development of the past decades.

The problem here is why the Chinese economy has turned to slow from 9-10% GDP growth to about 6%. Some analysts have suggested that real economic growth is only about 3-4%, much lower than the official economic data. One prime reason is that Chinese industries have lost their advantage and competitiveness, because labor costs have risen so fast, while office rents have also increased rapidly. Another reason was the revaluation of the renminbi in 2005 against the dollar. The conclusion is that China cannot sustain its economic development only by relying on old economic development models. It needs to create new ones. One possibility is to strengthen research and development (R&D) to boost the level of its industries. But who is going to be the main player in this new stage of its economy?

The administration of President Xi Jinping seems to want to realize the goal by reforming state-owned enterprises. This is necessary, but the problem is how to do it. According to Xi, the solution is to improve M&A among these SOEs, in the belief that merits of scale could help Chinese industries strengthen their competitiveness.

It is not only rising labor costs that are behind the economic slowdown, but also fundamental and institutional problems. For example, one major problem is how to make a dictatorial political system work together with a market-oriented economic system. A market-oriented economy can only realize effective resource allocation by price mechanisms under a free and fair market system. But in China the government is still playing an important role in allocating resources. This is why SOEs are protected by the government. Private companies are not allowed access to the industries controlled by SOEs, such as power generation, financial, railway and energy industries. In these fields, private companies are not allowed to compete with SOEs.

The private sector in China creates the greatest employment, much more than among SOEs, but it is difficult for private companies to get finance from the state-owned commercial banks. As a result, private companies can only try to access niche businesses to avoid competing with SOEs. A typical example is the Internet business and distribution. Private distribution companies are much more effective in the express mail system (EMS), and although the scale of individual Internet private distribution companies is very small, their alliance enables them to achieve efficiency nationwide.

The solution for China to sustain its economic development could be to build a real market-oriented system to guarantee free and fair competition. Protection by the government can only damage the market and competition. Recently there has been an argument in China about the necessity for the industrial policy that protects certain industries and companies. Under a transparent economic situation, industrial policy could play a positive role to improve the development of targeted industries. If we take a look back at Japanese economic and industrial history, we can see that industrial policy played a very important role in the process of development. According to some academic studies, the government should play a role as a regulator but must not interfere in market competition. Actually the government in Japan usually plays a role in helping companies with their R&D. Japan's SOEs were privatized in the process of development during the 1970s and 1980s, and now these private companies are the main players in the market.

It is clear that government intervention damages the market mechanism for resource allocation. It is an important lesson from the Cold War that the centrally-planned economies failed. If China wants to sustain its economic development, it needs to build a market-oriented system.

Big Challenges for Xi Jinping Administration

Let's take a look at modern Chinese history. The first generation in the Mao Zedong era was the revolutionary generation. The leaders of

Mao's generation only wanted to strengthen the administration and their powers of control, so they struggled against their potential enemies, sometimes the Soviet Union, and sometimes the United States. As a result the economy in China in Mao's era fell into bankruptcy, exhausted from the strain of military competition.

Forty years ago Deng Xiaoping became the top leader. Deng was a realist; he understood that the administration could not be sustained without economic development. He started to practice open-door policies in 1978, and also started to reform the economic system, but he refused to reform the political system right up to his death in 1997. It seems that Deng recognized that political reform could damage the stability of Chinese society, but his real concern was that reform of the political system could damage the stability of the party. Deng also refused to reform the legal system.

For the Xi administration, corruption has become a big challenge which could damage the administration itself. Behind this lies the lack of governance and compliance in Chinese society. The anti-corruption campaign is supported by people nationwide, but they have come to ask themselves why party leaders have become corrupt. Some have openly criticized reforms and the open-door policy, while others criticize the market-oriented economy established by Deng. China is now at a very important turning point: either it creates a free and globally-oriented economy, or it goes back to a centrally-planned economy. Xi made a speech at the World Economic Forum in Davos, Switzerland, in January in which he criticized President Donald Trump for his "America First" protectionist policies. Xi emphasized that only globalization can sustain global economic development and realize prosperity in the world.

But it is not important what the politicians say; it is important how the politicians act. China gained access to the World Trade Organization (WTO) 50 years ago. But most developed countries have not recognized the status of a market economy in China. One of the reasons is that SOEs in China remain a monopoly inside the market, protected by the government. The amount of subsidies provided to SOEs by the government has been so huge that they have never been concerned about their solvency or about borrowing from the state-owned commercial banks. This investment in SOEs is the real reason for over-capacity, and the exports of SOEs are considered as dumping in the context of the WTO.

What is the real problem with SOEs? First of all, they are a platform for corruption among politicians. SOEs, including state-owned commercial banks, play a sort of sub-fiscal role for the government, which can force them to invest in a public project, such as a dam or railway, without any feasibility study. Of course, the government can also force the state-owned commercial banks to finance public projects, although it is forbidden according to the Commercial Act. The government has never stopped intervening in the management of SOEs and state-owned commercial banks, and politicians get a huge amount of benefits from such intervention. This is simply corruption.

