

China's Roadmap to Harmonious Society

Third Plenum Decisions on "major issues concerning comprehensively deepening reforms"

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Summary

In November 2013, the central committee of the Communist Party of China (CPC), at its third plenum, issued a Directives Paper (with 16 items and 60 prescriptions), setting out a long-term strategic compendium of China's reform agenda, based on the principle of separation between market and state under the unifying predominance of the Law. Its prescriptions refer to three basic objectives: inclusiveness, protection of rights, and improving economic efficiency.

The Directives Paper formulates an ambitious plan of reforms over the next 20 years, aimed at overhauling the factor price system. There are two pillars to the Reform. First, labor market developments should provide workers with enhanced bargaining power. Government is expanding the basic social safety net, promoting low catch-up, enforcing labor contracts and introducing collective bargaining. Second, capital market reform has been speeded-up by the urgency of dealing with non-performing loans held in state-owned enterprises and credit platforms guaranteed by local governments. The Government intends to foster bond markets, encourage private banks to finance SMEs, build a strong prudential framework, deregulate interest rates, and move to Renminbi convertibility in the new Shanghai free trade area.

We believe that the political feasibility of the Reform depends on the sequencing of its implementation. Benefits in the early stage would legitimate more contentious future policy decisions.

But the deep social changes involved in the Reform also imply risks. Reforming rural land and natural resource prices will be difficult. Farmers' land-use rights will be secured by law and made transferable in rural land markets. Fuel, water, electricity and carbon prices will rise progressively to their social marginal costs within an integrated urban rural model to accommodate 350 million migrants over the next 20 years. New smart cities and greater social inclusiveness will be spurred by relaxing the *hukou* system and the one child policy. Tough political decisions will be required related to fiscal sharing amongst local governments, and rebalancing the tax system towards more progressive direct taxes.



Achievements in 2013: economic restructuring, enhanced social welfare and streamlined government

Economic and Social Performance of a New Growth Regime (2013)

Macro-performance		Economic Structure		Income and employment	
GDP	7.7%	GDP breakdown	(%)	Growth in disposable income per capita	
GDP per capita (\$)	6,750	• Agriculture	10.0%	Urban	Rural
CPI	2.6%	• Industry	43.9%	7.0%	9.3%
CPI (food only)	4.7%	• Services	46.1%		
M2	13.6%	Contribution to GDP growth	(%)	27 regions raised minimum	
Urbanization rate	53.7%	• Consumption	3.9%	Wages by an average of	10%
		• Investment	4.2%	Newly created jobs (million)	13.1*
		• Exports	-0.3%	Registered unemployment rate	4.1%

Social Welfare		Government	
Rise in pension for retired employees	10%	Increase in fiscal income	10%
Rise in Social Security compensation standard		Administrative approvals eliminated	416
	<i>Urban</i>	<i>Rural</i>	Administrative fees eliminated
	13.1%	17.7%	348
Social housing		Three public expenditure reductions	35%
• Newly finished (million)	5.4	overseas trips, vehicles and official receptions)	
• Newly started (million)	6.6		
Rise in number of new college students from under-developed regions	8.5%		

* 3.1 million more than the target set in 2012.

Source: CEIC.

Objectives of urban planning presented at the national people's congress

(March 2014)

Urbanization Rate	2012	2020
Permanent urban residents (% of total population)	52.6	60
Permanent urban residents (with "hukou"; % of total population)	35.3	45
* Before 2020, China plans to:		
a. grant urban "hukou" to about 100 million rural immigrants;		
b. rebuild rundown city areas and villages inside cities for around 100 million people;		
c. enable around 100 million rural residents to relocate to cities in central and western regions.		
Public Services Provision		
Free compulsory education for children of migrant workers (%)		≥99
Free professional training for unemployed, migrant workers and young (%)		≥95
Basic pension for permanent urban residents (%)	66.9	≥90
Basic medical insurance for permanent urban residents (%)	95	98
Social housing for permanent urban residents (%)	12.5	≥23
Infrastructure		
Public transportation in total motorized transportation (%)	45*	60
Public water supply (%)	81.7	90
Rate of urban sewage treatment (%)	87.3	95
Rate of urban garbage treatment (%)	84.8	95
Rate of urban broadband access (%)	4	≥50
Provision of urban community service facilities (%)	72.5	100
Resources and environment		
Urban construction land per capita (square meters)		≤100
Percentage of renewable energy consumption	8.7	13
Percentage of green buildings in newly constructed buildings	2	50
Percentage of cities that meet national standard of air quality	40.9	60

* 2011 Data.

Source: Xinhua News Agency, 2014.

1 Overview of the decisions promulgated in November 2013

China's reform momentum has received renewed impetus from the announcement of the broad and ambitious Directives that concluded the third plenum of the central committee of the CPC (Communist Party of China) in November 2013. The Directives cover 16 domains and 60 detailed prescriptions. On March 5, 2014 Premier Li Keqiang reported on the work of government at the session of the National People's Congress, emphasizing the State Council's involvement and setting some quantitative objectives for 2014.

The reform plan is aimed at transforming the Chinese society. Its purpose is primarily political: evolution of the Chinese political system under the unitary principle of sovereignty and its symbiotic relationships with the development of civil society. However, the means to achieve those aims are economic and social. China will continue to pursue stable economic growth in order to provide ample employment opportunities for its citizens and maintain steady welfare improvements. Meanwhile, social justice must be preserved to enable inclusive and sustainable growth. The time line for the Reform is 20 years, and its objective is an original mutation of the current growth regime towards "harmonious society".

