January 25, 2013

"I cannot forecast to you the actions of Russia. It is a riddle, wrapped in mystery, inside an enigma."
-WINSTON CHURCHILL

The above line from Sir Winston, who unquestionably was one of the most prodigious quote-miesters of all time, could easily be applied today to that other former arch foe of the west: China. Most outside observers look at the Middle Kingdom with a collage of impressions, including awe, fear, suspicion, and confusion. Yet, I doubt that the typical westerner is aware of how prevalent these same views are within China itself.

In this month's guest EVA we are showcasing an essay written by David Kelly, Amanada Rasmussen, and Erlend Ek of the firm China Policy. This fine piece came Evergreen's way via our partner, GaveKal Research, in its recent China Economic Quarterly. It highlights how intense the internal debate is in China, even at the highest policy-making levels, on what the next stage of its economic miracle should look like.

Non-Asian readers may be surprised to learn that the Chinese leadership is extremely divided as to whether to continue down the path of "people's capitalism," which has largely been led by China's behemoth state-owned enterprises (SOEs), or to gradually, or even suddenly, emasculate these entities. Despite the tight media control that is the classic signature of what remains a Marxist state, the Chinese populace is becoming increasingly restive as the people witness on a daily basis the dark side of China's meteoric economic ascent.

My close friend Louis Gave was in Bellevue last week and shared an anecdote that illustrates just how problematic China's development has become for its citizens. Louis splits time between his residences in Hong Kong, Whistler, B.C., and Bartlesville, Oklahoma (now, that is some serious cultural diversity!).

Fortunately, for the last month he and his young family have been in the pristine environs of Whistler. Fortunate because he told me that about 10 days ago Hong Kong registered an air pollution index (API) of 150.   At that level, children are not allowed to go outside for recess and outdoor laborers like construction workers are told to stay home. Yet, incredibly, on the same day the API in Beijing was 900!

Consequently, the heavy industry development model that has been (and has provided) China's bread and butter for the last 30 years is literally becoming toxic to the country's health and welfare.   Additionally, the populace is showing growing intolerance for the corruption that has permeated so much of the ruling class. The top managers of China's SOEs have shown far more imagination when it comes to laundering their ill-gotten gains through Macau (often with a final destination in Canada) than in creating product innovation and enhanced job opportunities.

Obviously, what happens in China should be of interest to nearly all of us, especially those who believe that Chinese stocks and/or bonds offer refuge characteristics during a time when Western governments seem intent on massively depreciating their currencies. Therefore, I believe EVA readers should pay special attention to this intriguing view of the political forces colliding in China right now.

David_Hay_Signature

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SIX TRIBES
By David Kelly, Amanda Rasmussen and Erlend Ek

If there is one truth about the capitalist system, it is that markets produce inequality. Solving this problem was a major part of what a state-owned, planned economy was designed for. For the revolutionaries who followed Mao Zedong to victory, the Soviet model was the light on the hill: a way out of poverty and dependence that would rival capitalism in terms of economic performance, while also delivering social justice. At its core for half a century was an unwavering belief in public ownership, embodied in a vast web of state-owned enterprises (SOEs).

Today that belief is embattled. The cause of its decline is an open scandal: inefficient and wasteful SOEs are not only failing to deliver social justice, but are a major cause of China's accelerating inequality. In theory, SOEs are supposed to act in the interests of the state. Yet experience shows that China's state-owned economy, like its Soviet predecessor, is much better at breeding inefficiency and enriching a privileged elite. Instead of sacrificing self-interest for the greater good, many SOE managers are essentially free-loaders, jealously guarding their monopolies. Severed from the profit motive and hidden behind the protective curtains of the state, they are in a perfect position to take their nominal owners—the public—for a ride.

Nevertheless, state capitalism continues to hold sway. Industrial strategy is focused on creating a "national team" of state behemoths that can dominate strategic industries at home and compete with foreign multinationals abroad. But that does not mean that SOE reform is off the agenda. Indeed, as China's economy slows, there are already signs that the policy pendulum is inching from left to right. Leftists who supported the "Chongqing model" of state ownership associated with its disgraced Party chief Bo Xilai are in retreat, while proponents of market reform are advancing. Notably, the leading champion of liberalizing reforms is the Development Research Center—the State Council's very own think tank.

