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Supply Side Economics with Chinese Characteristics

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The Third Plenum of the 18th Congress of the Central Committee of the Communist Party of China (CPC) held in November 2013 was the first key party conclave held under the leadership of Xi Jinping. It adopted a very ambitious economic reform agenda in the form of a 60-point 'Decision on Several Major Questions about Deepening Reform'. The core principle underlying these reforms was encapsulated in the phrase 'decisive role of market forces in allocating resources.' The earlier phase of reform had acknowledged the 'basic role' of the market, and hence the change in terminology was significant.

Third Plenum Decision in Practice

The Third Plenum sought to restructure the role of the government from one of intervention to that of regulation. Thus, the government reserved to itself five functions: of macro-economic management, market regulation, public service delivery, supervision of society and environmental protection. While reform of the State-Owned Enterprises (SOEs) was included, the role of the state as direct ownership of economic assets was reaffirmed. It was, however, acknowledged that state and private enterprises were of 'equal importance' in developing the economy. The Decision accorded prominent importance to financial sector reform and liberalisation, including internationalisation of the Chinese currency and capital account. The overall objective of the Third Plenum reforms was to achieve a rebalancing of the economy away from an investment- and export-led growth model towards a consumption- and domestic demand-driven pattern of development and from an inordinate emphasis on manufacturing towards a greater stress on services as a source of growth and employment. This had been the objective of the 12th Five Year Plan (2011-2016), but it was acknowledged that efforts in this direction had not been achieved.

In particular, the more than US$600 billion stimulus package pumped into the economy in the wake of the global financial and economic crisis of 2007-08, went largely into infrastructure and real-estate development, undertaken by SOEs, and this meant a reinforcement of the existing strategy rather than a shift away from it. Over the next several years, investment rate in the economy remained well in excess of 45per cent of GDP, while consumption stagnated around 35-36 per cent, lower than many other emerging economies at a similar phase of development (Zhang 2016:18).

The Third Plenum reform seeks to rebalance away from investment- and export-led growth to consumption and domestic demand driven

In India, for example, the share of consumption in GDP has averaged around 60 per cent (The World Bank 2017). Currently, the share of consumption in Chinese GDP has gone up, and it was estimated at over 60 per cent in 2015, about 10 percentage points higher than the previous year (National Bureau of Statistics of China 2016). China is facing a situation of declining capital-output ratio, with US$4 of investment producing only a dollar of output in overall GDP (Zhang2016: 6). Excessive investment in infrastructure and capital-intensive industries has also resulted in massive over-capacity, especially in sectors such as steel, cement and aluminum. It is estimated that nearly a quarter of real estate built is lying vacant, even as more stock is being addedThe CPC's Third Plenum Decision sought to bring about important structural reforms, in particular, to the misallocation of investment but two years later it was obvious that the progress achieved had been patchy and in some areas there had even been a regression. It is against this background that an Economic Work Conference convened in December 2015 introduced the concept of 'supply-side reforms' as the new strategy to achieve the rebalancing of the economy (Jia 2015).

How much of a departure is this seemingly new approach from the Third Plenum reform agenda? Is it merely a re-labelling exercise? As analyst Barry Naughton has observed, 'In China, policies never fail; they simply get reinterpreted until they can be declared successful or else be forgotten' (Naughton 2016). Or is it something more substantive, a shift away from the market-oriented reforms of the Third Plenum to a selective state-directed strategy, with restructured SOEs playing a key role, in shifting the economy to a different trajectory?

In spelling out what supply-side reforms implied, the Economic Work conference identified five key objectives: reduce over-capacity, de-stocking or reducing accumulated inventories, de-leveraging, lower corporate costs through tax cuts and removing bureaucratic red tape, and improving weak links in the economy. An article in the official Chinese news agency *Xinhua* explained,

> 'The Chinese economy is no longer galloping ahead on the back of investment, exports and consumption. Adjusting banking regulations and interest rates have not been very successful in boosting investment or consumption. With growth falling below 7 per cent China's economy is in dire need of a make-over. Instead of working on the demand side, attention has turned to stimulating business through tax cuts, entrepreneurship and innovation while phasing out excess capacity resulting

> from the previous stimulus. Such measures areintended to increase the supply of goods and services, consequently lowering prices and boosting consumption.' (*Xinhua* 2015)

It should also be noted that unlike the Third Plenum Decision to give equal status to SOEs and private sector, the new Supply Side strategy accords a pivotal role to the former,

> 'as the core force of national economic development, SOEs should play the leading function in supply Side reforms. They should carry out every aspect of reform in a model way and become pioneers and main force of the reform.'

This reaffirmation of the role of SOEs comes alongside another key aspect of reform, that is, the assertion of Party authority over the board of directors in corporate governance. This is a major departure from the trend towards relatively autonomous and professional management of SOEs with state ownership of assets being separated from management.