1.1 Property rights at the core of the Reform

The core of the Directives is a deep overhaul of the state and legal institutions to define and secure property rights in order to differentiate between State and market attributes. A well-functioning market economy hinges on the Rule of Law. The Rule of Law means primacy and strict respect of the law as the formal social contract that defines the common interest. It is a necessary and sufficient condition for a free market: definition, recognition, respect and security of property rights, and organization and regulation of their free transfer through the market. But once these conditions are respected, market theory does not preempt the political regime required to guarantee them.

1.2 Free market and imperial sovereignty

The primacy of law is one of the most important achievements of the Chinese political philosophy that has prevailed for more than two millennia. It is based on the idea that a free market is entirely compatible with imperial sovereignty. Indeed, markets were prospering in China much earlier than in Europe. The duty of the party is therefore perceived to be in the capacity of the sovereign to reestablish this compatibility between markets and sovereignty. In other words, the gist of the third stage of the Reform (see below for the presentation of stages) is to restore the Rule of Law in its entirety. The Directives state unequivocally that the aim is to found "a socialist market economy on the basis of the decoupling of the State from the market".

1.3 Three overriding objectives: inclusiveness, rights protection, and enhanced economic efficiency

The Directives define the socialist market economy as a moderately prosperous society which encompasses three basic objectives. The first is *inclusiveness*. For the political regime this means that standards of living should improve for all citizens, so that they have a common interest in respecting the institutions. Inclusiveness involves increasing real primary income, and also reducing the wide-ranging inequalities in disposable income. It also implies universal basic social welfare, eradication of the excesses of corruption, administrative waste and abuses of power.

The second objective is *protection of rights*, property rights for the well-functioning of the market, but also legal and political rights to foster real democracy in civil society. The Directives emphasize improvement of rights in all domains of society.

The third objective is *improvement in economic efficiency*, which is the means to achieve the first two objectives. It is a strategic judgment is that growth should be maintained and become more qualitative in the next stage of the evolution.

1.4 The principle of separation

The principle of unitary sovereignty does not give rise to arbitrary power if it is under the predominance of the Law. The Law provides consistency to the three types of societal organizations, State, market and civil society. In China, democratic rule means that the Party, in the capacity of the collective emperor, must govern, according to the Law, for the welfare of the people. The Party of 85 million members includes young middle class people and implements an inner democracy. The predominance of the Law guarantees market freedom and autonomy of a vibrant civil society. It fosters an enlarged role for local formal democracy because the elective procedure is extended to the local level. More importantly, real democracy is spreading through social networks.

The present leadership understands that the party cannot regulate everything amid the myriad social issues involved in enhancing welfare. As long as there is no national political issue at stake, the Party encourages the development and registration of autonomous civil organizations (more than 500,000 NGOs registered in 2014). This is a gamble that new freedoms for civil-society groups will gather the energy and resources of civil society to handle environmental and social issues. Since China has a long tradition of solidarity networks, it is conceivable that involving social activist groups in sensitive issues (food safety, water supply, education, health care) will enhance social stability.

In emphasizing these principles, the Directives are announcing a political and social upheaval. The spirit of the Reform is encapsulated in the motto applied by the original promoters of ordo-liberalism in Germany before it was cheated by financial dominance: "*the market as much as possible, the State as much as necessary*".

The gist of the third stage of the Reform is to restore the Rule of Law in its entirety

According to the Directives, judiciary institutions will be separated from administrations. The everyday management of sovereign-owned enterprises will be separated from the State. The State will behave as an equity shareholder along with others, while the capital of State-owned Enterprises (SOEs) has been opened to private shareholders. The purpose of the Party leadership is not to privatize for the sake of private property, but to embrace multiple forms of ownership in the large diversity of enterprises in China: public, private, mutualistic and cooperative. Public enterprises will be subject to the performance criteria applied in competitive markets, in market structures not conducive to natural monopoly, to otherwise well-defined and publicized obligations.

1.5 The market as primary capital allocator

In economic terms, the market will be responsible for allocating capital whenever it is the most effective institution for this task. In separating State and market, and defining the State's responsibility over the economy, the Directives hope to apply a cure to the perverted legacy of the socialist era: the state does too much of what it should not do and too little of what it should do to improve its efficiency.

Overall, the responsibilities of the state can be expected to remain substantial. It will be responsible for regulating the macro economy based on strategic long-run planning. It will also cater for financial stability, and produce public goods. Strategic planning will be grounded on qualitative criteria made imperative for local governments, and replacing maximum GDP growth. The objective of strategic planning is primarily joint rural and urban development to achieve an ecological solution. Because it is estimated that 300 million people will migrate to existing or entirely new cities by 2030, planning to create and restructure cities that are compatible with environmentally-friendly models, must be a main objective of long-run planning and was heavily emphasized in Li Keqiang's report.¹ Projected economic reforms fall under this heading.

2 The three stages of the longer-term reform process: from agricultural to factor prices

In economic terms, the Ariadne's thread of the Reform, which started at the return to power of Deng Xiaoping in 1978, is the price system, keeping in mind that the economy is only a means and in no way an end in itself.

Stage 1 was led by the reform of agricultural prices, Stage 2 by the reform of industrial prices, and the upcoming Stage 3 will be led by the reform of factor prices. At every stage the changes have been introduced incrementally. The influence of the forces they set in motion spreads progressively within the dynamics of the stage.

2.1 First stage: economic responsibility

The stylized facts of the (past) first two Reform stages are useful to better understand future challenges. Each stage displays a pattern of joint transformation of economic structures and institutions within the limits of the political agreement within the party. This agreement circumscribes the mode of regulation, therefore the type of economic policy proper to that stage. The stylized facts are presented in table 1.

