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POINT OF VIEW

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ECONOMIC POLICY DURING XI JINPING'S FIRST TERM

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EXECUTIVE SUMMARY

- **The slackening of important economic reforms under president Hu Jintao and prime minister Wen Jiabao (2002-2012), as well as the stimulus measures taken in response to the 2008 crisis to boost investments, have all led to a huge build-up of debt and created imbalances in the Chinese economy, including in the financial markets and the industrial sector. As China's original drivers of growth have been waning, stagnation of the reform process could lead to a serious economic crisis and, consequently, deprive the Chinese leadership of the main factor legitimising the Communist Party of China, i.e. the constantly improving standards of living in China.**

- **When the new generation of leaders came to power in China, with Xi Jinping as president and Li Keqiang as the head of government, the Chinese leadership showed a strong ambition to overcome the *status quo* and resume reforms. A new draft reform agenda was presented in November 2013 during the third plenum of the CPC Central Committee, one year after the party's 18th congress. The key pledge that president Xi Jinping made at that time was to give market forces a 'decisive role' in the Chinese economy. The intention of the changes made 'in the spirit of the third plenum' was to break up the state monopolies, deregulate the real economy and the financial sector, restrict the role of state-owned enterprises (SOE), provide administrative support to private companies and open the Chinese economy to foreign capital. The reforms were intended to create a new impulse for growth by resolving the fundamental problem of the Chinese economy, i.e. the faulty and politicised resource allocation system.**

- **In the past, the high level of state intervention in the economy allowed certain groups associated with the SOE**

sector and the state-owned financial system, as well as the central and local-level bureaucracy, to reap extraordinary profits from economic growth. The new leadership regarded the vested interests which grew out of that situation as an influential political force interested in preserving the profitable *status quo*, and the main line of resistance to further reforms.

- **The move to centralise decision-making on economic reforms, one of president Xi Jinping's key decisions taken after the third plenum, was guided by the logic of countering the vested interests resisting reforms. In November 2013, the so-called Central Leading Group for Comprehensively Deepening Reforms was created. It became the key element in the 'transmission belt' of the Chinese reform process, giving Xi direct control of the most important changes and an instrument to overcome resistance within the bureaucracy. The anti-corruption campaign launched in 2013 was also an important tool for the implementation of reforms. While it was intended to serve wider objectives, it became instrumental in consolidating power, rapidly replacing the bureaucratic cadres and disciplining the officials in charge of the economy at all levels of the state administration.**

- **The new tools for implementing reform turned out to be marred by several defects, which contributed to further stagnation of reforms, while the concentration of decision-making powers in the hands of president Xi Jinping and his closest circle distorted the process of economic policy development. The government became marginalised and reduced to the role of an implementing body, which triggered a conflict over the division of competences between prime minister Li Keqiang and president Xi Jinping's circle, while also diffusing the responsibility for detailed formulation and implementation of reforms. The**

resulting vacuum allowed certain groups associated with the bureaucracy and interested in preserving the *status quo* to take over the initiative, of which the reform of state-owned enterprises is a case in point. The structure of the Central Leading Group has proven effective in initiating change but has not worked so well in sequencing actions and has created bottlenecks in the reform 'transmission belt'.

- **The changes initiated by Xi Jinping have reshaped the original relations between local governments in China and the central government in Beijing. However, despite partial centralisation, the success of reforms still depends on the involvement of the local administrations, which are often interested in maintaining the *status quo* because of the still unresolved local government budget problems and the inconsistencies in Beijing's actions and expectations. Another reason why the officials in charge of implementing reforms tend to be passive concerns their reluctance to take any risky decisions in the context of the ongoing anti-corruption campaign.**

- **The slowing down of China's economic growth has forced the country's top decision makers to modify their vision of economic reforms on many occasions. At critical moments, e.g. during the government interventions in China's exchange markets or the restructuring of the provincial government's debt, Beijing has tended to opt for deep interventions in the economy, which run counter to the 'spirit of the third plenum' and exacerbate existing problems. While the Chinese leaders seem to agree that reforms need to continue, a dispute is mounting within the top ranks of leadership about whether it is still necessary to employ stimulus measures while implementing the reforms. Continuing with the same stimulus methods as before, while reforms are stagnating, will exacerbate**

the problems of the Chinese economy, contributing to its further destabilisation.

- **The 19th Congress of the Communist Party of China, scheduled for the autumn of 2017, will bring about a 'new opening' in the key bodies of the CPC, which will probably allow Xi Jinping to fully consolidate his grip on economic policy. However, fixing the foundations of China's economy by resuming the agenda of the third plenum will require the CPC leaders to employ a considerable organisational and political resources, which will inevitably have to be diverted from other areas of governance. The fate of reforms will therefore depend on the individual calculations of Xi Jinping and his inner circle, who will have to weigh up the long-term benefits for the state and the party if China is put on a stable growth path against the short-term gains from the resolution of emerging economic, social and political problems.**

INTRODUCTION

Xi Jinping became the leader of the Communist Party of China in 2012 when the country stood at a particularly difficult juncture of its 'reform and opening-up' policy path, on which China had embarked 30 years before. The country had to face the deepest revision to its economic development model in decades, while at the same time dealing with the serious consequences of foregoing reforms in the previous decade and the problems generated by the huge economic stimulus operation undertaken after the 2009 crisis. Responding to those challenges, the new Chinese leadership with Xi Jinping at the helm decided to re-define the role of the state in the economy, resume the reforms and revise the institutional architecture supporting their implementation. The purpose of the present paper is to assess Xi Jinping's first term, in order to ascertain how effective the new mechanisms for reform implementation have been and to what extent they have addressed the major problems faced by the Chinese economy. The analysis is based on Chinese and foreign sources, including statements by Chinese state representatives and official documents, articles in the business press, China's statistical figures and their analyses, as well as detailed studies by foreign research institutions.

Part 1 discusses the main economic problems engendered by the imbalanced economic stimulus model developed in China in the previous decade and applied most intensively during the 2009 crisis. Part 2 outlines the main objectives of the new economic reform agenda put forward by the Xi-Li team and assesses the progress of selected reform projects which are of crucial importance for restoring balance in the Chinese economy. Due to limitations of space, the paper does not look into the reforms which concern the international aspect of China's economic development, such as the internationalisation of the Chinese currency or liberalisation of capital flows. Part 3 deals with the new institutional architecture created by Xi Jinping in order to gain control of the speed and scope of economic reforms. Finally, Part 4 points to the causes of the effective stalling of key reforms, which are related to the defects of the newly developed reform implementation mechanisms and the negative impact of the economic slowdown.

I. STARTING POINT FOR FURTHER REFORM

The economic policy objectives and agenda of the new Chinese leadership with Xi Jinping at the helm had to be focused, at least in the early period, on resolving the existing problems inherited from predecessors. The strong emphasis on what had been neglected by the previous leaders, which was notable during the handover of power in 2012, as well as the new leaders' pledges to 'resume' economic reform, were a response to the commonly held conviction within the top ranks of the CPC that reforms had indeed stagnated during the Hu Jintao and Wen Jiabao years, which some of their most vociferous critics dubbed the 'lost decade'.

1. The 'lost decade' of Hu and Wen

The courageous reforms implemented under Jiang Zemin and Zhu Rongji in the late 1990s, when China joined the WTO and partly privatised its public sector, gave a strong pro-growth impulse to the Chinese economy in the first decade of the 20th century. However, the strong economic growth which China enjoyed, thanks to access to global markets and its rising industrial efficiency, lowered the Chinese leadership's appetite for continuing difficult structural reforms. At the same time, various acute social problems, which had been gradually mounting since the beginning of the 'reform and opening-up' period, became evident in the form of rapidly deepening inequalities between different social strata and different regions of the country. Because of the potential threat that this situation posed to the stability of government, the Communist Party of China decided to abandon Deng Xiaoping's doctrine of *xianfu lun* (letting some get rich first). The Hu-Wen team decided to focus on levelling out the inequalities and building a 'harmonious society'. This entailed adopting a more moderate course of economic reforms and partly changing the priorities of China's transformation.

As the key reforms had come to a halt, the spectacular expansion of China's economy in the first years of the 21st

century occurred in a strongly regulated business environment in which market mechanisms remained restrained and were still subordinated to the state's development goals. Even though the prices of nearly all commodities had been liberalised, the planning institutions continued to control the prices of the basic means of production crucial for the economy, such as energy and raw materials, as well as interest rates on deposits. The state also indirectly influenced the prices of land (which legally remains state-owned) and labour (by controlling migration through the *hukou* residency registration system). Money supply remained in the hands of the nearly completely state-dominated banking sector, which was regulated more tightly than in other economies. The key economic sectors, including energy, banking and telecommunications, also remained strongly regulated and monopolised by state-owned companies, which additionally benefited from subsidies and bankruptcy protection measures.