The Chinese version of Supply Side reforms is very different from the set of policies, under the same label, pursued by US President Ronald Reagan in the early 1980s, to address high inflation, stagnant growth and depressed private investment. These were based on the economic theories of the Chicago School and included tax cuts for high-income categories, deregulation of the economy with the retreat of the state in the belief that markets were self-correcting and reduction in government expenditures. These were distinguished from the policies associated with the Keynesian school, which called for public expenditure to boost were based on the economic theories of the Chicago School and included tax cuts for high-income categories, deregulation of the economy with the retreat of the state in the belief that markets were self-correcting and reduction in government expenditures. These were distinguished from the policies associated with the Keynesian school, whichcalled for public expenditure to boost insufficient demand in the economy and enable utilisation of excess production capacity.

Chinese academics have themselves recognised this although superficially tax cuts and some aspects of deregulation may be similar. The Chinese understanding of Supply Side reform, unlike Reaganomics, accords a central role to the state and SOEs. The cutting of excess capacity in steel, for example, is being pursued through administrative decisions, not through market regulation. Debt-ridden state enterprises are not allowed to go bankrupt. They are merged instead with larger, more viable firms. In encouraging innovation, again it is the state, which is intervening directly, setting up well-funded R&D facilities in high technology sectors.

From a 'decisive role' to markets, the principle has been readjusted to a decisive role for the state instead

The Decision Modified

What is apparent by now is that the principle of according the 'decisive role' in markets that was key to the Third Plenum reforms has now been readjusted to return to a decisive role of the state instead. The argument adduced is that the economy is not suffering from an insufficiency of consumer demand but rather from a production pattern that is not aligned with changing consumer demand.

There is need to produce medium and high-end goods that the comparatively better off consumer demands and this is unlikely to be achieved by further doses of stimulus. This is a rejection of the Chinese 'growth economists' who argue that Chinese debt, though apparently large and expanding, should not be regarded as a constraint on expanded investment since a growing economy will be better placed to service the debt. The danger, by contrast, is if one opts for slower growth, which may result in lower capacity to manage debt and bring about the crisis that everyone wishes to avoid. The imbalance in the economy should be addressed by the market-based allocation of resources, which implies a reduced role of SOEs and minimising government intervention in investment decisions.

The situation since the Third Plenum Decision has seen patchy progress and in some areas even regressed

The Supply Side advocates reject this approach. Their strategy implicitly accords a major role in state intervention in addressing the current imbalance. The much publicized 'one belt, one road' initiative is an example of the new state-directed approach. It is intended to address in part, the overcapacity in China's infrastructure-related and heavy industry.

This new approach is said to have emerged from the Communist Party's Finance and Economic Leadership Group whose secretariat is headed by Liu He, one of the key and influential advisors to Xi Jinping. On 9 May 2016, there appeared in the People's Daily, the Party newspaper, a curious article attributed to an 'Authoritative Personage' (AP), who has been identified with Liu He and therefore, bearing the stamp of approval of Xi Jinping himself (People's Daily 2016). The AP rejects the argument that China could continue with debt-fueled growth. He maintains that 'It is unrealistic and unnecessary to add leverage to pump up the economy'.

He argues that the current phase of lower GDP growth will, without reforms, lead to 'no V-shaped, not even U-shaped but an L-shaped' recovery. Clearly, debt cannot be allowed to grow indefinitely. The way to avoid this is through Supply-Side reforms, and that requires enhanced, though, carefully directed state intervention. In other words, the capital allocation will continue to be determined by political power.

Agenda Stands

This shift in approach does not mean that the agenda associated with Third Plenum has been abandoned in its entirety. Some of the 60 items of reform have been implemented, and several others are in the pipeline. For example, interest rates on bank deposits and rates on which loans are extended have been fully liberalised. A deposit insurance scheme, promised by the Plenum, is now in place. The 'hukou' or urban registration system has been liberalised to allow rural migrants to tier-2 and 3 cities to have access to housing, education and health facilities (National Development and Reform Commission 2016). This will rationalise the process of urbanisation.

However, the reform does not as yet extend to tie-1 cities like Beijing, Shanghai and Tianjin where the problem is most acute. Notable progress has been made in financial sector liberalisation. There has been a steady and calibrated move towards a more flexible exchange rate regime for the Chinese currency, the renminbi (RMB). The daily reference rate is now determined against a basket of currencies rather than pegged to the US dollar. The rate may vary 2 per cent on either side of the reference rate, which itself is determined on the basis of the closing overnight rate and hence has greater predictability (International Monetary Fund 2017).

The emergence of the RMB as a major currency for trade settlement in line with the country's emergence as the world's number one in merchandise trade i.e. 15 per cent of global volume (World Trade Organisation. n.d.), has also enabled it to be included in the IMF's basket of major currencies which determine the rate for its Special Drawing Rights. This is despite the fact that the RMB is not fully convertible on capital account nor freely traded as the US dollar, the British pound, the Japanese yen and the Euro are. It is unlikely that China, under its present political dispensation, will settle for full convertibility but the trend towards financial liberalisation is likely to continue perhaps, in fits and starts.