Stage 1 was set up under the banner of economic responsibility. In 1979, 80% of the population was rural: the Reform therefore had to start with agriculture to earn legitimacy with the people. Economic responsibility means that farmers who were rural workers in an all-encompassing planned economy, had to learn how to behave as autonomous producers for incipient markets. However, in order to avoid disturbance to the food supply for the urban part of the economy, planning continued, hence the dual track that was the mode of the regulation in that stage.

Stage 1 encountered difficulties when the principle of responsibility was extended in the mid-1980s to industrial enterprises. Accommodating market behavior in communities of family farmers is one thing. But it is quite another to transform big enterprises being run as administrations, into competitive firms, and simultaneously

Table 1 – Core characteristics of the first two stages of reform

Stage 1: 1979-1989		Stage 2: 1993-2010	
Achievements	Contradictions	Achievements	Contradictions
<ul style="list-style-type: none"> • Dual track in agriculture: markets/planned quotas and increase in rural income • Commercial responsibility of firms • Subsidies to urban workers 	<ul style="list-style-type: none"> • Collapse of State budget and central government control • Collusion of local governments and SOEs • Explosion of directed credit and non-performing loans • Galloping inflation and fall in real wages 	<ul style="list-style-type: none"> • Demo dividend • Export-led growth, FDI and process trade • Capital accumulation in heavy industries • Centralization of fiscal resources • Privatization of small SOEs • Stabilizing monetary policy and resolution of banking crisis • Privatization of urban land and residential building expansion • Fast growth of GDP and real income 	<ul style="list-style-type: none"> • Discriminations against migrants: subsistence wage + hukou • Massive transfers of households to SOEs via the financial system • High energy and carbon intensity, environmental damage • Widening inequalities: rural/urban and income structure • Massive and widespread corruption • Misallocation of capital

1. Report on the work of the government, delivered by Li Keqiang, Premier of the State Council, at the 2nd session of the 12th National people's Congress on March 5, 2014.

to split a Gosbank into an efficient banking system. This task was beyond the regulation related to that stage, and therefore was dysfunctional, resulting in the crisis between 1989 and 1992.

2.2 Second stage: the Deng principles

The second Reform stage was based on principles that Deng succeeded in making acceptable to a badly divided party. They resolved the contradictions in the first stage and achieved progress in extending the market to include the manufacturing sector and the pressure of international competition. In 1996, a large number of public enterprises were privatized. So was urban land use in 1998. And China entered the WTO in 2001.

Under the new principle of regulation, and with new institutions fit for macroeconomic policy (central bank, banking regulation, central government budget), the second stage was initially highly successful. However, it did encounter difficulties (see table 1) which were magnified by the oversized stimulation plan of 2009.

2.3 The dynamics of the contradictions in the Reform process: example of the 1989-92 crisis

Over time, the dialectic between the virtues of gradualism and the continuously mounting contradictions in a specific mode of regulation showed its limits. This can be illustrated by the initial success of the agricultural reform and its subsequent difficulties.

There was a dual logic in the Reform. In 1980 the rural population constituted 80% of the total. Therefore, improving the life of the peasants was the surest way in the beginning to acquire legitimacy. Productivity had increased in the 1970s, allowing peasants to make a surplus beyond the Plan's requirements for delivery to the State, provided they could dispose of this surplus. The incentive was for the peasants to augment this potential surplus in order to sell it profitably. The government kept the requirements of the plan intact, so as not to disrupt food supply to the cities. It encouraged the creation of local markets at the margins where surpluses could be sold privately by the peasants, at market prices higher than the official buying price for the bulk of their production. The initiative was a big success. It triggered an increase in production that affected the market price which began to reduce to convergence with the official price. When convergence occurred, the dual track was wiped out and it was safe to remove the administrative allocation in agriculture.²

This success made the Reform popular. Rural income increased markedly, and the higher purchasing power of the rural population created demand for industry products.

However, the attempt to generalize the process came up against serious obstacles. With the relaxation of central controls over industrial production, the connections between firm managers, local party leaders and bank officials were disrupted. A spree of non-performing political loans erupted, and inflation flared, leading to an acute crisis.

(2) Fan Gang (1994), "Incremental change and dual-track transition: understanding the case of China", *Economic Policy*, vol. 19, pp. 99-122.

The crisis spread throughout the country and the legitimacy of the Reform was destroyed by the tragic events in June 1989 in Tian Anmen Square. Meanwhile, the autonomy of firms deprived the central administration of profits while there was no operational fiscal system in place. Central government lost its grip on the tools of power with the reduction in its budget to the benefit of local governments. The country was in real danger of fragmentation.

These very serious contradictions nurtured a political crisis. The party needed to regain authority. A powerful conservative faction recommended the backward step of a return to overall central planning. The progressive avant-garde appeared destabilized and lacking in orientation. Debates raged in the shades of the party's inner circles, culminating in Deng touring the South East of the country in spring 1992. Such was Deng's authority in the party, this visit constituted a turning point. He made the decision to push forward the Reform by generalizing the special industrial zones and inviting foreign FDI, to open manufacturing to international competition and progressively to deregulate industrial prices.

The second stage of Reform was highly successful in establishing an industrial base that has made China the world's second economic powerhouse. Trade flows to and from China have had a major impact on macroeconomic variables in primary resources producers and Eastern Asian countries.

3 Current key economic challenges: redeploying productive capacities

Distortions in the price system are the main challenge to the economic side of China's Reform.³ The structure of production needs to be redeployed to overcome them. But as often, structural change is difficult to enforce given the threat of rising unemployment associated with the economic transition between sectors and regions.

The Reform process therefore faces resistance and inertia among vested interests because of its large redistributive effects. Changes in statute (privatization) and market structure (demonopolization) eradicate rents and implicit subsidies, feeding political resistance. To counter these headwinds requires strong political leadership and a long view embedded in strategic planning.