Let half a dozen schools of thought contend
The policy debate in China can be divided into six major lines of thought, forming a broad political spectrum from left to right—from Marxist diehards who would return to an all-out planned economy to neo-liberals who would abolish SOEs altogether. The dividing lines are not always between identifiable groups, and it is not unusual for participants to subscribe to different positions at different times—or even at the same time. Few serious thinkers deny that inefficient SOEs need to be reformed. But differing views on how to prioritize these aims, and what

measures should be used to implement them, are—to say the least—politically divisive. Unsurprisingly, the most influential views fall in the middle of the spectrum.

1. Old Left

The Old Left are planned-era loyalists, who still adhere to the basic tenants of Marxist-Leninist and Mao Zedong thought. The class-struggle model of history still resonates, holding its place beside the newer doctrines of Jiang Zemin’s "Three Represents" and Hu Jintao’s "social harmony." State ownership is prized as a tool of class struggle, as it replaces the exploitative capitalist entrepreneur with a state-appointed manager who exists to serve the people. This sort of deeply conservative thinking remains surprisingly pervasive: many thinkers and Party officials still argue within a broadly Marxist framework. And all official policy documents continue to adopt a traditional Communist tone, even if actual policy is usually more pragmatic than ideological.

2. Holdouts

Defenders of the status quo include patriotic populists and those who stand to lose from reform, especially officials and SOE managers. Unlike the Old Left, they no longer bother talking about the evils of social inequality or class exploitation. Holding tight to the status quo out of self-interest, they view the SOE system as an intrinsic element of the "China model." What failed in the Soviet Union, the holdouts claim, works in China—just observe the country’s double-digit growth and elevation of 400m people out of poverty. For them, the paradox of SOEs causing inequality is a temporary problem that can be overcome. One prominent defender of the SOE model is freelance economist Du Jianguo, who launched a public tirade against World Bank chief Robert Zoellick during a press conference about China’s reform trajectory in 2012. For Du, all talk about privatizing SOEs is a foreign plot.

3. New Left

The New Left has a small activist core and a broad but vague following in universities, think tanks and policy circles. In the 1980s, New Leftists shared the populist allegiances of the early post-Mao era "new enlightenment" movement, which supported new jobs for urban workers and rural migrants. But they split from other leftist liberals in the late 1990s after witnessing the painful consequences of Premier Zhu Rongji’s decision to dismantle SOEs and lay off millions of workers. Absorbing criticism of "neoliberalism" imported from Western academics, the New Left accused liberal reformers of market fundamentalism. But with China’s global rise in the 2000s, they began to move away from their populist base. Instead they voiced support for the "China model" of state capitalism, which envisaged the profits reaped by big SOEs trickling down to ordinary people. Many championed the development of the populist "Chongqing model," under which SOEs were mobilized by the government to help fund social security programs.

Prominent members of the New Left have shifted their positions over time—and 2012 has rung further changes among them. Peking University’s Pan Wei and Tsinghua University’s Cui Zhiyuan, formerly a prominent adviser to the Chongqing government, have moderated theirvocal support for the Chongqing model following the demise of Bo Xilai. The economicslowdown has prompted Yang Fan, an economist at China University of Political Science andLaw, to join reformist critics calling for "balanced development"—economic developmentalongside social development and environmental protection. Yang argues that reformsassociated with liberal market principles are not by definition anti-socialist, but he shies awayfrom recommending wholesale market reforms to get there. Yang and Cui argue that SOEdividends should be sent to a special state security fund—an idea that runs close to someofficial views and has received support from reformists such as Tsinghua University economistBai Chong’en.

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4. Sasac’s cheerleaders

The State-owned Assets Supervision and Administration Commission (Sasac) champions the emergence of a "national team" of powerful, central SOEs. Counting Chinese members of the

Forbes 500 list like Nobel Prizes or Olympic gold medals, its cheerleaders are adamant that the aim of SOE policy should be to foster international competiveness. Sasac director Wang Yong and deputy-director Shao Ning want to tweak the status quo to develop Chinese Toyotas—globally powerful companies that are also crucibles of innovation. The most efficient system, they say, would be to divide SOEs between those that can become globally competitive and those which provide a buffer against potential instability by employing workers. Smaller SOEs that fulfill neither of these functions should be merged or privatized.