In addition, the problem of over-capacity is damaging the Chinese economy, which has been slowing down since 2010 *(Table)* because capital formation fell from 23.8% in 2010 to 8.1% in 2016. Meanwhile, investment in the property market also slowed from 33.2% in 2010 to 6.9% in 2016. Another concern over the economic fundamentals in China is the diminishing external trade since 2015. The growth of exports recorded -1.8% in 2015, and imports marked -13.2% in the same year. In 2016 export growth fell 7.7% and import growth dropped 5.5%. Maybe the Xi administration has to accept this new normal; otherwise it would have to decide on comprehensive reform of the economic system, including SOEs and state-owned commercial banks.

Free Floating Exchange Rate System

Is China the richest country in the world? No, but the Chinese government is the richest government in the world. It held $4 trillion in 2014. It has liberalized capital controls gradually since 2005. During the past 25 years, Chinese students going abroad could only buy $50 from a bank officially. Now residents in China can buy $50,000 every year. In 2015 about 120 million Chinese people went abroad for sightseeing. Some of them invested in the property markets in the US, Australia, Canada and New Zealand. Why do Chinese people often seem the richest people in the world? The answer is very simple: because the bubble in the property market in China is so huge. People can enjoy shopping in Paris and New York and Tokyo because they are holding many apartments in Beijing or Shanghai. The price of an apartment in Beijing and Shanghai is even more expensive than in Tokyo, but the average salary in Beijing and Shanghai is much lower than in Tokyo. Other data show that the total amount of the assets of billionaires in Beijing is greater than that of those in New York. Who would have believed that to be true? The income disparity in China is so huge that it must come eventually to damage the stability of society.

But the situation has changed since two years ago. Foreign reserves have been declining — by about $1 trillion over the past year. A huge amount of national wealth has disappeared in a capital

TABLE
Chinese economy statistics, 2010-2016

	Unit	2010	2011	2012	2013	2014	2015	2016
Real GDP	Year-on year	10.3	9.2	7.8	7.7	7.4	6.9	6.7
Primary industry	〃	4.3	4.3	4.5	3.8	4.0	3.9	3.3
Secondary industry	〃	12.2	10.3	8.1	7.9	7.3	6.0	6.1
Tertiary industry	〃	9.5	9.4	8.1	8.3	8.1	8.3	7.8
Fixed asset invest.	〃	23.8	23.6	20.6	19.6	15.7	10.1	8.1
Properties invest.	〃	33.2	27.9	16.2	19.8	10.5	2.8	6.9
Retail	〃	18.4	17.1	14.3	13.1	12.0	10.6	10.9
Export & Import	〃	34.7	22.5	6.2	7.5	3.4	-7.0	-6.6
Export	〃	31.3	20.3	7.9	7.9	6.1	-1.8	-7.7
Import	〃	38.7	24.9	4.3	7.3	0.4	-13.2	-5.5
Trade balance	100 million $	1,831	1,549	2,311	2,590	3,831	5,945	4.888
FDI	Year-on-year	17.4	9.7	-3.7	-2.9	1.7	7.9	13.5
Foreign reserves	Billion $	2,648	3,181	3,310	3,821	3,843	3,330	3,010
CPI	Year-on-year	3.3	5.4	2.6	2.6	2.0	1.4	2.1
Money supply (M_2)	〃	19.7	13.6	13.8	13.6	12.1	13.3	13.4
Income: Rural areas	〃	10.9	17.9	10.7	12.2	9.2	8.2	6.2
Urban areas	〃	7.8	14.1	9.6	7.0	6.8	7.5	5.6
Jobless rate	%	4.3	4.1	4.1	5.0	5.1	5.1	5.1

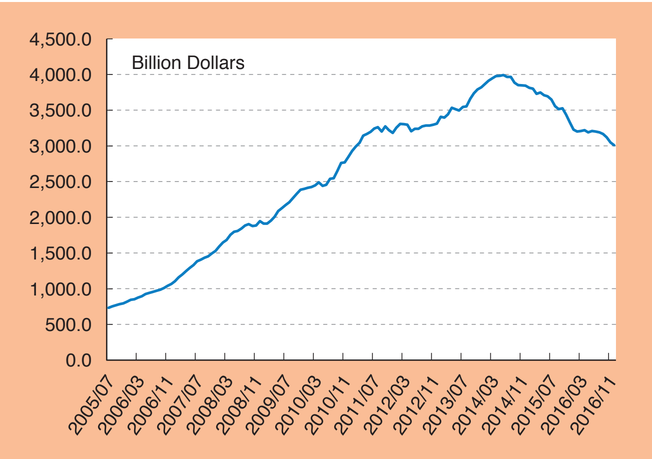
Source: Chinese National Statistics Bureau, The People's Bank of China