The change in leadership, which occurs in China every 10 years, was confirmed in November 2012 in the five-year session of the Party Congress. It renewed the central committee and promoted a new strong leadership dedicated to Reform, led by President Xi Jinping and Prime Minister Li Keqiang. The monitoring core of the central government (State Council) lost no time and 12 months later presented a comprehensive reform agenda for approval by the central committee.⁴

(3) Y. Huang (2010), "China's great ascendancy and structural risks: consequences of asymmetric market liberalization", *Asian-Pacific Economic Literature*, vol. 24, n° 1, pp. 65-85, November.

(4) The substance of the structural changes advocated in the Directives were planned in a powerful work undertaken by the development research center, a think tank close to the State Council, in collaboration with the World Bank, set out in a report written in 2012, and published by the World Bank in 2013 as: *China 2030. Building a modern, harmonious and creative society*.

Along with its outstanding performance in growth and trade expansion, the legacy of Stage 2 was a clutch of contradictions in the growth regime. Table 2 presents the nature, causes and consequences of distortions that call for a new mode of regulation. They can be grouped together since they pertain to a single logic: the distortions in price of production factors.

The treatment would seem to be the same as in the former two stages: giving more leeway to markets. However, the current problem is much more complex

- First, factor prices impinge directly on property rights, which is why their liberalization is so perilous. It depends on a much broader and more ambitious Reform as described above, which defines and regulates the extent of property rights under the law.
- Second, labor is not just a commodity. Labor rights in firms depend on formal contracts giving workers the ability to organize and to negotiate wages and work conditions in collective bargaining. Their enforcement depends on independent labor Courts to settle litigations.
- Third, additional policy tools are needed. Labor rights must be complemented by social rights to education, health and retirement. Land and subsoil resources are non-reproducible rent-generating factors that give rise to market failures. Carbon emissions and degradation of ecosystems have no or inadequate prices in all countries.⁵

3.1 Solution: towards the right liberalization-regulation mix

The challenges related to overhauling the factor price system are therefore many and very long term. How can they be fixed? The solution lies in a mix of progressive market liberalization and public regulation. Such a mix would represent a long-term strategic planning aimed at changing production structures in the direction of new urban rural development. The long-term view includes criteria for sequencing the Reform, setting regional priorities aimed at a unified national consumer market. This highlights the importance of rural land reform to allow migrants to move to cities based on the benefit of the full value of their land. This induces drastic changes to the hukou system of registration. It induces fiscal reform to provide local governments with the resources to fulfill their social responsibilities towards migrants so that they cease to be treated as second-class citizens.

(5) The experience of "free market" economies shows that all asset prices are subject to momentum dynamics that give rise to protracted misalignments leading in turn to starkly inefficient allocation of capital.

Table 2 – Distortions in the prices of production factors

Type of factor	Nature of distortion	Causes	Consequences
Labor	• Urban wage of migrants slightly > rural income → SOEs and subcontractors capture productivity gains	• Rural labor surplus • Social rights of migrants denied • No labor contract in private sector	• Wage share ↓ • Income inequalities ↑ • Weak bargaining power of labor and lack of human capital
Capital	• Base real interest rate << growth rate → cost of capital low for SOEs and high for SMEs	• Max growth needs very high invest rate biased toward SOEs in heavy industries	• Productive structure distorted → services undeveloped • Household saving trapped in low-yield deposits
Urban land	• Land market polarized: prices low for industry, high for real estate	• Land valued captured by local governments to substitute for insufficient fiscal resources: off-budget + value and collateral of credit	• High land price bars purchase of housing by low-middle income classes
Rural land	• Farmers expropriated: land seized by local governments		• Arable → constructible land → urban sprawl + brake to rural migration
Energy	• Heavily subsidized energy	• Extraction rights granted at very low costs	• Energy intensity of production much too high
Carbon	• Price inexistent or very low	• Externalities by degrading environment	• Pollution, water scarcity and soil deterioration

3.2. A tricky transition

The transition will inevitably be tricky. Structural change is painful in the shorter run (as explained above). But it also provokes large redistributive effects that raise opposition. Changes in statutes (privatization) and market structure (demonopolization) eradicate rents and embedded subsidies, feeding political resistance. To manage this requires strong political leadership and a long view supported by sound strategic planning.

4 Taking stock of past successes

To stand up to the challenges identified above, the State Council can count on favourable underlying conditions. In particular, Stage 2 also came with strong economic growth, which massively eradicated poverty and allowed the emergence of an urban middle class. On this strong social foundation, the policies aimed at resolving the distortions exhibited on table 2 are well under way.

4.1 The rise of the middle class: potent driver of Reform in the new Stage

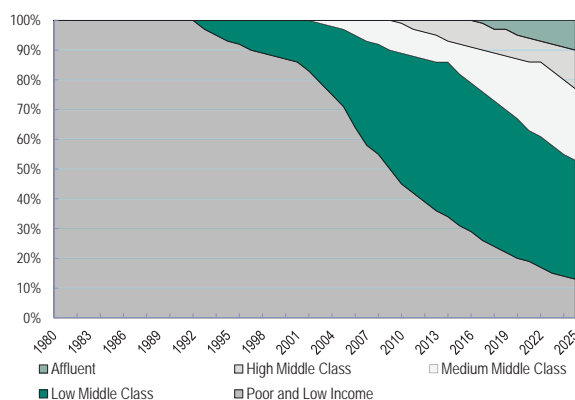
Looking at labor markets, the third stage of Reform already yielded significant results. The recent rate of wage growth has been high and social benefits have improved. Increased wages should result in consumer demand for better services. It should also lift the prices of non-traded related to traded goods, raising the profit margin of firms in the services and consumer goods sectors. This might in turn generate demand for labor to substitute for the reduction in production capacity in oversized industrial sectors.

