A fierce battle hobbles China’s march to the market
>By Richard McGregor
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Liu Guoguang, a once influential but long retired Marxist economist, recently burst back onto the scene with an incendiary warning for the Chinese government. If it did not rein in market reforms and deal with the growing, gaping rich-poor divide, China would “change its colour”: code for the “red” Communist party losing power.

Mr Liu is not the first planned-economy throwback to rage against the market during China’s quarter-century of liberalisation but very few have received as much attention. Almost overnight, symposiums were staged around the country to study his “economic thought”, including one at Ya’nan, the Communist party’s old revolutionary base.

“The government has already lost control of many sectors and, of the state enterprises that are left, we seem to be willing to sell them, to foreigners or anybody,” says Liu Rixin, a longtime senior planning official.

Nostalgia aside, the words of the retired economist resonated so widely because he explicitly linked the survival of single-party rule to the maintenance of a dominant role for the state in the economy. The nexus between the two is rarely so openly acknowledged but it is the central underlying issue in a finely balanced, highly politicised and often very nasty battle over economic policy under way in China.

It will have a bearing on all manner of reforms, such as privatisation and foreign investment in the finance sector. Some measures have already been delayed – such as a law to clarify private property rights, a reform vital to empower individuals fighting against arbitrary confiscation of their assets.

The debate has gained extra edge in the lead-up to next year’s once-in-five-years Communist party congress, where the top leadership posts will be decided for 2007-12. The congress is expected to confirm president Hu Jintao and Wen Jiabao, the prime minister, for a second five-year term – but that is only half the struggle. They will also want to ensure that their loyalists dominate the Politburo, to solidify their own line of succession.

On one level, the attack by the elderly economist seemed to symbolise a backlash against Mr Hu’s government. But such straightforward interpretations no longer apply in a China where few debates fit neatly into an old-style Marxists-versus-the-market template. How, after all, could Mr Hu be criticised for the rich-poor gap when he, along with Mr Wen, has made tackling it a centrepiece of his economic policy?

When Mr Hu took over from Jiang Zemin three years ago, he inherited a country wealthier than it had been for generations but also more unequal. China is now less equal than the US and Russia, according to the World Bank, and income inequalities are still widening. And while incomes have mostly risen across the board, the social wage – the hallmark of the old system, which provided free health, education, housing and an old-age pension – has been drastically cut, all but disappearing in the countryside.

China spends less than one-fifth of the developed-country average on health and education, according to a report this month by the Organisation for Economic Co-operation and Development. In rural areas, where China's poorest communities live, nearly 90 per cent of health costs are borne by individuals. Even as official poverty levels have been falling and literacy rates rising, education researchers are discovering that drop-out rates among rural children from junior secondary schools average 30-40 per cent. "This is the most under-reported story in China – the country's massive failure to educate its rural youth in the 1990s," says Yasheng Huang of MIT Sloan School of Management.

Mr Hu and Mr Wen did not shy away from these problems when they took power. Instead, they embraced them, declaring that addressing the rich-poor gap and improving the lot of those left behind by the boom years, especially farmers, would be a hallmark of their administration. Their policy response, however, has so far satisfied few of the warring camps in the debate and the leadership is under fire from many directions. Mr Hu and Mr Wen "have opened their flank because they have promised a New Deal", says David Kelly, of the East Asian Institute in Singapore.

To old Marxists such as Mr Liu, Mr Hu and Mr Wen have not done enough to uphold government – and, by implication, party – control of the economy. Alongside them, as part of a loose ragtag coalition that marches under the "anti-reform" banner, celebrity economists such as Lang Xianping, who fronts a popular television show in Shanghai, have criticised privatisation as a slow-motion Russian-style theft of state assets.

Many mainstream economists counter that the Hu-Wen administration is shaping up as a disaster precisely because it refuses to tackle the state's still dominant role. For these economists, pushing the rich-poor gap to centre stage is simply a device by the leadership to increase the role of the state in business. "A government or a party that is not elected by the people is constantly under pressure to justify its legitimacy, so this acted as a kind of negative political campaign to distance themselves from their predecessors," says one Shanghai-based economist. "They then use this to argue for government intervention, for a very visible hand, and that benefits the officials themselves."