Recent reports indicate that Chinese authorities, faced with an RMB declining rapidly against other major currencies and the consequent renewed surge in capital outflows, have informally introduced more strict capital controls (Asian Development Bank 2016).

However, as in the past, these may again be relaxed once the situation stabilizes. China has also liberalised, in successive steps, its foreign investment regime. Under the Qualified Foreign Institutional Investor (QFII) scheme, launched in 2002, 27 foreign institutional investors, including banks and sovereign wealth funds can invest in Chinese equity within a quota of US$80 billion. The Qualified Domestic Institutional Investor scheme, launched in 2006, has allowed Chinese domestic financial institutions like commercial banks, security companies, asset management companies and insurance companies to invest in offshore financial products. The current limit is US$90 billion allocated among 132 Chinese financial institutions.

Later in 2011, China went further and launched the RMB Qualified Institutional Investor (RQFII) scheme, which allowed select foreign institutions to use offshore RMB funds to invest in Chinese equities and other RMB denominated financial instruments such as bonds. The quota is US$70 billion and 135 foreign financial institutions have been given approval under the scheme. And more recently, in 2013, China has announced – though not yet implemented – a Qualified Domestic Individual Investor scheme, which would allow individual Chinese investors to invest up to RMB1 million in foreign equities and financial products (The Global Times 2015). The quotas and the number of qualified investors will likely increase in future steps.

Whether the Chinese version of supply side reforms will be more successful than the Third Plenum approach remains to be seen

Two new initiatives have been implemented recently. Under the Hong Kong-Shanghai Stock Connect, Hong Kong residents can invest up to US$47 billion in Chinese securities listed on the Shanghai stock exchange. Chinese investors on the other hand, can invest up to US$39 billion in equities listed on the Hong Kong exchange. A similar Shenzhen-Hong Kong Stock Connect is being established soon (Xinhua 2016).

In 2013, the Shanghai Free Trade Zone (FTZ) was set up to experiment with much more liberal investment and exchange policies, using the negative list approach rather than direct regulation. Subsequently, similar FTZs have been set up in Guangdong, Tianjin and Fujian. However, latest reports (Yu 2016) indicate that these pilot projects have not really taken off and there are concerns that they are being used to facilitate illegal transfers of capital to jurisdictions abroad bypassing capital controls put in place to prevent capital flight.

Conclusion

A mixed picture, therefore, emerges on China's economic reforms and intentions. There is no doubt that there has been steady opening up and liberalization of the Chinese economy across the board, delivering accelerated rates of GDP growth and rapid industrialization of the country. This trend continues but in a more measured and calibrated manner.

In 2001, after China joined the WTO, China under Premier Zhu Rongji, brought about a major reform in the SOE sector, closing down a very large number of loss-making and inefficient enterprises resulting in large-scale unemployment. However, the rapid growth of

the economy thereafter, enabled much of the surplus labour to be put to work again. The private sector, wholly-owned subsidiaries of foreign companies and joint ventures between Chinese public and private sector firms and foreign firms, became the engine of growth for the economy.

What we are seeing now is the return of the SOEs as the intended agents of growth in a new economic environment. The Chinese state and, in this specific context, the CPC, is likely to be more interventionist in the economic sphere that has been the case since Deng Xiaoping's more radical reforms initiated in 1992 after his well-known tour of the southern provinces.

Whether the Chinese version of Supply Side reforms will be more successful in addressing the acute and increasingly unbalanced nature of Chinese growth than the Third Plenum approach remains to be seen. How it will be impacted by the Trump presidency in the US is another element of uncertainty. A possible trade war between the world's largest trade partners may compel an authoritarian China to revert to even more overt interventionist economic policies than has been evident so far, in order to deal with its disruptive consequences.

China may suffer economic setbacks due to both domestic and external causes. Given the unbalanced nature of its economy, the very large and expanding volume of its overall debt to GDP ratio, estimated at 280 per cent (Rapoza 2015), the exposure of its economy to global headwinds and the brittle nature of its politics, a major crisis could be triggered by some unexpected event such as a stock market crash or massive flight of capital.

However, in the more than three decades of unprecedented growth, China has accumulated physical assets and a considerable knowledge pool which should enable it to recover its growth trajectory to its trend line. Well before it celebrates the hundredth anniversary of its Liberation in 2049, it would have emerged as by far the largest and most powerful economic and political power in the world. ■

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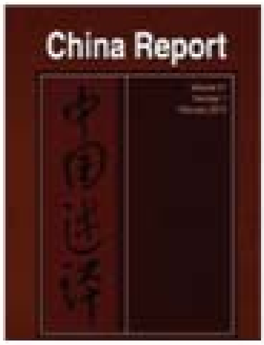

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