An emerging middle class in fast-track mode is underway. In the 30 years since 1980, the number of absolute poor (less than \$1,000 per year) has declined steadily. The dramatic changes after 2003 (resolution of the severe banking crisis) produced a large increase in the size of the low-middle class (ranging from \$5,000 to \$15,000 per year). In the next 5-year plan (2016-2020) the higher middle class income categories are expected to rise substantially (figure 1).

We see the rise of the middle class as the most potent force to transform China's growth regime. In coming years, rising real income among the middle class should diversify the range of consumer goods and services towards products with higher income elasticity, boosting activity in skilled labor-intensive sectors.

An optimistic scenario could unfold on that basis. Higher earnings among a wider population could also reduce the informal economy and boost tax revenues to finance basic social welfare. Demand for better and higher education is likely to increase steadily. Greater education opportunities and higher levels of education could in turn enhance social cohesion and political stability through inclusiveness.

Figure 1 – Population in China by range of GDP per capita (% of total population)



Source: National Bureau of Statistics, China Watch BBVA Research.

4.2 Labor market developments have been favorable

The catch up in wages had already started before the third stage of the Reform was announced. In contrast with previous episodes⁶, the growth slowdown since 2011 has been accompanied by a sharp acceleration in wage increases (figure 2). This evolution is the effect of both a shift in bargaining power towards workers with the shrinking of the younger age population (first "Lewis" turning point), and a deliberate government policy to raise minimum wages steadily.

(6) In the two earlier phases of growth slowdown, real wages slowed much more than per capita GDP; in 1989-90, the average real wage declined and in 1998 it stagnated under the backlash of the Asian crisis.

The sustained increase in industrial wages has reverberated in the enterprises in the Eastern regions. They are being forced to review their strategies and upgrade production processes to

achieve productivity gains, or relocate abroad or inland where wages are lower. In parallel, the government has invested in higher education to supply a larger number of skilled workers. It has also invested in public goods and infrastructures to encourage inland relocation. Urban development, transport, logistic, infrastructures and high-end professional services have been targeted to attract FDI in Western and central regions.

The service sector has already become larger than manufacturing and more dynamic. Investment is bearing the sign of this evolution.

In 2012 FDI declined 6.2% in manufacturing, but increased 4.8% in services. The service sector is bolstering the contribution of consumption in growth. Private consumption growth has contributed 4% of 7.8% GDP growth rate in 2012, 3.9% of 7.7% in 2013 and is likely to contribute 5.7% out of 7.4% GDP growth in 2014⁷.

Endogenous changes in labor markets are being complemented by institutional reforms to reduce inequalities, via the provision of basic social welfare for health care and retirement. Further progress towards more equality will require unification of the rights between urban and rural residents. We think this will be achieved by a more centralized provision of social benefits. We also believe that the financing of the social welfare system will distinguish contributory benefits financed by labor contributions, and non-contributory benefits financed by a social tax levied on every income.

Figure 2 – Real wage growth and GDP growth per capita (% y-o-y)



Source: BBVA Research, Economic Watch. Eagles, January 2013, p.5.

(7) Furthermore the share of consumption in GDP, as registered in the national accounts (around 38%) is presumably underestimated according to academic studies based on surveys. It might be underreported for three reasons: imputed rents of homeowners are too low, part of private consumption is counted as corporate expenditure and auto consumption is widespread in the rural economy. An estimate of the downward bias adjusts the consumption share at 43% to 46% GDP. This not at odds with the figures in Korea and Japan at the same level of GDP per capita.

The regulation of primary wages might also evolve, with the development of collective bargaining within firms to align real wage increases and productivity gains. But although the introduction of collective bargaining is conceivable in large SOEs and foreign multinationals and encouraged by central government, it is likely to meet strong resistance in private firms. Incentives will therefore have to be provided with financial and fiscal advantages.⁸

5 China's financial situation and Reform: a work in progress

5.1 Debt cleaning: the risk lies in the corporate sector

An indication of total and private sector debt is provided by central bank data.⁹ On the basis of total social financing plus private finance and foreign debt, total private non-financial sector debt was 203% of GDP at end-June 2013 (34% for households and 169% for business). This is high, but not disproportionate when compared to many advanced countries.¹⁰

Turning to public sector indebtedness, total government debt stood at only 34%, not a very high figure!¹¹ Foreign debt is less than 1% for the public sector and 3% for the corporate sector.

On these numbers, we would judge China's overall debt situation as being relatively balanced, in particular when looking at the debt dynamics related to economic growth and investment. It is true that the growth of total debt has been rapid since the 2009-10 stimulation plan and its aftermath (22% yoy). However local government debt was restructured and resulted in lower bank financing (79% guaranteed to end 2010, to 57% to June 2013), rescheduled bond finance (7%-10%) and hybrid securities coupled with public private partnership (14%-33%).

This being said, we do not deny that some of the poorest provinces are in a weak state, and will likely only be solved by a direct transfer from the central government.

The real debt issue lies in parts of the corporate sector where there is overcapacity. In those sectors, over 25% of listed companies have a ratio of gross operating profits to paid interests less than one.¹² Emergency adjustments of firms under financial stress include selling tradable financial assets and rolling over debts. Those adjustments are temporary devices and are vulnerable to interest rate rises, which is why the progress of financial reform

(8) One could also foresee that the Government will broaden its financing by extending VAT to all sectors, and generalize the experimental resident property taxes introduced in some provinces. More generally, long run labor policies could be completed by relaxation of the single child policy.