In a decision of fundamental importance for China's future economic development, the Hu-Wen team assigned an important role in stimulating economic growth to the public sector. Even though some enterprises had been deeply restructured or liquidated in the late 1990s, China still had around 150,000 companies controlled by the central government and local governments. Nominally operating on market principles, those companies often served as a tool to stimulate GDP growth – an alternative to increased budget spending – with the central government's approval. For the Chinese bureaucracy, especially at the local level, economic success is closely linked to advancement within the structures of the CPC, which introduced an important political element into the economic calculations of state-owned companies. The effects of the Hu-Wen team's strategy on state-owned companies first became visible shortly after the 2002 plenum. While in 2001, investments in the Chinese economy had increased by 13% year on year, in 2003 the figure was already 26%, with state-owned companies accounting for three quarters of the growth.[1] China reported investment growth rates exceeding 25% a year, i.e. more than twice as high as overall GDP growth, for the next 9 years of the Hu-Wen term.[2]

With an economic system based on extensive state intervention, the Chinese government had all the instruments it needed to continue applying its model of state-controlled economic growth based on multi-level planning. However, as the Chinese economy expanded, became more complex and more open to foreign actors, the government was less and less able to strictly and effectively control it, with potentially amplified consequences arising from any misguided regulations. Meanwhile, the bureaucracy remained very influential, often guided by its own particular interests that were not necessarily aligned with sustainable economic development objectives. **The resulting market signal distortions engendered the fundamental weakness of the Chinese economic system, i.e. the systemic misallocation of economic resources. The problem surfaced most visibly during the 2008 crisis when the Chinese leadership launched its massive stimulus operation.**

2. The 2008 crisis: stimulus and destabilisation

The Chinese government's response to the global economic crisis of 2008 was fully in line with the logic of the Hu-Wen team's economic policy formulated in the preceding years. While the crisis did not directly affect China because of the country's insulated

1 Dan Blumenthal i Derek Scissors, China's Great Stagnation, The National Interest, 17.10.2016, http://nationalinterest.org/feature/chinas-great-stagnation-18073?page=show

2 The share of private companies in total investments was growing systematically in the period in question but it exceeded 50% only in 2015, while the state-owned sector continued to play the key role in this respect. See: Nicholas Lardy and Zixuan Huang, China Private Investment Softens, But Not as Much as Official Data Suggest, PIIE, 19.04.2016, https://piie.com/blogs/china-economic-watch/china-private-investment-softens-not-much-official-data-suggest

financial system, it had an adverse impact on the global market situation, undermining the demand for Chinese exports. In order to avert destabilisation, the Chinese government developed a two-year stimulus programme which was launched in late 2008 and early 2009 with a budget of more than CNY 4 trillion (around US$ 590 billion) of public money, which corresponded to nearly 12% of China's GDP. Most of the funds were channelled into infrastructure development including roads, railways, airports and energy infrastructure. The second most important category of spending comprised investments in improving the standards of living, including housing, environmental protection and rural development.[3]

An important element in the implementation of the stimulus concerned delegating responsibilities to local levels of governments, i.e. provincial, county and city governments. Hoping to benefit from the huge investment funds and lucrative contracts for local political-business groups, the local administrations responded enthusiastically to the announcement of the stimulus package: within a short period after the programme was announced, the Central National Development and Reform Commission received project applications worth a total of CNY 18 trillion.[4] This massive collective undertaking, however, stumbled on the absence of adequate sources of financing. The central government had committed only CNY 1.18 trillion, i.e. less than 30%[5] of the total stimulus package amount, while the local governments were expected to shoulder the remaining costs. Yet their ability to increase spending by running wider deficits was

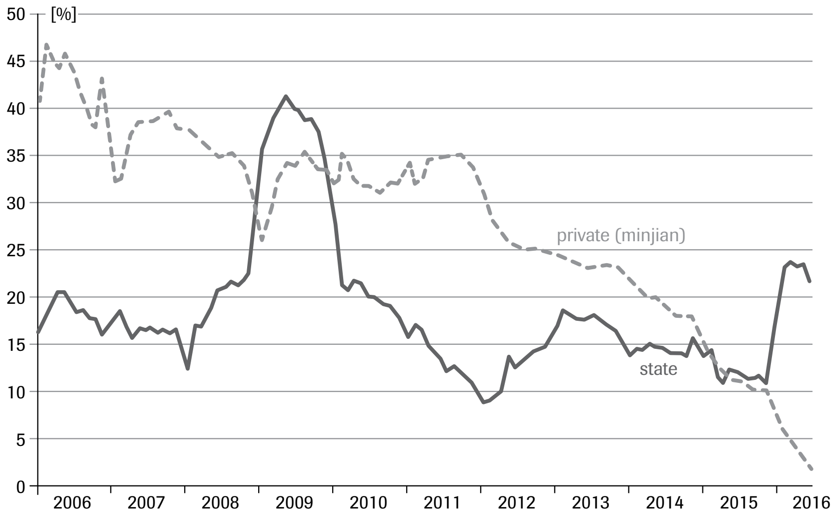
3 NDRC Details Four Trillion Stimulus Package, Caijing Online, 01.12.2008, http://english.caijing.com.cn/2008-12-01/110033094.html

4 地方政府出台18万亿投资计划 资金来源引关注, 25.11.2008, Xinhua, http://news.xinhuanet.com/fortune/2008-11/25/content_10407671.htm

5 Zheng Yongnian and Chen Minjia, How effective will China's four trillion yuan stimulus plan be?, *Briefing series*, issue 49, China Policy Institute, 03.2009, http://nottingham.ac.uk/cpi/documents/briefings/briefing-49-how-efficient-4-tln-yuan.pdf

legally limited as they could not, for instance, issue bonds without the central government's consent. Because of those constraints, much of the stimulus was implemented using instruments other than budget spending, i.e. through investments by the SOE sector, a majority of which are controlled by local governments, as well as the so-called Local Government Financing Vehicles (LGFV) for infrastructure development. Through these, local governments could borrow money from the financial markets, both from state-owned banks and from the rapidly growing shadow banking sector, which offered high-interest loans and was not subject to the regulations applicable to official financial institutions.

Chart 1. Investment growth in China, % year-on-year, 2006-2016



Source: Peterson Institute for International Economics

In parallel with the budget spending stimulus, in 2009 the Chinese central bank launched a quantitative easing operation which involved a series of interest rate reductions and decisions to lower mandatory reserve levels for banks and supplied the Chinese economy with a huge volume of cheap capital. In 2009 China reported an unprecedented increase in the supply of loans: at the end of the year the total value of loans in the portfolios of China's financial institutions was close to CNY 40 trillion, i.e. had increased by as much as 32% over the previous year.[6] Responding to the first negative effects of flooding the markets with extra capital (such as the marked growth of housing prices in late 2009 and early 2010), the central government introduced a series of regulations to limit money supply. Credit limits for banks were tightened and regulations were adopted to constrain the inflating speculative bubble in the housing market.

Chart 2. Increase in the volume of CNY-denominated loans outstanding, % year-on-year, 1998-2016

Source: tradingeconomics.com, People's Bank of China

This tighter monetary policy created an enormous pressure on those entities which had borrowed money to start large-scale investments that were not always economically viable and often politically-motivated. The long-term infrastructural projects implemented by the LGFV, the housing sector suddenly cut off from capital supply, and the SOEs expanding their

6 China reports record 9.59 trln yuan in loans in 2009, Xinhua, 15.01.2010, http://news.xinhuanet.com/english/2010-01/15/content_12816059.htm

production capacity, all needed additional financing. As the supply of loans from state-owned banks shrank, they turned to the so-called shadow banking sector,[7] with the official banks acting as intermediaries and benefitting financially without burdening their balance sheets. While the shadow banking sector had been growing in China since 2001, when this kind of operations were first authorised, the 2009 stimulus plan turned out to be the real catalyst of its development. The sector's opaqueness makes it difficult to assess its size but according to various estimates the shadow banking sector expanded ten-fold in the years 2008-2013, from CNY 4.5 trillion to around CNY 20-46 trillion (corresponding to 35-81% of China's 2013 GDP).[8]

3. China's economy on a downward slope

The stimulus model formulated and implemented during the term of Hu and Wen turned out to have many potentially destructive effects on the Chinese economy. It engendered complex problems in the real economy, the financial system and public finance. Resolving them became the principal challenge for president Xi Jinping's team which came to power in 2012. **However, the original stimulus model had already brought about certain consequences which constitute a fundamental limitation on the new Chinese leadership's economic policy.** Until new ways to promote growth are developed – which will require deep structural reforms – any further stimulus action using the old methods will only deepen the existing imbalances, augmenting the risk of a major economic crisis.

7 The system of finance companies playing a role similar to that of banks, which are not covered by the official regulations and not part of the banking safeguard arrangements.

8 Douglas Eliott *et al.*, Shadow Banking in China: A Primer, *Economic Studies at Brookings*, Brookings Institute, 2015, https://www.brookings.edu/wp-content/uploads/2016/06/shadow_banking_china_elliott_kroeber_yu.pdf

The massive corporate debt pile is the principal challenge faced by the Chinese economy. Even though the increase in the volume of credit was slower in the years that followed the record-breaking 2009 and oscillated around 15% a year, in the context of dwindling GDP growth the credit supply turned out to be growing several times faster than the economy. According to some estimates, China's debt increased from around 160% of GDP in 2005 to 247% of GDP in 2015, with corporate debt accounting for two thirds of that figure.[9] On top of that, the the degree of credit creation needed to stimulate a given amount of GDP growth has been gradually rising: while in the years 2003-2008 it took 1 CNY of new financing to generate 1 CNY of GDP, in 2015 it was already as high as 4 CNY, and just one year later – 6 CNY.[10] Thus, the Chinese economy has found itself in a situation where mounting debt generates increasingly subpar growth. Meanwhile, the fate of the sectors which embarked upon expensive long-term investments in the period of weaker growth depends on their ability to continue borrowing money. The debt pile is currently considered to pose the greatest threat to China's economic future, and a heated debate on the potentially imminent debt crisis is unfolding. The issue is in the focus of major international financial institutions and a growing number of foreign observers, many of whom are starting to believe that China will not be able to get out of the debt spiral.[11]

9 The figure also includes sovereign debt, the banking sector's debt and households' debt. See: Digging Into China's Growing Mountain of Debt, Bloomberg, 28.08.2016, https://www.bloomberg.com/news/articles/2016-08-28/digging-into-china-s-growing-mountain-of-debt

10 Calculations by Morgan Stanley, quoted in: China's growth sucks in more debt bucks for less Bang, Reuters, 23.06.2016, http://www.reuters.com/article/china-economy-debt-idUSL4N1A908F

11 Views about the possible form that the crisis in China will take vary widely – from the 'Japanese' scenario of long-term economic stagnation to more apocalyptic visions involving a disintegration of the Communist Party of China. See: Michael Pettis, If we don't understand both sides of China's balance sheet, we understand neither, 09.2015, http://blog.mpettis.com/2015/09/if-we-dont-understand-both-sides-of-chinas-balance-sheet-we-understand-neither/

China's financial system has been growing bigger, less transparent and more interdependent. The share of bad debts in the portfolios of Chinese banks has also been growing. While the stability of the largest state-owned banks is not at risk thanks to the relatively strong regulations in place, the growing pressure of bad debts and the fact that banks are often forced to intervene in the ailing sectors of the economy make further liberalisation and reform of the banking system difficult. As the capital markets remain underdeveloped, the massive volume of capital circulating in China's financial system has been struggling to find adequate rates of return and has often ended up in the shadow banking system, making the whole financial sector even less transparent and the size of the economy more difficult to estimate. Large streams of money have also been flowing into the housing market and the corporate stock and bond markets, generating speculative bubbles that pose a serious problem for the government.