For the Marxists, the growth in inequality and popular disenchantment with reform are directly related to the rise of the entrepreneurial economy and private wealth. Mr Huang at MIT turns this proposition on its head, asserting that the backlash against "reform" in China is in fact rooted in disenchantment with a state-controlled economy that is acting against the public interest.

“The resilience of the state sector is a result of vast, powerful vested interests, powerful because so many of the remaining state enterprises are essentially wholly-owned subsidiaries of government agencies,” he says. “The best examples are the health and education sectors. Price inflation in these sectors since the mid-1990s has been rampant. At the same time,private entry into these two sectors has been minimal. Bureaucratic windfalls are enormous.”
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State monopolies and oligopolies retain tremendous power to keep competitors from entering their sectors. For example, Chalco, the sole supplier of domestic alumina in China, has defended its monopoly by refusing to grant potential rivals licences for the technology needed to refine China’s peculiar low-grade bauxite. It has done so with the support of the ministry in charge of the sector.

In telecommunications, the Ministry of Information Industry has overseen at times chaotic oligopolies in the fixed-line and mobile businesses, shuffling top executives between companies to ensure they retain their ultimate loyalty to the government, their owner, and not the brand. Wu Kegang, president of Yunnan Hong Wine, a private spirits company in south-west China, recently lamented his fate in such a business environment. “As entrepreneurs we are condemned either to being the concubines of state enterprises or the mistresses of multinationals.”

Some economists believe the disabling impact of such official rent-seeking is exaggerated. “There are profits to be made [in telecoms, for example] but, if you look at the return on equity of these guys compared to single monopoly providers in other countries, it is night and day,” says Jonathan Anderson, chief economist for the Asia-Pacific at UBS in Hong Kong.

Nicholas Lardy, of the Institute for International Economics in Washington, is a strong critic of the Hu-Wen administration’s “miserable failure” to quell credit growth in 2003 and 2004 and their foot-dragging on the reform of China’s currency. But he sees more favourable omens flowing from the government’s deregulation of interest rates, allowing banks more flexibility to lend to entrepreneurs. “Interest rate liberalisation is a very strong benchmark of reform and it has probably resulted in stronger lending to the private sector,” he says.

In the one area that there is a consensus on the need for urgent action – the countryside and small villages where most Chinese live – there is also increasing division about the proper response. Under a policy named the “New Socialist Countryside”, Mr Hu and Mr Wen have begun to roll out measures for the rural sector, including grain and livestock subsidies, tax cuts and extra infrastructure, health and education spending. The battery of measures is intended to have a quick impact. “[Hu and Wen] do not much believe in trickle-down. And even if they did, they are impatient,” says Stephen Green, of Standard Chartered in Shanghai.

China’s direct subsidies to farmers are low by international standards, although they measure slightly higher when all spending, including infrastructure, is counted. The new policies have already had an impact on poverty in some rural areas – but critics say they threaten to create an aid dependency on China’s small and mostly uneconomic farms in the process. Liu Fuyuan, head of a government think-tank in Beijing, says the aim of the “New Socialist Countryside” is laudable but the policy is “wrong”. “The only way out of this corner is not to subsidise farmers but to make sure that we have fewer of them,” he says. “So we must make them move to the cities.”

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In rural areas the most sensitive issue, and one the government so far has dared not touch, also revolves around giving greater play to the market, with all the risk that entails. City residents can now buy and sell their homes but rural land remains under collective ownership and cannot be traded by farmers.

As a result, land in rural areas has less than 10 per cent of the value of urban land, according to a report by Zhou Tianyong, of the Central Party School in Beijing. “And that is a conservative estimate,” he says. Other Chinese researchers say that rural land can be worth as little as 2 per cent of the value of urban land.

