The long weekend

China's leaders will soon reveal their ambitions for economic reform

Running the world's biggest country requires sacrifice. For the Communist Party's top 376 officials on its central committee, the sacrifice includes the occasional weekend. From Saturday November 9th until the following Tuesday, they will gather in Beijing for the third time since Xi Jinping became head of the party nearly a year ago. The "third plenum", as this meeting will be called, is the new leadership's chance to lay out its stall on economic reform. In the past similar gatherings have shaken the world. The third plenum in 1978, for example, sealed Deng Xiaoping's authority over the party, allowing his vision of "reform and opening up" to prevail. Another third plenum, in 1993, set the stage for a ruthless shake-out of loss-making state-owned enterprises (SOEs).

If the past provides the inspiration for ambitious reform, the present furnishes the compelling need for it. In recent years China's growth has slowed significantly to under 8%—and were it not for a timely fiscal stimulus would be slower still. Some of the slowdown is inevitable, the consequence of a diminishing technological gap with the rest of the world and a declining working-age population. But two other macroeconomic trends are causing concern. The investment spending sustaining China's growth appears to be yielding sharply lower returns. At the same time, credit is growing faster than GDP (see chart 1). It suggests that people are borrowing to buy assets, particularly land and property. The more these assets appreciate, the more people borrow.

Will Mr Xi rise to the occasion? He has done nothing to downplay expectations. As the son of an early revolutionary leader, he seems more comfortable in power than his predecessor, Hu Jintao, who ran a disappointing third plenum ten years ago. He has already imposed his style on the presidency, dispensing with some of the pomp and extravagance that used to attend the position. Perhaps, like aristocrats everywhere, he feels free to break with established practices because it was people like him who established them.

In taking a keen interest in economic reform, Mr Xi has encroached on the formal responsibilities of the prime minister, Li Keqiang, who oversees the economy. This is not unprecedented: Jiang Zemin, president from 1993 to 2003, also busied himself with economic affairs, Helen Qiao of Morgan Stanley points out. It is also potentially a good sign. Both the president and the prime minister share similar views about reform. By engaging in economic matters, Mr Xi is presumably backing his prime minister rather sidelining him.

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Reformers sit throughout the government. Zhou Xiaochuan, who helped clean up the banks in Mr Jiang's time, has been governor of the central bank for a decade. From there he can oversee the liberalisation of interest rates, exchange rates and capital flows. The finance ministry is now headed by Lou Jiwei, another accomplished technocrat who previously ran the China Investment Corporation, the country's sovereign-wealth fund. Under Mr Jiang, he helped reclaim a bigger share of the country's fiscal revenues for the central government. Under Mr Xi he may have to revisit that fiscal settlement, giving a bigger share back to local governments. Even Wang Qishan, a tough-minded financial expert who does not have an economic brief in this government, may yet exert a powerful if indirect influence on reform. As head of anti-corruption efforts, he is an intimidating figure for any compromised SOE boss hoping to obstruct progress.

The road map Mr Xi will submit to the third plenum has been months in the making. It draws on the advice of China's ministries and the wider network of official research institutes and think-tanks. To knit it together, Mr Xi has appointed Liu He, a thoughtful, reform-minded policy adviser who was educated at Harvard's Kennedy School and whom Cheng Li of the Brookings Institution once compared to Larry Summers, the brilliant academic who became Barack Obama's economic guru. As a technocrat, Mr Liu has no power to impose his own ideas. But in picking him, Mr Xi clearly endorses some of the things he stands for.

Mr Liu used to work for the Development Research Centre (DRC), an official think-tank serving China's cabinet. He had a hand in the "China 2030" report published last year by the DRC and the World Bank, which detailed the reforms China would need over the next two decades. In recent days China's media has been abuzz with another DRC reform plan, known as the "383" plan, which is equally ambitious. It sets out three overarching reform principles ("effective markets require effective states and vice versa" is one), no fewer than eight reform priorities (cutting red tape, breaking up monopolies, reforming land ownership, liberalising finance, reforming the public finances, reforming state-owned enterprises, promoting innovation and opening up to foreign investment) and three broad strategies for achieving them.

The 383 plan shows that China's government has its own in-house advocates of liberalisation. It is not only outsiders (let alone just foreigners) who champion the cause of sweeping economic reform. However, the DRC is free to espouse what is desirable without much concern for political feasibility. Mr Liu no longer enjoys that luxury. His plan may echo the 383 plan's opening refrain that the state and the market must evolve together. But how much of the middle eight will make it into the plenum document is unclear.

The central committee can be expected to endorse the government's efforts to cut red tape. It will promise to spend more on pensions, health care and affordable housing. It may also raise taxes on natural resources and further liberalise electricity prices. But it is unlikely to take on the fiscal and SOE reforms that are necessary to redress the gross misallocation of capital.

Fiscal reform is difficult because it requires the central and local governments to renegotiate the division of revenues and responsibilities, says Shen Jianguang of Mizuho, a Japanese bank. Local-government outlays, especially at the county level, run far ahead of local revenues (see chart 2). This spending is also often wasteful. Local governments scramble to promote industrial activity rather than public amenities, poaching trade and investment from their neighbours by duplicating whatever worked next door.