The investment stimulus has led to overproduction in the housing sector and a substantial increase in the number of uninhabited new dwellings. In the course of the main stimulus operation in 2009 and the further stimulus measures taken via the LGFVs, investments (in the public sector as well as in the private sector, which has responded strongly to the construction boom) have focused mainly in sectors offering rapid short-term growth. The massive infrastructural investments and rapid growth in the construction sector have generated extraordinary demand for the products of heavy industry, such as cement, steel and coal, and indirectly also electricity. In many instances, local authorities viewed the mere extension of a coal mine, steelworks or power plant as a way to stimulate the economy and achieve higher local GDP growth – an important factor in nominations to higher party positions. This has led to substantial overproduction in some sectors such as steelmaking and coal extraction.[12]

[12] In 2015, China's coal extraction capacity was estimated at 5.7 billion tonnes a year, of which only around 3.9 was used while new facilities with extrac-

Using the SOE sector as a means of stimulating the economy has considerably suppressed its profitability, which decreased from 5% in 2007 to around 2.2% in 2015.[13] Importantly, state-owned companies are usually protected against bankruptcy through direct interventions or arrangements allowing them to roll their debt indefinitely, for political and image-related reasons. They also benefit from informal links to the CPC structures and more favourable investment risk ratings based on the expectation that the state will provide financial assistance if needed, while bankers face lower penalties for failed investments if the case at hand is a state-owned company. The political decision not to allow state-owned companies to fail and to grant them privileged access to capital has led to the emergence of a sizeable group of so-called *zombie companies* which support themselves solely by taking on more debt.

Channelling massive funds to investments and the privileged treatment of state-owned capital have engendered the phenomenon of *guojin mintui* ('the state advances, the private sector retreats') in China. The weaker competitive position of private enterprises, and especially the small and medium-sized companies, which are important drivers of innovation, as well as the tougher conditions for doing business which private companies face, have become one of the main barriers for development in China. This situation has many negative consequences. Entrepreneurs running private businesses who need, for instance, to

tion capacity of 1.4 billion tonnes were under construction (of which around 0.8 billion of new capacity was being built illegally). Steel production in the same year was estimated at around 0.8 billion tonnes, with total capacity of around 1.2 billion tonnes. See: Lu Zhiyao, State of Play in the Chinese Steel Industry, PIIE, 5.06.2016, https://piie.com/blogs/china-economic-watch/state-play-chinese-steel-industry, 我国煤炭行业产能家底基本摸清, Jingji Ribao, 12.01.2016, http://www.ce.cn/xwzx/gnsz/gdxw/201601/12/t20160112_8203711.shtml

13 *Return-on-assets (ROA).* See: Andrew Batson, Villains or Victims? The role of SOEs in China's Economy, *China Economic Quarterly,* Vol. 20, No. 2, 2016, http://research.gavekal.com/sites/default/files/CEQ%20Q2%202016.pdf

obtain a loan from a state-owned bank, increasingly have to rely on personal contacts with the administration, as a result of which many SMEs turn to the shadow banking sector. There have been many cases of state-owned enterprises taking over their private competitors, e.g. in the steelmaking sector. Finally, access to cheap capital has encouraged many managers in state-owned enterprises to enter completely new markets, e.g. the lucrative real estate market into which many government-controlled companies with no previous links to the sector have expanded since 2009.[14]

Sustaining the current stimulus model should be treated as a factor that will delay the thorough restructuring of China's economy. There is consensus among the Chines elites on the need to fundamentally transform the structure of the Chinese economy and find new drivers of growth capable of replacing the old model, based on cheap labour and favourable demographics, which has all but exhausted its potential. In keeping with the experiences of other East Asian nations, the solution envisaged is to restructure industry by developing high technology and innovative sectors and to expand the role of the services sector. Growth is to be driven by domestic consumption by the several hundred million-strong middle class, instead of unsustainable investments. The stimulus model employed in the previous decade has been shown to trap capital in sectors with relatively lower efficiency and narrow added value (steelmaking, the cement sector, the extractive sector) and exacerbate the systemic risks in China's financial sector. While some kinds of investments, e.g. infrastructural investments, are conducive to a change of the economic model, the negative consequences of their excessive scale and unsustainable financing models clearly outweigh the benefits.

14 China Fortifies State Businesses to Fuel Growth, *New York Times*, 30.08.2010, http://www.nytimes.com/2010/08/30/world/asia/30china.html?hp

II. RECONSTRUCTION IN THE 'SPIRIT OF THE THIRD PLENUM'

1. A new impulse for change...

In late 2013, having preliminarily consolidated its power after one year in office, the new Chinese leadership presented an ambitious economic reform agenda which directly addressed China's mounting problems. **Xi Jinping personally took over responsibility for drafting the official reform programme, thus encroaching on the economic policy competences traditionally vested in the prime minister**. During the third plenum of the 18th National Congress of the CPC, the Plan for Comprehensively Deepening Reforms (*quanmian shenhua gaige*) was presented – it was an orientation document to guide reforms in the fifteen areas of crucial importance for China's further development.[15] From the point of view of the country's mounting economic problems, the most important provisions in the document concerned the pledges to deeply reform the economy along market principles, resume the reform of state-owned enterprises and change the relations between the central government and the local governments.

The central point of the new economic reform agenda was the pledge to change the role of the state in the economy and grant market forces 'a decisive role' – it was formulated to address the fundamental problem of misallocation of resources in China's economy. The intention behind the reformers' decision to increase the role of the market was to improve the economy's efficiency and generate a new pro-growth impulse. Also important from this point of view was the pledge to streamline the allocation of capital by developing state-of-the-art capital markets and allowing the private sector to open small and medium-sized banks.

[15] Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform (Beijing: CC CPC), http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602.htm

A plan was also presented to open the economy to foreign investors and to introduce a system for free convertibility of the Chinese currency. It was announced that markets would be opened to private companies, apart from those sectors reserved for the state, that the regulation of prices of key means of production would be abolished, that monopolistic practices and unfair competition would be combated, and that formal barriers to engaging in business activity would be removed.

Prominent in the new reform agenda were projects to improve the state of local budgets while strengthening central government oversight. The plans to fix local government finance, control its mounting debt and implement tax reform should be seen as an effort to eliminate one of the main drivers of debt, i.e. the activities of local government officials seeking to stimulate local economic growth in order to gain political or financial benefits or improve the financial situation of the local administration. A need was identified to create a standardised, transparent budgetary system for local governments (with an extensive reporting system) and to improve the methods of debt management. The reformers promised to introduce new taxes, including personal, real estate or environmental taxes, to improve the condition of local budgets and indirectly curb the wasteful use of resources in the industrial sector and the uncontrolled price increases in the housing sector. Finally, it was also announced that some spending categories would be taken over by higher levels of government (i.e. provincial government and central government), and that transfers from central government would increase.

One of the most important pledges in the new reform agenda concerned a limited reform of the state-owned enterprise sector, which had enjoyed privileged access to resources despite its relatively lower efficiency. The main aim of the reform was defined as improving the efficiency of the state-owned sector by stepping up oversight over its activities and making them more transparent. This was to be done by increasing the involvement of private capital in state-owned companies (through the so-called mixed-ownership reform) while at the same time altering the rules on SOE management. The reform envisaged that state-owned business assets would no longer be managed by a delegated supervisory institution, but instead – by specially established funds tasked with multiplying state-owned capital. Concerning the conditions for doing business, SEOs were to be put on the same footing as other economic actors. Importantly, even though the intention of the proposed reform was to open the state-owned sector to market forces and increase competition, official documents still directly stated that SOEs would continue to play a dominant role in the economy and continue to serve as an economic policy instrument.[16] This language revealed one of the most significant limitations of the reform 'spirit', showing that the proposed changes would be evolutionary in nature and that the new leaders were averse to radical economic solutions such as large-scale privatisation.

2. … and the drifting of key reforms

The capital markets, which were expected to improve the financial situation of SOEs and offer better access to capital to the most efficient sectors of the economy, did undergo some degree of liberalisation. However, responding to a series of shocks in Chinese markets, the government moved to implement a series of measures which strengthened the state's control of the economy, quite against the 'spirit of the third plenum'. The deepest regression occurred in the Chinese stock markets which, after the initial liberalisation (e.g. of IPO rules) were again brought under strict control in 2015, with temporary suspensions of trading, a halt on new IPOs and a prohibition for investors from selling stock. According to various estimates, interventions to save the stock market could have cost as much as US$ 234 billion, with most of the money coming from state-owned

[16] *Ibidem.*

financial institutions, which further increased the pressure on the banking sector.[17] In the years 2015-2016 some changes were implemented in the bonds market, e.g. a greater number of companies were allowed to issue bonds and wider access to the market was granted to individual investors.[18] However, the dynamics of this market's growth is strongly linked with the prospects for its internationalisation (admission of foreign institutional investors), and thus depends on the progress of liberalisation of China's capital account – and here the Chinese leaders are acting cautiously because of the risk of sudden capital outflows.