(9) The most up-to-date estimate of public debt is the NAO (National Audit Office) report.

(10) 18% of business debt is guaranteed by local governments.

(11) The NAO assessment is higher because, unlike practice in the OECD countries, it includes implicit contingent debts. In this larger scenario, outstanding public debt is 56% of GDP, 23% central government and 33% for local governments.

(12) See Wind (2013), CEIC and BBVA Research, in BBVA Economic Watch, September 6.

must be steady and careful. Government has programmed an orderly reduction in the sizes of SOE in overcapacity sectors, backed by conditional and temporary aid. The programme consists of instructing the big banks not to grant new credit to over-indebted businesses until overcapacity has been wiped out, and to reschedule existing debt using government guarantees for losses on loans that might become irreducibly non-performing.

5.2 Capital market reform: much awaited interest rate liberalization

The much expected liberalization in interest rates is the linchpin of financial reform. It is appropriate to tame the shadow banking which doubled from Rmb18 to 36trn between end-2010 to end-2012 with the expansion of WMPs (Wealth Management Products) distributed by banks to attract wealthy people by promises of high and riskless returns. Since May 2013, the PBoC (People's Bank of China) has been active in open market interventions to withdraw the excess liquidity that allowed shadow banking to flourish. The objective is to force all financial intermediaries to take responsibility for their risks to prepare themselves for deeper financial reform.

In the first quarter of 2014, the government hardened the restriction on credit to produce a sharp contraction in shadow banking, which was responsible for as much as 50% of new credit in 2013. The trusts, the main vehicles of high-risk credit which channeled the saving funds collected by banks into the wealth management products offered to their wealthy clients, suffered a severe blow. Their loans in March 2014 were 78% down from the year before when shadow banking was in full swing. So sharp was the contraction that it impinged on total social financing, the broadest measure of credit of the non-financial economy. In the first quarter of 2014 total social financing fell by 9% (y-o-y).

Meanwhile, the big banks must re-intermediate their wealth management products and take responsibility for the casualties of reckless investment of those funds. They have ability to comply because of the huge profits they had reaped in 2009-2010 in the aftermath of the stimulation plan. The *China Banking Regulation Commission* (CBRC) has forced the banks to use undistributed profits to boost equity and to make provision against future losses. In mid-2013, the capital ratios of the major banks were higher than the Basel III requirement (10%-12% instead of 8%) and provisions were three times higher than NPL ratios, which admittedly were very low at the time. NPLs will rise sharply. However, the banks can absorb losses in all but extreme consequences (less than 5% likelihood of NPLs jumping to 7% credit outstanding).¹³

(13) In the 1998-2002 crisis, NPLs on politically connected loans exploded in the aftermath of the Asian crisis. They reached more than 25% of bank assets the Big Four. Three bad banks were created to take up the bad loans, transform them in long-run bonds or swap them into equities. They were capitalized by the central government partly out of foreign exchange reserves. The present solvency problem is small in relation to present government resources compared to the turn-of-the-century financial crisis.

If and when implemented, interest rate liberalization can be expected to transform the business models of banks. Rates on bank credit have already been released and deposit rates will follow progressively, while an insurance deposit scheme has become operational. But the risk here is of a dual trap. First, disintermediation could be excessive if market rates rise higher than the ceiling on deposit rates while these latter are progressively relaxed. Second, risk taking by banks could become uncontrolled if rates are liberalized all at once. The move must be carefully planned to avoid bank destabilization while non-performing loans rise with the cleanup of overcapacity in the heavy industries.

Another big chunk of the government's financial reform is the rebalancing debt financing in the direction of marketable securities. In developing bond markets several improvements are expected: in the short run, help to solve local government debt problems by rescheduling via long-maturity bonds; in the longer run, better asset portfolio allocation of institutional investors, greater opportunities for households making it easier to circumscribe the shadow banking, and broad and deep domestic financial markets to sustain shocks that might arise with future Renminbi convertibility.

More structural reforms are underway to better finance SMEs based on expectations of high growth in consumer goods and services which will be driven by strategic planning for a new urbanization drive that will increase the urban population by 300million people by 2030, and the pursuit of Go West strategies. To finance the private sector, the Directives encourage establishment of private banks in small and mid-sized cities. The prerequisite for this bold move is a legal resolution regime to deal with bank insolvencies in an orderly and equitable way. To stimulate bottom-up innovation in the Guanxi networks of SMEs, institutional investors and development banks should set up private equity funds.

The party has the will to reform use rights on rural land to secure the rights of farmers

■ 6 Land reform and natural resources

Land market reform is the most radical one. The party has the will to reform use rights on rural land to secure the rights of farmers. Markets will be created to transfer land use rights with the purpose of unifying rural and urban property markets for all constructible land. Conversely, a minimal overall area of arable land in the whole country (120m ha) has been fixed by the government for food security reasons. Since this threshold is about to be reached, the new urbanization drive must be accomplished without more net loss of arable land. In other words, urbanization must become more concentrated in existing cities via reconstruction of rundown urban areas (experimentation in Shenzhen). Meanwhile, abandoned constructible land in suburban districts must be rehabilitated and reconverted to agriculture. Otherwise, as migrants move to new cities and abandon their rural housing, developers must offset the new urban housing on previously

rural land by transforming rural constructed land back into arable land for cropping or pasturing. A legal framework will be enacted and specialized financial intermediaries will arrange the complex transactions through associated insurance contracts.