Both problems would be eased by an annual tax on the market value of properties. It would provide a stable source of revenues for local governments, helping to bridge the gap between their receipts and outlays. It would also encourage local governments to invest in public goods, such as clean air or better drainage, that raise the value of properties, thereby increasing the tax base. Despite its theoretical appeal, such a tax does, however, pose some practical difficulties, including the need for up-to-date registers of ownership and credible calculations of a property's value. Overcoming those obstacles will serve as one test of Mr Xi's reform credentials.

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State enterprises are another source of wasteful investment. After the 1993 plenum, thousands of loss-making SOEs were sold, scrapped or merged, resulting in about 40m people losing their jobs. But in recent years, the retreat of the SOEs has ground to a halt (see chart 3).

Not even the DRC envisages outright privatisation of the SOEs. Its 383 plan looks instead to Singapore's Temasek, a state-owned holding company, as a potential model. The state could be a patient, long-term investor in enterprises, seeking to maximise the value of its holdings. Xiao Geng of the Fung Global Institute in Hong Kong advocates that the government's stake in the SOEs should be held by the National Social Security Fund, which was set up to plug the gaps in China's pensions.

The SOEs shuttered in the 1990s were loss-making drains on the exchequer. Many of the remaining SOEs, especially those owned by the central government, are profitable, however. That makes them far more difficult to cull: they are sacred cows because they are cash cows.

Unfortunately the SOEs' nominal owner does not greatly benefit. The SOEs pay too little in dividends, and what they pay is collected not by the finance ministry but by the State-owned Assets Supervision and Administration Commission (SASAC), which oversees them. It then ploughs these earnings back into the SOEs under its purview. Another test for Mr Xi, therefore, is dividend policy. He will pass if SOEs are required to pay higher dividends and to pay them not to SASAC but to the central government's coffers.

Given the obstacles they face in improving SOEs and local public finances, China's budding reformers will press ahead where they can, in the hope that half-measures build momentum to finish the job. In some cases, this strategy may work. In allowing shadow banks to proliferate, for example, China's liberalisers have created pressure for interest-rate deregulation. Until formal banks are allowed to raise the rates they pay on deposits, they will lose customers to lightly regulated alternatives offering higher yields.

Yet there are potential dangers to this "skewed reform", as Louis Kuijs of the Royal Bank of Scotland puts it. Were China, for example, to liberalise interest rates and capital flows without removing any of the SOEs' privileges, it might find that finance simply flows more freely to the same firms that already gobble up more than their fair share. Even commercial lenders, able to price risk and set interest rates freely, would be keener to lend to big firms that dominate their markets and can count on the state should they ever get into trouble.

China's leaders set great store by gradualism. Even the momentous 1978 plenum changed the country by increments in the following months and years. But gradualism is not the same as inertia. It has been many years since the last big changes. If China's leaders wait another five or ten years to renew the momentum of reform, the consequences will take more than a long weekend to fix.

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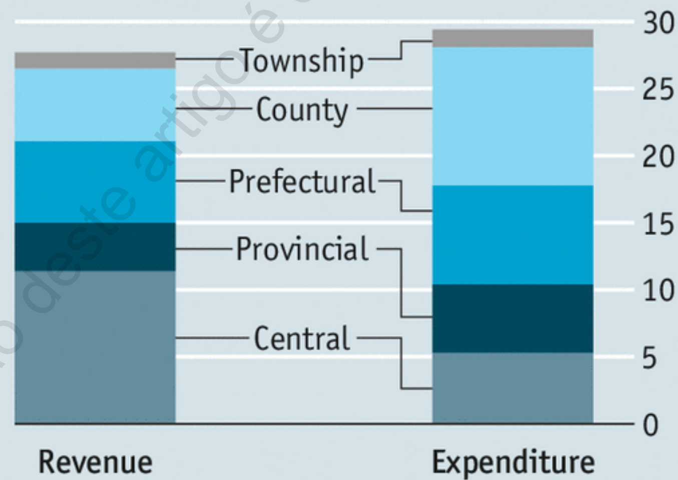

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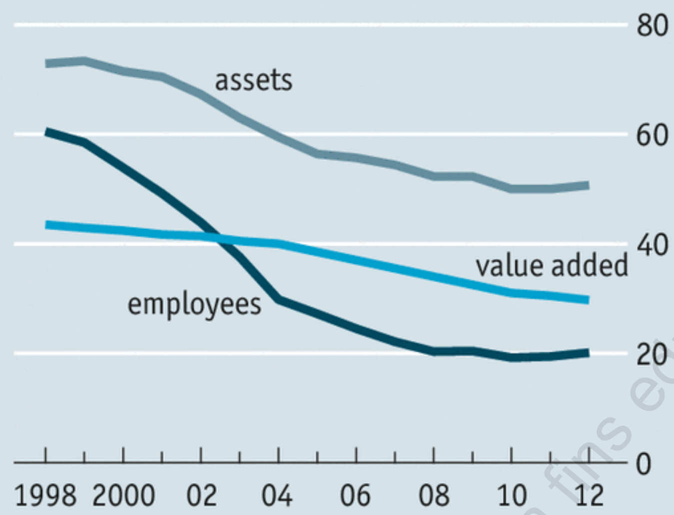

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