Relatively large progress has been made in reforming China's banking system, which is of crucial importance from the point of view of improving the allocation of capital in the economy and increasing Chinese consumers' purchasing power. However, the banking sector's condition worsened again after the banks were engaged in some ad hoc interventions to prop up the economy. The years 2014-2015 were marked by significant changes in the banking sector: interest rates were gradually liberalised (e.g. the upper limit on banking account interest rates was abolished), a deposit insurance scheme was created, and licences were granted to a certain number of private banks. This contributed to increasing competition in the sector and a strengthening of the position of smaller banks. However, the state-owned sector remains dominant, with smaller provincial and city banks gaining importance, which increases the exposure to risks associated with the shadow banking sector. Moreover, the problem of the state-owned enterprises' privileged access to capital remains unresolved, with state-owned businesses paying

17 China's 'national team' owns 6% of stock market, *Financial Times*, 26.11.2015, https://www.ft.com/content/7515f06c-939d-11e5-9e3e-eb48769cecab

18 With the progressing liberalisation, the bond market has been increasingly unstable, prompting state interventions such as the suspension of trading in futures in December 2016. See: Why buying China bonds and stocks is looking dicey, CNBC, 16.12.2016, http://www.cnbc.com/2016/12/16/why-buying-china-bonds-and-stocks-is-looking-dicey.html

interest on their loans at rates 0.5 to 1 percentage point lower than private companies.[19]

Fiscal reforms have gained momentum, with visible changes in taxes and the budget and debt governance system. However, the measures taken so far have eased the pressures on local governments only temporarily, without providing them with stable sources of revenue that would allow them to service their debt. In their final form, the reforms also lack the initially envisaged 'pro-market' component and lead to greater pressures on the banking sector. Beginning in 2014, a number of measures have been taken in China to make it easier for local governments to service their debt, e.g. by abolishing some restrictions on borrowing and opening the possibility for local governments to issue bonds, which made them less dependent on the shadow banking sector. The activities of the LGFVs have also been regulated and limited. Moreover, the central institutions have launched a scheme, worth around CNY 15 trillion, to replace high-interest local debt with bonds that are easier to service.[20] The initial proposal drafted by the Ministry of Finance assumed that a large market would be created for local government bonds, which would be bought by China's financial institutions on market terms. However, facing no interest in such risky instruments on the part of banks and concerned about the consequences of possible halting of local government spending, the government decided to force the state-owned banks to purchase the bonds. That eased the short-term pressure on the local governments, but

19 The comparison concerns the major state-owned enterprises that have access to banking credit. Many small and medium-sized companies still have to obtain capital from the *shadow banking* sector, which offers interests rate of up to 20% per year. See: Wojciech Maliszewski *et al.*, Resolving China's Corporate Debt Problem, *IMF Working Paper*, 2016, https://www.imf.org/external/pubs/ft/wp/2016/wp16203.pdf

20 China Said to Peg Local Debt Swap Program at 15 Trillion Yuan, 02.12.2015, https://www.bloomberg.com/news/articles/2015-12-02/china-said-to-peg-local-government-debt-swap-program-at-15t-yuan-ihomcrti

the measure was implemented on terms that contradicted the ‘spirit of the third plenum’.

The central government has also introduced several changes to local-level budgetary planning rules, imposing regulations on the drafting of multiannual budgets and measures to improve the transparency of spending. However, the reforms have not been fully implemented because of the resistance of local government officials who tend to sabotage co-operation with the central government, such as in assessing the real volumes of debt and setting future debt limits.[21] This is the case because the reforms are taking place in the context of a major reform of the taxation system, which has undermined the budget revenues of local governments. The reform entails a wider application of VAT, and VAT revenues are channelled to the central budget to a wider degree than revenues from the previously applicable business tax were. Meanwhile, work on the other taxes that were supposed to fortify the local budgets are still in progress. As direct transfers from the central budget have not increased significantly, the widening budget gaps have been forcing local officials to look for financing beyond the official channels.

The reform of the centrally managed SOEs (*yangqi*) started with a significant, two-year delay. Owing to the large number of central institutions involved and their contradictory visions of what needs to be done, the detailed reform agenda is inconsistent and at times internally contradictory. So far there has been little progress on its implementation and the original objectives of the third plenum have been achieved to a small extent only. The detailed reform plan translating the objectives set by the third plenum into concrete measures was not published until 2015. Because the works had involved a number

[21] Barry Naughton, Local Debt Restructuring: A case of Ongoing Authoritarian Reform, *China Leadership Monitor, No. 47*, 2015, http://www.hoover.org/research/local-debt-restructuring-case-ongoing-authoritarian-reform

of institutions with divergent objectives, the original agenda was expanded to include a number of minor changes, some of which are mutually contradictory. For instance, it includes proposals to increase the autonomy of company management boards as well as a commitment to strengthen the role of the CPC structures in nominating managers. The official documents also contain no specific provisions on solutions that would be of fundamental importance for the reform, such as the detailed blueprint for the structure of the managing funds, which leaves quite a lot of room for interpretation to the implementing institutions.

The implementation of the reform has also been delayed by conflicts over the division of responsibilities, surfacing during the formulation of detailed reform plans: for instance, the SOE reform was designed by the relatively pro-market Ministry of Finance but its implementation, after a long impasse, became the responsibility of the government and officials with links to the economic bureaucracy, as a result of which its momentum waned and the pilot projects implemented in over a dozen centrally managed SOEs turned out to be very moderate.[22] Some factors unrelated to the political process have also played a role, including the chaos in China's exchange markets, which blocked one of the basic channels for transferring shares to the private sector as part of the mixed ownership reforms. The most notable change implemented so far concerns the launch of a series of mergers between the centrally managed SOEs, leading to the emergence of huge concerns, the expectation being that this will improve their efficiency. However, the mergers have mainly strengthened the market position of the companies involved, calling into question the intention to put private sector on an equal footing with the state-owned sector. Moreover, the first experiences offer no

[22] State-owned enterprises at a crossroads: Key features of China's new SOE reform, Asia Pacific Foundation of Canada, p. 14, https://www.asiapacific.ca/sites/default/files/filefield/soe-report-final.pdf

evidence of the expected synergies and profitability gains.[23] The obstacles hindering the implementation of reforms at the central level have also affected local governments, which have been implementing their own version of the reforms in the locally managed SOEs since 2013 and are carrying out their own pilot programmes. Because of Beijing's inconsistent policy, reforms have been postponed and – in the absence of central co-ordination – the dynamics of their implementation depends on the prevailing local circumstances and balance of interests.[24] Consequently, the economically stronger provinces, such as Guangdong or Chongqing, have been more committed to reform and faster to resolve problems such as the zombie company issue. The degree of change in the provinces most affected by stagnation in the heavy industry, such as Shanxi or Liaoning, has been much weaker and the changes implemented have been much more conservative.[25]

The Chinese government responded to the stagnation of the third plenum's agenda by launching a supply-side reform in 2015. The umbrella term encompasses various solutions which are expected to contribute to the restructuring of the economy but are based, to a large extent, on *ad hoc* measures implemented by the administration. The reform has five pillars: reducing the debt pile, curbing overproduction, reducing existing production overcapacity, reducing oversupply in the property market, and lowering the cost of doing business. Most of the measures taken to date concern overcapacity: the central institutions have set quotas for the reduction of production capacity over the next five years, especially in the coal mining sector (500 million tonnes) and steelmaking (150 million tonnes). In order to lower the cost of doing business, the reform plans envisage various tax reductions

[23] Why China's $1 Trillion Merger Makeover Could Fail, 08.09.2016, https://www.bloomberg.com/news/articles/2016-09-07/china-s-1-trillion-makeover-of-bloated-soes-attracts-skeptics

[24] State-owned enterprises at a crossroads..., *op. cit.*

[25] Wojciech Maliszewski *et al., op. cit.*

intended to support businesses. The new reform plans also encompass the economic administration reform launched back in 2013 by prime minister Li Keqiang, which have recently lost momentum. It aimed to address the problem of arbitrariness of bureaucratic decisions, reduce the number of licences and permits and delegate decision-making,[26] but its practical implementation was hampered by the low involvement of local governments. The supply-side reform is a relatively new initiative and as such, it has not been fully developed yet, but in 2016 Beijing clearly identified its implementation as a priority.

26 Baogang Guo, New Trends in China's Administrative Reform, *China currents*, vol. 13, No. 2, 2014; http://www.chinacenter.net/2014/china_currents/13-2/new-trends-in-chinas-administrative-reform/

III. A NEW ARCHITECTURE FOR DEEPENING REFORMS

Shortly after taking the lead in the CPC in 2012, Xi Jinping started to systematically and thoroughly concentrate power in his hands. He quickly emancipated himself from the influences of his predecessors and put himself in control of the key bodies of the CPC, which also included taking personal control of the army.[27] This triggered a debate among foreign observers about the possible end of China's model of 'collective leadership' while comparisons were drawn between Xi's political position and the status of Deng Xiaoping or even Mao Zedong.[28] The new architecture for deepening economic reform, created after 2013, was fully in keeping with that trend, making Xi Jinping a central figure in the entire process.

1. Reform as a way to combat vested interests

From the very start, the new Chinese leadership has represented the deepening of economic reforms as a battle against the vested interests (*liyi jituan* or *jide liyi*) which had emerged at the intersection of the state and the economy. In view of China's endemic corruption, the rise of such groups was an inevitable consequence of the Chinese model, in which the state plays the leading role in economic development. For large sections of the bureaucracy and the private businesses with links to the government, preserving the *status quo*, i.e. the existing level of regulation, the privileged position of SOEs and the state-dominated financial system is

27 In the past, the leadership of the CPC's Central Military Commission was not automatically handed over to the new CPC secretary general, which allowed the real leader to keep behind-the-scenes influence (from which both Deng and Jiang Zemin benefited).

28 That status was partly sanctioned when Xi was given the title of the party's 'core' leader (*hexin*), previously granted only to Mao, Deng and Jiang Zemin. See: Chris Buckley, China's Communist Party Declares Xi Jinping 'Core' Leader, *New York Times*, 27.10.2016, https://www.nytimes.com/2016/10/28/world/asia/xi-jinping-china.html?_r=0

necessary for their success and ability to keep enriching themselves. Those groups should be also seen as a force interested in a continuation of the practice of maintaining the economy under conditions of constant fiscal and monetary stimulus, which is unsustainable, yet, with the lucrative projects it involves, generates massive benefits for the officials and companies involved. In this context, the Chinese central-level bureaucratic circles' resistance is also an obstacle to reform because the state's withdrawal from the economy will undermine their political position and curb their powers, which in itself may trigger opposition to the projected changes.