The prices of natural resources are the most distorted. Yet reducing energy intensity, water and air pollution are overriding immediate objectives that are certain to be reemphasized in the next five-year plan (2016-2020). The distortion in prices has high social costs. It entails excess consumption, insufficient returns and recurrent dearth of supply due to insufficiently profitable prices. Disruptions occur in electricity, refined oil, natural gas and water. Those tariffs are being rescheduled over three years, to bring them closer to their social marginal costs. The redistributive effects must be managed by direct subsidies for low-income households. Carbon valuation is being conducted through a cap-and-trade market (already tested in Guangdong), or a carbon tax, or both, to meet the quantified objective of carbon abatement defined by the NDRC (*National Development and Reform Commission*). In addition, government will set a notional carbon price based on economic calculus to compute the internal rate of return of infrastructure projects, to enable the contribution of those projects to greenhouse gas abatement to be valued and specific financing made available.

6.1 Fiscal reform and sequencing

It is not realistic to believe that the current budget will be able to support all the foreseen reforms and their consequences. Past episodes have shown fiscal shortcomings that have not been addressed. The latest broad fiscal reform dates from 1994. Twenty years ago, the urgency was for central government to regain control over the nation's income. The sharing of revenues between central and local governments went largely unheeded. No balancing out mechanism was instituted between rich and poor provinces. Furthermore, subsidies for needy lower levels

of government (counties and municipalities) were provided via hierarchical administrative levels which created lot of slack and corruption. The result was huge mismatch between tax resources and responsibilities for provision of public goods and services to the population. The mismatch occurred at all levels of the territorial administrations throughout the country. It has been the main reason for the runaway race to indebtedness of local governments in financing of the 2009 stimulation plan, which was financed less than a third by central government.

Fiscal reform is not fully accounted for in the Directives, since some basic decisions such as tax sharing require constitutional changes which in turn depend on political arbitrages yet to occur. Another heavy tax system reform is the rebalancing between indirect and direct taxes, the latter being too small a part of overall revenues. A property tax to boost direct taxes and dampen real estate price speculation in big cities is long overdue. To raise government revenue for social welfare, government

Table 3 – Tentative sequencing of economic reforms

Reforms most likely to 2015	Reforms possible to 2020	Most difficult reforms
<ul style="list-style-type: none"> • Price of natural resources and electricity • Liberalization of interest rates and capital account opening • Extension of VAT to services • Carbon tax • Universal social welfare 	<ul style="list-style-type: none"> • Larger coverage of income tax • Reform of hukou • Reform of rural land use rights • Reform of pensions • Demonopolization of some services • Collective bargaining 	<ul style="list-style-type: none"> • SOE privatization • Property tax on real estate • Elimination of a territorial administrative level • Tax balancing rule

will demand higher dividend payments from SOEs and add the proceeds to the general budget. A new wave of privatization of SOEs would provide the State with more resources to finance costly social reforms.

To handle still contentious reforms, sequencing in the government's strategic planning must be carefully designed. Like Deng at the start of the process, Chinese authorities are prioritizing the most urgent economic and most legitimate political changes for the improvement in social welfare and environment to provide the momentum for further ambitious reforms and irreversible advance of the dynamic process. Table 3 presents a tentative possible sequencing of economic reforms. The assumptions made stem from the gradual process in response to the aspirations of civil society, from progress in political compromises beyond what is agreed in the Directives, and maturity of technical preparation, including experimentation, in specific constituencies.

7 The political economy of Reform in the perspective of China's conception of sovereignty

China has developed at breathtaking speed in the last 35 years, in all dimensions related to the term "development": increase in real income, eradication of absolute poverty, infrastructure building, education, industrial expansion, and technological progress.

Yet, the philosophy of the Reform is largely misunderstood in the West. The deep conceptual reasons for this state of affairs are often confused with political prejudices. In issuing the document dealing with "the decisions on major issues concerning comprehensively deepening reforms", the CPC clearly expressed confidence in the sui generis path taken by China. Not only does China have its own brand of capitalism, it also brings forward a theoretical framework to explain the path chosen and the choices of future policies. To evoke this framework, we take briefly two major theoretical issues: an endogenous reform process as opposed to an adjustment to a predefined equilibrium, and the prospect of a Chinese brand of real democracy as opposed to Western claims to the universality of democratic institutions.

7.1 China's Reform: an ongoing, never-ending endogenous process

Western theoretical concepts underpinning societal development thinking, are normative. It is believed that there are ideal forms that express the essence, the true being behind what we can observe with our experience of the world. In economics, the ideal form is the competitive general equilibrium of the pure market economy. Every economic achievement must be gauged against this norm. Therefore, the meaning of historical development is teleological; it is supposed to be adjustment

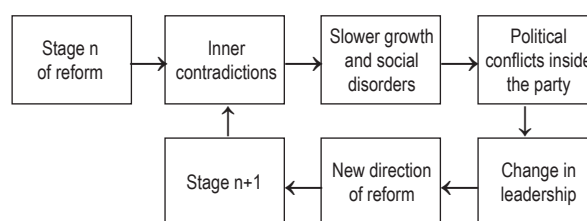
toward the perfect equilibrium.

Applying this yardstick offers no understanding of China's Reform, because Chinese political economy is entirely alien to Western thinking. As explained by François Jullien, Chinese narrative never refers to an essence. It tells of movement, the Dao; silent, global and continuous transformation.¹⁴ Everything is in flux, everything is becoming. There is no permanent essence, therefore no ultimate aim that gives the direction of future evolution. There is also no transparency. Everything lies in the lapse of time and in ambiguity.