One influential proponent of Sasac's central role is Hu Angang, the director of the Center for China Studies at Tsinghua University. Hu is identified as a prophet of the mid-1990s tax reforms, which reasserted central-government control over the country's purse strings. The "national team" meme also enjoys support from the influential Global Times, a patriotic newspaper which argues that SOEs and private companies should work together at home in order to be more competitive abroad. Other SOE cheerleaders stress the economies of scale provided by monopolies in public utilities. State Grid Company CEO Liu Zhenya, for example, argues that the state's monopoly over the transmission and distribution of power is needed to prevent the kind of power shortages that have plagued India since it privatized its own electricity industry.

5. Reformists

Reformists believe that wholesale changes are needed to current policy to make SOEs more productive. These critics were pushed out of the limelight during the stimulus years of 2009-10, but they have regained influence as economic growth has slowed. One notable proponent is the Boyuan Foundation, a Hong Kong-registered think tank that represents liberalizing factions of China's political and business elite. Boyuan was founded by former China Merchant Bank chief Qin Xiao, who argues that the state has no long-term need of SOEs. A member of the Communist party aristocracy with a Cambridge PhD in economics, Qin explicitly views himself as a "public intellectual." The Boyuan Foundation's influence among top policy makers means it has the potential to play an unusually significant role in the SOE debate.

Far more influential, however, is the Development Research Council (DRC), which sits within the central government policy sphere. The DRC's joint report with the World Bank, China 2030: Building a Modern, Harmonious, and Creative High-Income Society, outlines the reforms China needs to make to complete its transition to a market economy. The DRC's concern is that the current political and economic elite enjoy excessive privilege and undue power, leaving China at risk of being caught in a middle-income trap. It argues that proper accounting of SOE assets and liabilities, rolling back Party influence, and introducing more free market principles are matters of urgency. The DRC's Chen Qingtai says the government should ensure that SOEs are carriers of "public capital"—meaning they should be responsible for cleaning up and caring for the communities they affect by their resource extraction, manufacturing, and delivery of utilities.

6. Abolitionists

Abolitionists take the reformist critique to its natural conclusion. Academics Xu Xiaonian (China Europe International Business School in Shanghai) and Lang Xianping (China University of Hong Kong) have hinted that Sasac should be abolished. SOEs, they argue, are citadels of elitism and prone to potentially ruinous over-investment. They point to the debt created by the economic stimulus of 2009-10, which they describe as akin to "drinking salt water when you're thirsty." More market-oriented reform is necessary, they argue, to ward off the dangers of slow growth.

The list of policy intellectuals taking this general proposition has lengthened greatly this year:

Wu Jinglian at the DRC, Ceng Ke at Peking University, Zhang Liwei at the Sichuan Academy of Social Sciences, and Mao Yushi of the Unirule Institute of Economics (an independent think tank) are only a few. Zhang Weiying, senior economist at Peking University's Guanghua School of Management, argues that workers and enterprises should be left entirely to rise or fall with market forces. Via this "learning process," he contends, the country will develop. Chen Ningyuan, a financial columnist, says Sasac should cut loose and privatize SOEs that operate counter to market principles, especially where they have little specific expertise or comparative advantage over private enterprises.

Efficiency vs equity

Most thinkers on the right favor privatization, but as a first-step compromise argue that efficiency and equity will best be reached by placing SOEs in market conditions under the rule of law. The job of government regulation is merely to iron out the worst excesses of the market. Whether SOEs are privately or publicly owned is less important, in this view, than the consistent and transparent application of laws and regulations. At the other end of the political spectrum, the left portrays China—a still developing country with a wide and widening income gap—as under siege from the West. That means government, SOEs and private enterprise must band together. The Chongqing model briefly offered hope of a way out in which the government regulated the market while insisting on corporate companies' commitment to social justice.

The right emphasizes the need to make the rules of the game clear; the left wants to keep the rules fuzzy. The right wants the government to reduce its role to that of referee only; the left would prefer it to remain a player as well. The right uses the rhetoric of universal values, rule of law, transparency and accountability; the left is more concerned about ensuring "people's livelihood" through greater government interference.

What impact will these arguments have on actual policy? Reformers do have some influence: China's leaders know that the current SOE status quo is unsustainable. There are signs that the cry of "All power to the SOEs," led by Sasac's cheerleaders, reached its peak in 2009 during the economic stimulus. Since then, the voices of reform have got louder. But moderate reforms are far more likely than root-and-branch privatization. That means tweaks to sustain SOEs as national champions, minor market reforms and transparency measures to boost their efficiency, and mild re-distributive measures to shore up social security. So long as a powerful elite continues to benefit from the status quo, the scandal of waste and ill-gotten gains in the state-owned sector is unlikely to be rectified.

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