The economic reform agenda proposed during the third plenum in 2013 aims at reducing the state's control of the economy, which will considerably restrain the opportunities to derive extraordinary benefits from access to power. **Thus, the implementation of the reforms announced by the new leadership inevitably opens a political conflict within the CPC, which will require the leaders to become actively involved in overcoming the administration's resistance at the level of central, provincial and local institutions and resistance from the huge sector of SOEs.** From the moment he took power, Xi Jinping has made it clear that the easy phase of reforms which made everyone satisfied was now over, and has presented the resumption of reforms as 'navigating a deep-water zone'.[29] He has also described the reform process as a revolutionary struggle against vested interests, in which one would need to use 'real spears and swords'.[30] Shortly after his inauguration in March 2013, prime minister Li Keqiang explicitly warned against the interest groups who would be seeking to block the reforms, pledging to fight a tough battle that

29 Xi says China's reform enters deep-water zone, Xinhua, 01.04.2014, http://news.xinhuanet.com/english/china/2014-04/01/c_133230720.htm

30 The Chinese idiom真刀真枪 (*zhen dao zhen qiang*) means serious action, but in this context it might be interpreted more literally. See: 习近平：改革是动既得利益 不真刀真枪干不行，China Net, 28.06.2016, http://www.china.com.cn/news/2016-06/28/content_38759911.htm

would be like 'cutting off one's own hand'.[31] Pointing to the administration, he warned about the resistance of people who would be losing power and influence as access to the markets becomes liberalised and competition increases.[32]

Seeing the reform as a battle against vested interests has also become one of the dominant views in China's press and economic debate. The press regularly publishes expert comments which link the vested interests operating in China with the discrimination against the private sector or the growing inequalities. Vested interests are also often blamed for the delays or failure of specific reform projects.[33] Finally, influential Chinese economists and economic journalists including Chi Fulin of the Chinese Institute for Reform and Development, Li Yining of the University of Beijing[34] or Hu Shuli, editor-in-chief of China's leading business weekly *Caixin*, point to the existence of interest groups as an obstacle to China's further development.

Unlike the reforms implemented by Deng Xiaoping in the 1980s and 1990s, the conflict opened by the Xi-Li duo is not strictly ideological in nature. Back then, the reformers' main opponents were the conservative, communist party elites while the bureaucracy at various levels, especially at the local and provincial level, to which the reforms offered opportunities of enrichment, was a potential ally.[35] Today's situation is the opposite. Planning the specifics and implementing the agenda of the third plenum will require

31 自上而下的改革, *China Daily*, 09.11.2013, http://www.chinadaily.com.cn/china/2013cpctps/2013-11/09/content_17093720.htm

32 李克强：改革会触动利益会动"奶酪"但我们义无反顾，CPC News, 13.03.2014, http://cpc.people.com.cn/n/2014/0313/c164113-24626615.html

33 Xinhua Insight: China's new reforms must breach vested interests, Xinhua, 04.11.2014, http://news.xinhuanet.com/english/indepth/2013-11/04/c_132857921.htm

34 Vested interests, inertia "hard nuts" in China's reform, Xinhua, 06.03.2014, http://news.xinhuanet.com/english/china/2014-03/06/c_133166965.htm

35 Willy Wo-Lap Lam, Chinese politics in the Era of Xi Jinping, Routledge, New York 2015, p. 152.

overcoming the resistance of the Chinese administration at all levels and mobilising its members. **The current CPC leadership views the vested interests embedded in the Chinese state apparatus as the main opponents of reforms, who may actively or passively resist the projected thorough restructuring of China's economy. The activities of the leadership in Beijing have been subordinated to the logic of internal conflict since 2012, necessitating the development of new tools to discipline the administration cadres and tighten control of the reform process.**

2. Establishment of the Central Leading Group for Comprehensively Deepening Reforms

The new Chinese leadership decided to use the structures of the Communist Party of China as the basic instrument in gaining control of the economic reforms. To this end, it used the network of so-called leading small groups (*lingdao xiaozu*) existing within the CPC Central Committee, i.e. the permanent or temporary informal forums grouping the leaders of the key bodies in the CPC and the state administration, whose role is to initiate and implement policies and build consensus at the top tiers of power.[36] Because they are embedded in the central structures of power, the leading groups of the CPC Central Committee play a crucial role. More than a dozen such groups exist currently, dealing with key issues ranging from finance and the economy to party development, propaganda and ideology, and to foreign policy, cyber security and the army. The formula of an informal leading group as a vehicle of co-ordination is very common in the Chinese political system – several dozen such groups work with the State Council (government) of China and within the Chinese People's Liberation

[36] The first leading small groups were established back in the late 1950s, but they did not become an important tool for the co-ordination of reforms until the Deng Xiaoping period. The groups were gradually developed and refined by successive generations of Chinese leaders.

Army.[37] Groups are also often established at lower levels of government, including the provincial level, or within individual central institutions.

Xi Jinping's rise to power within the CPC was followed by a re-construction of the network of leading groups operating within the CPC Central Committee, as a result of which the groups gained a bigger role in the process of economic policy development. The so-called Central Leading Small Group for Comprehensively Deepening Reforms, established by the third plenum in 2013 to implement its reform agenda to 2020, became a pivotal element of the new architecture (hereafter: Leading Group for Deepening Reforms). It is an elaborate structure and has its own working sub-groups in charge of particular reform areas, including a Subgroup on the Economic System and Ecological Civilisation, responsible for economic affairs. The Group also holds a senior position role in relation to some existing leading groups and has taken over some of their responsibilities.[38] The Group meets regularly, currently every month, and has a relatively small secretariat in charge of organising work. Like the other groups, it has a strongly hierarchical structure in which the chair, in this case Xi Jinping himself, holds a dominant position.[39]

The intention of the Chinese leadership was to make the Leading Group for Deepening Reforms a key element in the economic reform process. Its tasks include defining the directions of reform, initiating specific solutions and, importantly, 'overseeing

[37] Alice Miller, The CCP Central Committee's Leading Small Groups, *China Leadership Monitor*, No. 26, Hoover Institute, 2008, http://www.hoover.org/research/ccp-central-committees-leading-small-groups

[38] This is particularly important in the case of the Leading Group for Finance and Economy in charge of regularly reviewing the government's economic policy and setting priorities for China's five-year plans.

[39] The Group's proceedings are not fully public, e.g. not all details of the reforms discussed are publicly disclosed. Nevertheless, the lists of topics on the agenda and of the group's members, as well as media reports on the Group's meetings do provide some knowledge about the way it functions.

and pushing forward' the implementation.[40] Available information suggests that the Group has been successfully accomplishing those tasks, at least in the procedural dimension. As one of the first outcomes of its work, the Group has compiled a list of 366 specific reforms to be implemented by 2020; while the list itself is not publicly available, the reforms are being successively initiated according the Chinese media. The Group's activities are focused on initiating reforms, while the task of drafting detailed specific projects is delegated to other specialised leading groups and then to the lower levels of the party and the state administration, as well as to individual central, provincial and local institutions. The Group's secretariat appoints working groups comprised of institutions involved in the reform. The Group subsequently gives its opinion on the drafts and regularly oversees the implementation process. In the years 2014-2015, more than one hundred different measures were on the Group's agenda, of which around one third concerned economic reforms.[41] It is notable that the Leading Group deals not only with issues of fundamental importance for the Chinese economy, such as the reforms of taxation or SOEs, but also very specific and relatively minor changes such as the establishment of a system to locate lost ID documents of Chinese nationals.

The Leading Group for Deepening Reforms has become not only a new channel for initiating and controlling reforms, but also a basic tool for co-ordination between the central institutions of China's administration and for overcoming the expected resistance to change – that is because even a secretary general such as Xi Jinping, who is considered to be in a very strong position, does not have fully discretional powers in making key nominations in the state administration, especially

40 Barry Naughton, It's All in the Execution: Struggling with the Reform Agenda, *China Leadership Monitor*, No. 45, Hoover Institute, 2014, http://www.hoover.org/research/its-all-execution-struggling-reform-agenda

41 Lance L. P. Gore, Xi Jinping's Reform Leading Group: Two years in Operation, IPP Review, 11.05.2016, http://ippreview.com/index.php/Home/Blog/single/id/134.html

during his first term. Appointments in the administration are decided by the party's highest bodies, in particular, the Politburo of the Central Committee (a key body comprised of 25 people). Its current composition was not Xi's decision – it reflects the party's balance of power back in 2012. Consequently, Xi Jinping does not have unrestrained freedom to build a strong pro-reform team in the key central institutions. Many important posts in the State Council (government) and key institutions have been occupied by people representing the interests of the bureaucracy responsible for economic planning or the interests of state-owned companies, or indeed officials burdened with corruption links, i.e. groups less enthusiastic about reform, which may potentially delay any change in the *status quo*.[42] With the leaders of all key state institutions (who are all also CPC members) participating in the Leading Group for Deepening Reforms, all the main centres of power concerned by economic matters are represented within it, including the National Development and Reform Commission (the main planning body), the central bank, SASAC (the institution overseeing SOEs), as well as the ministries of finance, education, industry, trade and the environment.[43] By bringing together all the actors crucial for the reforms within one forum, the party leaders have created a powerful tool to co-ordinate, build compromise and transfer knowledge, while at the same time overcoming the resistance of the central bureaucracy to the extent the pro-reform fraction's strength allows. The personal involvement of the CPC leaders in the political process, i.e. the interventions into the course of reforms that they can make in the Group's meetings, allows them to amplify the power of political persuasion of individual institutions and officials.

[42] For instance, the positions of deputy prime ministers were taken by Wang Yang, the former chief of the SASAC (the institution overseeing the largest state-owned companies) and Ma Kai, a man with links to the National Development and Reform Commission which often advocates state interventions.

[43] The Group also includes 14 of the 25 members of the Politburo and 4 of the 7 members of the Standing Committee. In total, it has 43 members. See: Lance L. P. Gore, *op. cit.*

The leading groups embedded within the CPC have also become an important channel for co-ordinating reforms and overcoming the resistance of the bureaucratic cadres at lower levels of the state administration. Within months of the third plenum, Leading Small Groups for Comprehensively Deepening Reforms were created at the provincial level, in the main government agencies, China's largest cities and in some of the state-owned enterprises.[44] Their structure largely mirrors that of the Leading Group for Deepening Reforms created by the CPC Central Committee; in the personal dimension they bring together the local party elites and key officials, and also have specialised sub-groups (in some cases the subgroups are more elaborate and adjusted to the local needs) and their own secretariats. The meetings of the provincial leading groups take place regularly (most groups have already held around 20 meetings each), and the matters discussed concern both the implementation of the guidelines coming from the Central Leading Group for the Deepening of Reforms and development of local projects. Importantly, procedural powers are again concentrated in the hands of the party secretaries – at the provincial level it is usually them, and not the governors, i.e. administration chiefs, who are at the helm of the leading groups.[45] The aim is to enable a similar mechanism as at the central level where the authority of high-ranking party members is a way to overcome the resistance of officials.