7.2 The Reform is the joint transformation of economic structures and institutions

In China, Reform is global, pluralistic, and gradual.¹⁵ It feeds on its own contradictions. It does not refer to any ideal model. If there is something that is perennial, it is the aspiration to preserve the unitary sovereignty in an ever-changing, more pluralistic society. As explained above in analyzing how the mode of regulation of a particular phase gives rise to inner contradictions that accumulate to erupt in crisis, the Reform is a self-perpetuating process that goes through stages of progress interspersed with crisis in which political monitoring matters. In those critical crises the objectives and mode of governance are restated by the new leadership that has won the argument within the Party. The process is illustrated in figure 3.

Figure 3 – The dynamics of Chinese Reform



(14) Jullien F. (2009), "Les transformations silencieuses", Grasset, Paris, 2009.

(15) For a comprehensive understanding of the reform in its early years, see G. Chow (2002), *China's economic transformation*, Maiden MA, Blackwell Publishing.

7.3 Three types of formal democracy

Democracy is a paradox.¹⁶ It means that the people have power over the people. The paradox develops in a self-fulfilling, two-way process: the one way is nominal power which means that power is legitimate if it proceeds from the people. Vice versa, is real power which is power exerted upon the people. Nominal power is sovereignty. Real power is “legitimate violence of the State”. Democracy therefore is meaningless unless it specifies how real power is made legitimate under nominal power. However, the word democracy does not define the institutions that make State power responsible and accountable to the people, which accounts for the distance between formal and real democracy.

We believe that there are three, not one, possible sources of legitimacy.

The first is *value-based legitimacy*. This is the Confucian principle. Legitimacy is found in the common interest which is pursued in the rituals, whereby everyone recognizes the relationships to others as the source of their own humanity. In another value system, one might dispute that the Kantian principle of embodied moral value, acting as an imperative guide of individual action, defines the common interest. Value-based legitimacy is a strong uniting concept. However, heterogeneous societies with conflicting aspirations erode common values.

The West invented *procedural legitimacy* via the principle of electing representatives of the people. Real power is exerted according to the view the majority has of the common good. This is power over the people and therefore over minorities. This second source is a stable source of legitimacy as long as the procedure is not contested. However, real power is vulnerable to partisanship, the paramount influence of money, the divisions enhanced by sectarian appeals to citizens. It is essentially myopic, being entirely under the influence of the electoral cycle and vulnerable to the manipulation of financial lobbies. Hobbes was very pessimistic about that political regime.

The third source is the Chinese conception of good government or *welfare-based legitimacy*. The emperor exerts power for the common good of the people. The social contract between the people (the sovereign) and the emperor is the Law, supposed to encapsulate and formalize the common good. Therefore, democracy means governing for the good of the people according to the Law. It involves bureaucrats being selected by meritocratic procedures and “ratifying the name” in exercising their attributions, meaning doing what their competences entitle them to do in servicing the common good. An important advantage is the long-run horizon, opening space for long-run planning but the Achilles heel in this source of legitimacy is related to aligning the interests of bureaucrats with the intent of the sovereign as defined by the Law.

Concentration of wealth has occurred several times in the long history of the Chinese empire, as a side effect of merchant capitalism capturing wealth or weakening central power. Before their final decay under colonial invasion and exploitation, imperial institutions had always recovered from dark episodes and reinstated the supremacy of central power. The present era of rising inequalities and widespread corruption is no different. The latest struggle inside the party, which has generated a strong reformist leadership, has opened the way for political governance under the primacy of Law. In redefining the role of the State and correlatively giving wider scope for debates and actions stemming from civil society, the party leadership is searching for legitimacy to confront vested interests.

7.4 Can China develop its own brand of democracy?

The paramount objective is still the multi-century preserve of the unity of the country in strengthening the unitary sovereign. To achieve this in the 21st century, central authority must be made compatible with increased participatory and interactive democracy.

In the long-run history of China, local communities and networks based on lineages, on cultural shared values and on moral beliefs were created.¹⁷ They still exist today. According to Lili Tsai, two counties with the same per capita income might have very different provision of public goods, depending on the embeddedness or not of local bureaucrats in such networks. It means that care for the people depends heavily on ethical norms internalized or not in the behavioral pattern that commands their duty.

The lesson is that local communities are able to mediate local conflicts, offer complementary social services and supervise the performance of local governments. However, change must be made to institutionalize the selection of bureaucrats according to meritocratic criteria and the monitoring of their behavior to increase the legitimacy of the administration. To make local governments accountable through social supervision, the people must have transparent and accurate information. This will be a two-way process: enhancing the political awareness of the population, and putting local social and political issues under the scrutiny of the people. The relational network of Chinese society should complement the hierarchical supervision within the Party to make the bureaucrats accountable at all levels of the public administration.

Democracy, as defined by the principle “*governing for the good of the people*”, is backed by the pressures of social demand through the types of institutions pinpointed above. It also needs the efficient strategic planning of central government, guided by a long-run aim of achieving the nation’s objectives. Setting up the institutional principles to establish the proper mode of regulation was the purpose of the November 2013 Directives established by the CPC central committee.

(16) Rosanvallon P. (2008), *La légitimité démocratique*, Le Seuil.

(17) Lili Tsai, *Accountability without democracy: solidary groups and public goods provisions in rural China*, Cambridge University Press, 2007.

8. Conclusion

The restoration of China's standing in the world has entered a new era with the third stage of its all-encompassing Reform. The co-evolution of productive structures and social institutions will enter new unknown territory. China is forging its own way to a socialist market economy and experiencing its own brand of democracy. If successful, China will attract much attention worldwide and will become a stronghold of soft power.

The impact of China's reforms will be felt worldwide. It will foster regional integration, not only in trade but also in finance and monetary cooperation. China will also become a global partner in the international political arena, a Middle Empire open to the world in the 21st century search for international governance.

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CEPII Policy Brief
CEPII's insights on international economic policy
CEPII – Paris – 2014
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