flight believed to have taken place since the decline in GDP due to the possible collapse of the bubble economy. I want to emphasize that the overseas Chinese, who brought their assets into China as hot money, have started to shift their financial assets abroad now. However, the Chinese government still holds $3 trillion dollars as reserves. Basically there should be no concern about the risk to international payments at this moment. But many researchers have pointed out that the government bought $1 trillion of US Treasury bonds, and also borrowed another $1 trillion from abroad for the SOEs. In addition, the Chinese government is also injecting capital into the Asian Infrastructure Investment Bank (AIIB), while also putting the big "one belt one road" project into practice. As a result, they (many researchers) say it could face a shortage of foreign reserves and the risk of international payments in the future *(Chart 1)*.

Theoretically it is impossible for any country to target the three goals of (1) free capital flow, (2) fixed exchange rate and (3) sovereign monetary policy all together at the same time. First of all, we cannot see how China could abandon a sovereign monetary policy. Secondly, the regulation of capital flow would not function in China. So the only choice is to let the renminbi float freely. Otherwise speculation in China will damage the stability of the financial system.

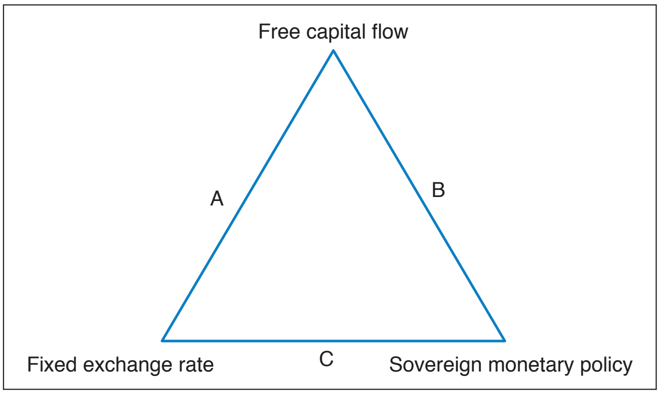
The International Monetary Fund has been warning China again and again that it must tackle its non-performing loans as soon as possible. The current managed floating system is a dirty float which cannot stabilize foreign exchange rates. It is thought that China is aiming to realize a real free float system soon, but this will not be easy to achieve. First of all, China needs to liberalize interest rates, but to do so it will also need to privatize the state-owned commercial banks. The government also needs to rebuild a real market-based

CHART 1
Chinese foreign reserves



Source: The People's Bank of China

CHART 2
Impossible trinity for a nation's financial policy



Note: The impossible trinity is a trilemma in international economics whereby it is impossible for a country to have all three of the following at the same time: fixed exchange rate (A), free capital flow (B) and sovereign monetary policy(C).
Source: Compiled by the author

securities market and stop intervening in the financial markets *(Chart 2)*.

Outlook for Chinese Economy in 2017

In January, a group from Beijing University made a presentation to the National Committee on US-China Relations in Washington DC. They showed the audience a very optimistic view of the Chinese economy. The leader of the group was Lin Yifu (Justin Lin), a former chief economist of the World Bank. Lin is an optimist about the Chinese economy. Several years ago he emphasized in a paper that China could sustain 8% annual growth over the coming decades. We don't know the precise context of this optimistic view. But it is clear that it is almost impossible for China to maintain 8% GDP growth driven by investments and exports. It is also important to protect the environment under economic development.

The problem here is that the economy has slowed down since five years ago, as I have mentioned. The fundamentals of the Chinese economy are still very strong, but its economic structure and industrial structure are not effective. Former President Hu Jingtao once put forward a new doctrine of "scientific development" but failed to realize it. In some sense the new normal may not be bad news for China. Only the harmonization of economic development and environment protection and fair income distribution can sustain economic development.

When we take a look at the reality of the economy, we cannot be as optimistic as Lin. It is hard to believe that China can sustain 8% annual growth in GDP over the coming decades, and it is not necessary for it to be pressured into doing so. The new normal situation can be considered pragmatic for China.

Instead of high-speed economic growth, the government needs to do more to reallocate income equally among the nation to overcome income disparity. It also needs to take anti-pollution measures. The problem of PM2.5 and the pollution of water and land are damaging the people's health.

The conclusion here is that the Chinese economy could grow at the level of the government target of 6-7% in 2017, but I personally believe it could slow down to 5-6% this year. If China can sustain annual economic growth at about 5%, it could become a real engine for the global economy. In its current stage the Chinese economy has caught up by depending on low labor costs and export industries. In the coming stage China must strengthen innovation and improve efficiency. But such goals can only be realized under a real market-oriented economy and it is time for China to create one.

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Long Ke is senior fellow at Fujitsu Research Institute.