3. The party's role: to discipline and mobilise

The activities of the CPC Central Commission for Discipline Inspection (hereafter Central Disciplinary Commission) are another tool which has been built within the CPC structures to discipline the

[44] According to various estimates, around 800 such groups were established at various levels in 2014. See: Barry Naughton, 'Deepening Reform': The Organization and the Emerging Strategy, *China Leadership Monitor*, No. 44, Hoover Institute, 2014, http://www.hoover.org/research/deepening-reform-organization-and-emerging-strategy

[45] *Ibidem*.

bureaucracy and indirectly, to extend the party leadership's control over the implementation of reforms.[46] Led by Wang Qishan, a member of the Politburo Standing Committee and one of Xi Jinping's most trusted aides, the Commission launched the so-called anti-corruption campaign in 2013 and has since been conducting very comprehensive scrutiny of officials suspected of corruption; the Commission's proceedings have led in many cases to expulsion from the party or imprisonment sentences. Anti-corruption campaigns have been launched in China before, serving to consolidate power, wage inter-faction wars within the CPC or to strengthen the party's popularity by imposing exemplary punishments on corrupt officials. The same elements are also present in the anti-corruption campaign launched by Xi Jinping in 2014.[47] **However, the scale and duration of the present campaign are unprecedented, which indicates that the campaign is designed as a tool to change the political *status quo* in China, and that is very significant for the prospects of implementing economic reforms.** Unlike the previous 'wars' on corruption (which typically gained momentum when a change of leadership was about to take place), the current campaign has not lost momentum four years on,[48] and the aim of Wang Qishan is to build permanent, long-term mechanisms for the 'self-purification' of the party into

46 The Commission is not part of the Chinese administration of justice – the investigations are conducted by party bodies, but the measures employed include house arrest and interrogations. Selected cases are referred to the prosecution authorities and end in imprisonment sentences.

47 The fight with the 'tigers', of whom around 150 have been convicted or excluded from the party, should be seen as a way for Xi Jinping to consolidate his grip on power within the party. Many experts point to the fact that the anti-corruption campaign has not directly affected any of Xi's political allies.

48 According to various estimates, in the years 2013-2016, the Central Commission for Discipline Inspection investigated corruption allegations against 100,000 to 200,000 officials of various levels, some of whom were excluded from the party or convicted for corruption. In 2015 alone, around 330,000 people faced disciplinary proceedings (not necessarily linked to corruption), and of this number, 14,000 were charged by the prosecution authorities. See: 中纪委晒2015反腐大数据：去年全国处分33.6万人, Sina, 15.01.2016, http://news.sina.com.cn/c/2016-01-15/doc-ifxnrahr8329230.shtml

the Chinese political system.[49] The scope of the campaign is also unprecedented as it reaches both the 'tigers' (high-level officials and party members) and the 'flies' (lower-ranking officials and party members), to use Xi Jinping's metaphor.

The anti-corruption campaign has played an important role in reshuffles within the central institutions in charge of economic governance, stepping up pressure on the bureaucracy and enabling rapid replacement of some officials. For the leadership in Beijing, stepping up pressure on the bureaucracy is also a way to improve the quality of governance of SOE assets and budget spending.[50] The Central Disciplinary Commission has been active in the institutions in charge of economic regulations, as well as several state-owned companies. The anti-corruption campaign has targeted the National Development and Reform Commission, which is the chief planning office and the market regulator for many sectors. In the years 2012-2013, investigations were launched against many key officials in charge of price regulation and the NDRC deputy chief, Liu Tienan, who was in charge of the energy sector. Among those arrested was Jiang Jiemin, the chief of SASAC, the government agency overseeing the state-owned enterprises controlled by the government. In 2014, state-owned companies became the campaign's targets, with investigations opened in every one of the 112 centrally-managed concerns,[51] in the aftermath of which many bosses of the largest oil, energy and extraction companies were removed from their positions, as were the chiefs of several banks.

The anti-corruption campaign has become a means of exerting systematic pressure on the bureaucracy and accelerating

49 王岐山在十八届中央纪委六次全会上的工作报告, Xinhua, 24.01.2016, http://www.ccdi.gov.cn/xwtt/201601/t20160124_73389.html

50 Jonathan Fenby, China's corruption probe bares its teeth, BBC, 20.02.2015, http://www.bbc.com/news/world-asia-china-31503967

51 China's state-assets manager gets even tougher on graft, Xinhua, 20.01.2016, http://www.chinadaily.com.cn/china/2015-01/20/content_19354480.htm

the rotation of cadres, while at the same time building up Beijing's political influence at the local level. According to some estimates, around 90% of the audits were conducted at the level of provinces or lower.[52] The 'purge' in local institutions and party bodies serves a complex set of objectives: it is a reaction to the loosening of control over party structures and their progressing erosion, as well as to the impunity of local officials, which has been undermining the party's legitimacy. The instruments used in the campaign indirectly help to centralise the Chinese political system, making the party structures more hierarchical, which influences the functioning of the administration.[53] The disciplinary measures and reshuffles should therefore be treated as a way of 'clearing the field' for the implementation of reforms and breaking the resistance of the groups sustaining the *status quo.*[54]

52 Anna L. Ahlers i Matthias Stepan, Top-level design and local-level paralysis: Local politics in times of political centralization, [w:] Sebastian Heilmann *et al.*, China's core executive: Leadership styles, structures and processes under Xi Jinping, MERICS, 2016, http://www.merics.org/?id=1065

53 In the past, the Commission's activities at the local level used to be controlled by the local party committees, which led to obvious conflicts of interest and rendered effective control impossible. The reorganisation carried out by Wang Qishan has resulted in the formation of a much more hierarchical structure in which the local commission bosses and their deputies are appointed by the higher levels, to which they directly report, while the ultimate oversight is conducted by the Central Discipline Inspection Commission.

54 This interpretation is substantiated in view of statements by the Chinese leaders and the message coming from the state-owned press. See: New stage in anti-corruption Fight, *China Daily*, 5.04.2014, http://www.china.org.cn/opinion/2014-03/05/content_31676604.htm

IV. THE MAIN CHALLENGES FOR REFORM

The reform implementation pathway adopted after the third plenum in 2013 largely relies on the structures of the Communist Party of China. Even though the party's main bodies have also previously played an important role in reforms, that role was largely limited to setting general directions and taking key political decisions. The strong powers of the Leading Group for Comprehensively Deepening Reforms and its significant role in the reform 'transmission belt' amount to a partial adjustment of China's original model of economic policy development. Embedded in the CPC structures, the Group has been given an important and partly formalised role in the process, which also includes the power to initiate reforms, delegate tasks and oversee progress. **This means that – to some degree – the key competences have been shifted from the domain of the state (government) to the domain of the party, thus disrupting the reform implementation mechanisms which have been in place for years.** The very process has simultaneously become more centralised, with the CPC leadership gaining more influence on the specific shape of reforms, at the expense of the local administrations. And finally, the new model has also given Xi Jinping personally more influence on the directions of economic policy. The systemic changes implemented by the Xi-Li team have brought about many negative consequences which go towards explaining the weakness of the implementation of key reforms from the third plenum's agenda.

1. Disruption of the political process

The so-called top-level design (*dingceng sheji*), i.e. the idea of centralising the reform process by granting the government in Beijing wider competences in shaping the reforms, has been one of the basic concepts accompanying the concentration of control of the reforms in the hands of the CPC top leadership. It entails a partial departure from the decentralised model relying on local experimenting, which had been in place for several decades.[55] Even though that model is still in use in many spheres of the state's functioning, it has been implemented where it applies to the key issues named in the third plenum's agenda. Now it is the central leadership that defines more details of the reform programmes, starting from initiatives within the central Leading Group for Deepening Reforms, the specifics of which are subsequently defined by the selected central institutions. The role of the local governments, organised into local Leading Groups for Deepening Reforms, is to 'respond' to the reforms and develop innovative solutions that fit the local conditions. This shift of emphasis in the political process disturbs the balance in relations between the central government and local administration (discussed in the next section), and places a greater responsibility for detailed policy design upon the central institutions in Beijing.

To date, the activities of the Leading Group for the Deepening of Reforms, which has absorbed the biggest share of the powers transferred in connection with the *top-level design* concept, have revealed several important defects of the new architecture for the implementation of reforms. An important role in the reform process has been given to an only loosely formalised body convening relatively infrequently and embedded within the CPC rather than the state administration. While the Group does have a secretariat, its organisational capacity is limited and the secretariat's work is limited to setting meeting agendas and initiating co-operation between selected institutions.[56] Many observers have noted that the structure works relatively slowly and fails to foster an adequate

[55] It provided relatively wide freedom to the local and provincial administrations in developing reforms, which has led, inter alia, to considerable institutional differentiation between China's regions. For example, different parts of China operate different social security systems.

[56] Barry Naughton, After the Third Plenum: Economic Reform Revival Moves toward Implementation, *China Leadership Monitor*, No. 43, Hoover Institute, 2014, http://www.hoover.org/research/after-third-plenumplenum-economic-reform-revival-moves-toward-implementation

sequencing of reforms.[57] Specific solutions, initiated by the Group or put forward by other institutions, are negotiated between the key centres of power and moved to the implementation phase only when 'the conditions are ripe', as emphasised in many documents. As a result, specific projects get approved by the top party leadership in a random and unsynchronised manner, which prevents synergies and jeopardises the success of reforms in areas where changes should be implemented in a meticulously crafted sequence (such as the finance sector). Because of the multiplicity of actors involved, and potentially also a piling up of tasks in a situation of limited human resources, many important projects have been stuck in the 'transmission belt' – of the several hundred topics on the agenda, a little over a dozen have entered implementation phase as of now.[58]

The new tools to control reforms have been embedded within the existing structures of the party, i.e. within the leading groups whose original functions concerned co-ordination and control, but which did not have the institutional capacity, staff or expertise needed to formulate specific reforms on their own. As a result, the decision-making centre located within the Leading Group for the Deepening of Reforms has been forced to rely fully on the existing state and party institutions. This has created opportunities for reforms to be hijacked by groups interested in preserving the *status quo*, which can use means such as proposing illusory change which, in reality, would keep the existing power relations in place, delaying procedures or even sabotaging certain specific solutions. This scenario could be observed in the case of one of the absolutely key reforms, i.e. the SOE reform. The draft mixed ownership reform, formulated by the Ministry of Finance at the request of the Leading Group for Deepening Reforms in the 'spirit of the third plenum', very clearly ran counter to the proposal promoting continued interventionism, put

57 *Ibidem*.

58 Lance L. P. Gore, *op. cit.*

forward by SASAC, i.e. the institution which would be in charge of the ultimate implementation of the reform at the central level. Ultimately this contradiction had to be resolved by the government, in which the existing economic bureaucracy, including the former SASAC chief and currently member of government, held an influential position.

Even though the reform's failure is attributable to a complex nexus of causes (including chaos in the capital markets and lack of enthusiasm on the part of the private sector), the reason why it lost momentum may be linked to the failure of the political process. The complexity of that process also dilutes responsibility for the fate of reforms, thereby undermining accountability.[59] While the Leading Group for the Deepening of Reforms may be regarded as an effective instrument to initiate reforms and, to the extent that the top CPC leadership is willing and able to do so, amplify the influence of selected reformers, its capacity at the level of reform implementation is much more limited.

2. Resistance from the local bureaucracy

The methods adopted by the leadership in Beijing to regain control of the state apparatus, based on a mass mobilisation of the bureaucratic cadres via party channels, do not ensure full involvement of the local bureaucracy in the implementation of the third plenum's reforms. **As a result, the reforms, which are characterised by a conflict of interests between the central authorities and the local governments, have been facing passive resistance.** Meanwhile, the involvement of local governments is crucial for the implementation of the third plenum's reform agenda since they play a key role in the entire process. Even if the previous reform model based on local initiatives and experiments has been

[59] Barry Naughton, Shifting structures and processes in economic policymaking at the centre [in:] Sebastian Heilmann *et al.*, China's core executive: Leadership styles, structures and processes under Xi Jinping, MERICS, 2016, http://www.merics.org/?id=1065

partly revised, in the context of the decentralisation which has been underway in China since the 1980s the local administration remains the most important actor. This is because, in the final implementation of institutional changes, it has the executive competences and the knowledge about local conditions not accessible to the government in Beijing. The lack of local involvement has already led to considerable delays in carrying out various reforms from the third plenum's agenda. The argument about obstruction from local vested interests, which is often raised in China, may well be true but the alleged obstruction is difficult to trace and assess, and its significance should be declining as the anti-corruption campaign progresses. In expert debates, the incoherence of the new system of incentives for officials involved in the reforms is often identified as one of the more important causes of the reforms' stagnation. Another factor contributing to local resistance concerns the unstable financial situation of local governments and the absence of adequate compensation for the fiscal burdens that come with the reforms.

The development of a new architecture for the implementation of reforms after the third plenum was accompanied by important changes in the system of evaluation of local bureaucratic cadres, which was intended to tie promotions more closely with commitment to a more sustainable growth model and implementation of the reforms initiated by the national government. As the Chinese authorities announced China's entry into a new phase of development, in which the country's economy was expected to grow more slowly but more sustainably, that meant that the performance of local administrations would no longer be measured using hard indices based mainly local GDP growth. China is now supposed to plan its actions taking into consideration other, less measurable objectives such as improvement of the quality of public services or environmental protection. At the same time the local administrations are encouraged, through the pro-government press promoting the 'spirit of the third plenum' and frequent field visits by officials from Beijing, to put forward innovative reform initiatives, which will then be evaluated via leading groups for the deepening of reforms. This puts the local bureaucratic cadres in a situation where they have no clarity about the desirable effects or Beijing's ultimate expectations, as a result of which many adopt a passive, wait-and-see attitude.[60] Meanwhile the stepped up pressure related to the anti-corruption campaign, and the real threat of demotion within the party faced by low-performing officials, discourages the bureaucrats from taking any radical reform initiatives.

Successfully boosting local GDP has been a way for local officials to secure promotions, but it has also been fundamentally important for local governments because of the tax revenues needed to finance basic public services. One of the outcomes of the reforms carried out in the 1990s was to transfer a large proportion of tax revenues to the central budget, which considerably undermined the financial position of local governments.[61] They started to increasingly rely on selling land use rights (land is owned by the state in China), and transfers from the central budget.[62] The gap between local revenues and spending needs is one of the main sources of China's economic problems – it incentivises the local governments to stimulate the real estate markets (to ensure revenues from land rights sale), take on more debt or encourage investments by SOEs. **Until alternative sources of budget revenues are provided, the local governments will remain determined to stimulate the economy in an unsustainable way.** That means in turn, that adequately synchronising and prioritising reforms is a crucial task – and given the defects of the reform architecture adopted by Beijing, also a crucial risk – in resolving the Gordian

[60] Anna L. Ahlers i Matthias Stepan, *op. cit.*

[61] The share of local governments in total budget revenue decreased from around 70-80% to 45-50%, while their share in total spending remained at around 65-75%. See: Yinqu Lu and Tao Sun, Local Government Financing Platforms in China: A Fortune or Misfortune?, *IMF Working Paper,* 2013, https://www.imf.org/external/pubs/ft/wp/2013/wp13243.pdf

[62] Depending on the province, the share of land rights sales in total revenues ranged from 30% to 50% in 2009, *ibidem*.

knot of local finance. Until the tax reform is completed and the volume of transfers from the central budget increases, the local bureaucratic elites will not back the provisional attempts at combatting local problems, such as stopping the shadow banking sector from financing public spending, cooling down the real estate market or reducing the production capacity of local industry,[63] as they face the threat of running budget deficits and seeing local businesses go bankrupt and unemployment increase. Moreover, the new competences transferred to the local governments may also end up being used to stimulate the local economies, as illustrated by the decentralisation of the construction permit procedure for new coal power plants, following which the number of new boilers under construction increased dramatically.

3. The Xi factor: personalised economic policy

The party secretary general Xi Jinping has used the decision-making structure based on leading groups to gain personal control of the reforms. The concentration of power in his hands should be seen as one of the main objectives of the changes implemented, and not as an unintended side effect. So much is evident from the way Xi has been gradually concentrating many capacities relevant to reform governance in his hands. He currently heads the Leading Group for the Deepening of Reforms as well as several other key groups including the Leading Group for Financial and Economic Affairs, which has been in place since the start of the 'reform and opening-up' period. His position gives him extensive control of the functioning of the leading groups, providing both insight into each of the reforms on the agenda and the tools to potentially initiate a change of direction or stop work on a given reform. Thus, Xi Jinping has become the

[63] As there are considerable differences between China's provinces, this situation affects the deeply indebted regions that rely on 'old' industries (such as Shanxi or Liaoning) to a much greater extent than the rich provinces like Guangdong or Shanghai.

central figure in the economic reform process, making its success partly dependent on the personal factor.

The side-lining of the collective leadership principle and the concentration of power in Xi's hands makes the dynamics of reforms partly dependent on his personal attitude towards economic issues. The amount of time and attention that Xi can devote to the economic reform matters is limited by his unprecedented involvement in foreign policy issues, his efforts to strictly control the army and the internal struggles within the CPC. The Chinese leader's biographers also point to the fact that he has relatively little experience in economic governance, with which he has dealt only while serving as the governor of the Zhejiang and Fujian provinces. Unlike prime minister Li, Xi has no degree in economics, which may lead to a relative marginalisation of the reforms question. It also means a bigger role for his economic advisors, especially Liu He, who is the chief of general office of the Leading Group for Financial and Economic Affairs and reportedly the main architect of the third plenum's agenda and the author of the top-level design concept. However, Xi's advisers hold relatively weak positions in the party (Liu He is not a member of the Politburo), which may slow down the reforms in the situation where Xi's attention is focused on other priorities.

The concentration of power in Xi Jinping's hands also makes his personal ideological orientation a factor in the discussion of the reforms' chances of success. On the one hand, Xi has expressed support for market reforms since the beginning of his term and has been very clear in referring to the reform legacy of Deng Xiaoping (his first official trip was to the province of Guangdong and the city of Shenzhen, the destination of Deng's famous 'southern tour'[64]). On the other hand, however, he has constantly underlined

64 The 'southern tour' refers to Deng Xiaoping's visit to the southern province of Guangdong, regarded as the stronghold of market reforms, and Shenzhen, the city hosting China's first special economic zone. The aim of the symbolic trip was to overcome resistance against change within the conservative left-

the leading role of CPC in China's development, as evidenced by his numerous speeches and the official documents.[65] **It should be concluded that from the point of view of Xi Jinping and the more broadly understood party leadership, the principal objective of reforms is invariably to consolidate the party's power and strengthen its social legitimacy by ensuring a steady improvement in living standards across China.**[66] This means the Chinese leaders will be cautious in implementing reforms that involve a risk of political instability, and such risk increases as the economic situation in China deteriorates. According to experts, such a position is expressed in fragments of speeches made by Xi, who spoke on various occasions about the need to 'carefully prepare reforms', 'avoid making mistakes that cannot be rectified or reversed', and 'eliminate extreme solutions'.[67] **In this interpretation, the Leading Group for the Deepening of Reforms may serve Xi as an instrument of total and 'double-sided' control of the reforms, allowing him to overcome resistance to reforms but also to block overly ambitious moves.** That is important because apart from the groups defending the *status quo* there are also groups within the party which advocate more radical liberalisation and which therefore may be seen as a threat to economic stability and to the leading role of the CPC itself.[68]

wing of the CPC, which was criticising Deng's reforms after the Tiananmen Square events in 1989. The effects of the visit included a considerable speeding up of reforms which led to the deep restructuring of state-owned enterprises in the years 1995-1997, among other outcomes.

65 As well as the campaigns Xi has launched to promote ideological purity, his efforts to limit pluralism, and most importantly, the absence of any meaningful progress of the political reform.

66 Teresa Wright, Party and state in post-Mao China, Polity Press, Cambridge 2015, p. 1-17.

67 Why Xi's APEC Summit Remarks Are Being Misinterpreted, *Caixin*, 16.10.2013, http://english.caixin.com/2013-10-16/100592595.html?sourceEntityId=100594992

68 One of the proposed ways to resolve the imbalances in the Chinese economic system is to launch painful adjustment processes, allow a larger number of bankruptcies to take place and 'cleanse' the economy using market forces. Other pro-reform groups argue that further growth should be based on a change of the business environment, the development of independent

The concentration of power in the hands of the secretary general of the Communist Party of China (who is at the same time president) is a **departure from the unwritten rule, observed since the 1980s, that oversight of economic reforms should be a competence vested in the prime minister who heads the state administration and the key institutions responsible for the implementation of reforms**. While prime minister Li Keqiang is the deputy head of most of the major leading groups, questions over the relation between Xi and Li and the division of decision-making competences between them remain unclear. Since 2014, Li Keqiang has been much less conspicuous in the media and some observers have noted the delays in the prime minister's flagship project, the Shanghai free trade zone, viewing this as evidence of his political marginalisation. One of the most frequently mentioned reasons for this, apart from a conflict over economic competences, concerns a potential inter-faction fight within the CPC – as Li Keqiang originates from the Communist Youth League and is regarded as a protégé of the previous president Hu Jintao.[69] Because of the opaqueness of the Chinese political system, experts formulating opinions on the Xi-Li duo's general outlook on the desirable direction of reforms need to rely on interpretations of official statements and often come to contradictory conclusions: while some view the 'left-wing' and party-focused Xi Jinping as the one blocking reforms, others believe that resistance to reforms comes from the stimulus advocate Li Keqiang.[70] If there is indeed a fundamental conflict over the division of competences between the two key centres of power, and potentially also an ideological conflict, that should be regarded as a major hindrance for

regulatory institutions, and, most importantly, rule of law and independent courts.

69 Why Xi Jinping has no need of factions in the Communist Party, SCMP, 8.08.2016, http://www.scmp.com/week-asia/opinion/article/1999155/why-xi-jinping-has-no-need-factions-communist-party

70 See: Willy Wo-Lap Lam, *op. cit.*, p. 159; Barry Naughton, Two Trains Running: Supply-Side Reform, SOE Reform and the Authoritative Personage, *China Leadership Monitor*, No. 50, Hoover Institute 2016, http://www.hoover.org/sites/default/files/research/docs/clm50bn.pdf

reforms that can be removed only after the 'new opening' in the aftermath of the CPC congress in 2017.

4. Economic slowdown and instability

During the three years that have passed since the announcement of the new reform agenda at the CPC Central Committee third plenum, the Chinese leadership has had to operate in an unusually tumultuous and unstable economic environment that is without precedent in the entire 'reform and opening-up' period. The steady slowing down of GDP growth, which has morphed into recession in some provinces, has been accompanied by a series of speculative bubbles in the financial markets, two serious breakdowns in the stock exchanges in July 2015 and January 2016, as well as a significant outflow of capital abroad. **China's entry into a period of economic slowdown and deep economic instability has prompted the party's top leadership to change its view about the most desired speed and scope of reforms and adopt much more cautious positions than in 2013, when the third plenum's agenda was initially announced.** The party leaders also sometimes resort to tested tools of economic intervention. Meanwhile, a heated debate is going on within the top ranks of the CPC and among economic experts about what kind of economic policy would be most adequate in the current conditions of slower growth and stagnating reforms.

The CPC leadership may be deliberately delaying any measures which involve the risk of uncontrollable economic developments such as a sudden slowing down of the GDP growth rate, drastic breakdowns in the financial markets or a sudden increase in unemployment. Deepening certain market reforms would be equivalent to giving up important tools of economic governance, which the Chinese leadership may use to buttress economic stability if needed. **In recent years, when the Chinese leadership faced major threats, it often opted for deep ad hoc intervention using tried and tested tools, which in many instances meant**

taking a step backwards from the pro-market agenda of the third plenum. The involvement of state financial institutions in interventions to save the stock exchange in 2015 may serve as an example here, as it resulted in a massive *de facto* nationalisation of the companies listed in Chinese stock markets and the introduction of strict regulations in the financial markets.[71]

The prime example of this cautious approach on the part of the Chinese leadership concerns the supply-side reform, which was made a priority in 2016. **Unlike the reforms that were included in the original third plenum agenda, it is not about resolving China's most urgent economic problems of debt, overproduction and inefficiency through a broad, structural reconstruction of the market environment which would then enforce adjustment processes by exposing companies to heightened competition. Instead, it relies on administrative instruments to administer some 'bloodletting' to the Chinese economy in a controlled manner.** The reliance on political means may be a reaction to a genuine stagnation of the key pro-market reforms, which makes it necessary for the reformers to focus all their political clout on one project, but it also means a return to the long-used, relatively safe methods of economic governance. As on many occasions in the past, the quotas for the reduction of redundant production capacity are set by the NDRC for specific industries and provinces, and implementation in the regions is then enforced using political channels. The administrative mechanism is used to attain other objectives of the reform, such as alleviation of debt, which is done using state financial institutions specially established for that purpose and tasked with collecting and writing down bad debts, as was the case in the 1990s.

71 Another example concerned the imposition of additional restrictions on the convertibility of the renminbi in reaction to the massive outflow of capital in 2016 – a move which ran counter to the policy of opening China's capital account.

Given the prospect of a further slackening of GDP growth in China, the biggest question is the one concerning the Chinese leadership's attitude towards using the established economic stimulus instruments. This question is one of the most significant points in the dispute within the CPC top leadership, as illustrated by the situation triggered by the publication, in May 2016, of an extensive commentary about the role of stimulus in implementing the supply-side reform on page two of the government newspaper, *Renmin Ribao*. The commentary was published in the form of an interview with an unnamed 'authoritative person' (*quanwei renshi)*[72] and was a reaction to the economic policy developments in the preceding months when the Chinese authorities, expecting the new reform to have a negative impact on economic growth, decided to implement additional stimulus measures in late 2015 and 2016. Among other measures, monetary policy was eased, new infrastructural projects were launched and SOEs considerably increased investments, reinvigorating the growth of commodity prices and heavy industry. In the interview, the 'authoritative person' expressed damning criticism of such policy, describing the potentially 'lethal' threats coming from the piling up of debt (risks for the financial markets, recession, loss of savings by the public) and arguing that short-term stimulus was based on 'fantasies' about the possibility of quickly restoring rapid GDP growth while, in reality, the growth rate should be expected to enter a downward trend. In that situation, the priority should be to gradually reduce the debt pile, reduce overcapacity, etc. The text named neither the author nor the direct addressee of the criticism, but there is consensus among experts that the top leadership of the CPC had been involved in its publication.[73] The

72 开局首季问大势, *Renmin Ribao*, 09.05.2016, http://paper.people.com.cn/rmrb/html/2016-05/09/nw.D110000renmrb_20160509_1-02.htm

73 The most common interpretation is that the 'authoritative person' is Liu He, Xi Jinping's chief economic advisor, head of the Leading Group for Finance and the Economy and the main author of the *supply-side reform* concept. The main addressee would then be prime minister Li Keqiang who, on the account of his position, is Liu He's main political adversary in the battle for control of China's economic policy. See: Barry Naughton, *op. cit.*

incident should be seen as proof that there is indeed a split within the top ranks of China's leadership between a group arguing that the country needs to 'tighten its belt' now, and a group which believes that stimulus is the way to get through the difficult times.

V. OUTLOOK FOR THE FUTURE

The pro-market agenda put forward at the third plenum in 2013 to redefine the role of the state in China's economy has stumbled on a number of obstacles during Xi Jinping's first term, as a result of which the crucial reforms have been stagnating. The factors which contributed to this included defects in the new reform architecture, resistance from sections of the bureaucracy interested in preserving the *status quo*, as well as the economic problems which prompted the party's top leadership to act inconsistently. Because some of those problems are political in nature, the 19th congress of the CPC, which takes place in the autumn of 2017, may potentially be the single most important event for the continuation of reforms. In keeping with the informal rules on key nominations observed within the CPC, a 'new opening' is to be expected within the top ranks of the party leadership – at least 11 of the 25 members of the Politburo will be replaced, including 5 out of the 7 members of the Standing Committee (the party's most important body).[74] The political decisions taken at the congress will translate in early 2018, after the inauguration of the 13th term of the National People's Congress, into reshuffles within the state administration.

There are many indications that the coming CPC congress will enable Xi Jinping to use his political position, which has been strengthened considerably in recent years, to place his people in the most important party bodies and central state administration institutions.[75] That would lead to people associated with Xi's circle being appointed to key posts, which would facilitate building consensus between the most important centres of power and might resolve some of the conflicts over division of responsibilites, which have been paralysing the current reform architecture. Also important

[74] Those numbers may change – because the rules for selecting new members are not formalised, the secretary general may adjust the specific numbers.

[75] In an extreme scenario, Xi could even decide to replace Li Keqiang and appoint a new prime minister.

will be the steps that may be taken to refine the tools for disciplining the administration and consolidating the new system of incentives for local officials, in order to get them involved in the reform process. In the new political arrangement, market reforms may be resumed – as the vision of reforms laid down in the documents of the third plenum remains valid and largely addresses the long-term challenges facing the Chinese economy.

Nevertheless, the scale of challenges remains huge, and the continued use of stimulus measures in recent years has made the situation of the Chinese economy even more complicated. **In order to fix the foundations of the economy by resuming the agenda of the third plenum, the CPC leaders will have to commit considerable organisational and political resources, which they consequently will not be able to use in other areas of state governance. The fate of reforms will thus depend on the individual calculations of Xi Jinping and his circle, who will have to weigh the long-term benefits for the state and party that returning to path of stable growth could offer against the short-term benefits that can be gained by resolving *ad hoc* problems.** In that sense, the success of reforms will depend primarily on the dynamics of China's GDP growth, as well as the minimum growth threshold below which the Chinese leadership would opt for stimulus again. The reforms are likely to be affected by unpredictable economic phenomena, such as sudden breakdowns in the shaky financial markets or shocks in the global economy, i.e. the kind of events which the Chinese leadership to date typically strove to resolve at the expense of its reform agenda. Preserving growth 'at any cost' could be one of the tools to ease the internal social tensions. Finally, unpredicted external developments may also be an important factor, such as a rise in international political tensions, which might prompt the Chinese leadership to continue the unsustainable stimulus policy in order to be able to maintain room for manoeuvre in foreign policy.

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