Such differentials offer an irresistible financial incentive to corrupt officials to take rural land, reclassify it and sell it on for homes or factories. The central government understands this but fears that allowing farmers to sell their small lots would leave tens of millions of them without land, which has in effect been their safety net. Such a reform, Beijing fears, could lead to discontent and insurrection.

The mass appropriation of land and assets, in both cities and in the countryside, by officials or businessmen with government connections in the last decade has also been the main factor in a backlash against privatisation in the last year. Not all of it has been corrupt but China’s hazy ownership laws mean much of it was conducted quietly, without oversight and has brought handsome returns. “That was good economics but it had negative political consequences, since ‘bad privatisation’ ultimately causes a political backlash,” says Mr Green. “The party has also realised that its legitimacy comes not alone from delivering growth but also from ensuring that this growth is shared.”

Li Qingyuan, a veteran official and executive in the finance sector, takes a more sanguine view of where the current debate will lead. It is nothing like the “scary discussions” of the early 1990s, she says, when there was a genuine leftist resurgence in the wake of the 1989 Tiananmen Square crackdown. “This kind of argument comes up from time to time but I don’t think it will last long and obstruct the pace of reform,” she adds. “The general trend is irreversible.”

But that is precisely what worries the Marxists the most. For the octogenarian Mr Liu, until recently written off as a dinosaur in the debate, it is the most powerful argument in years he has been able to muster for reining in the market economy. Such reforms mean a larger private sector and a smaller state – and, ultimately, greater pressure for a more pluralistic politics and institutions able to adjudicate economic disputes free of arbitrary political interference.

But while Mr Liu and the party have allies among an entrepreneurial elite dependent on government favours to build their businesses, it is an alliance that is increasingly resented and under attack. “If westerners think the current growth model can be maintained,” says the Shanghai-based economist, “they are making a big mistake.”

Additional reporting by Sun Yu

OMINOUS UNDERTONES OF AN ATTACK ON REFORMS

Zhou Xiaochuan has been an unusually activist governor of the People's Bank of China, promoting foreign investment in finance and steering reforms of interest-rate and currency policy through a cautious and often suspicious bureaucracy.

So for anyone attuned to the subterranean rhythms of Chinese politics, an article published last month in a small Hong Kong newspaper attacking Mr Zhou had ominous undertones.

The article gave him no credit for his policy work as central bank chief, instead damning him as unprofessional. His support for market devices such as derivatives would attract foreign "wolves" into China and lead to an explosion in bad debts. "As Zhou gave more and more public speeches, people have been unable to figure out whether the central bank governor was speaking on behalf of the country or just himself," the article said.

This last reference, to Mr Zhou's apparent ambition, gives the lie to the attack and underlines how much economic policymaking has become caught up with top-level politics ahead of a Communist party congress at the end of next year. Mr Zhou has been widely tipped for promotion to vice-premier at the congress, which takes place every five years. Such an elevation would position him as a future prime minister.

The paper, Chengbao, identified the author of the article as an employee of an anonymous Hong Kong think-tank, providing no contact details. "I am absolutely convinced that the author of this article is on the mainland," says a Chinese economist. If so, it would not be the first time the Hong Kong press has been used to plant personal political attacks that could not be published in China itself.

It is no secret why Mr Zhou and his supporters have accumulated enemies over the past year. At a time when market reforms have been under pressure, they have pushed ahead with their agenda and achieved notable successes.

With the backing of the PBoC and the bank regulator, China has launched the stock market listing of its three biggest state banks, something unimaginable a few years ago when they were sinking under bad loans. The currency has been de-pegged from the US dollar, allowing the PBoC to start to develop a genuine trading platform for the renminbi. And interest-rate deregulation is well under way, meaning loans can start to be priced to reflect risk.

The PBoC also wrested control of corporate bonds from the chief planning agency, which had allowed the market to wither because it was unwilling to bear the risk of approving issuances. The central bank cleverly got around the planning agency by establishing a market for short-term notes that could be rolled over every 12 months, making them bonds by any other name.

As the mysterious author of the Hong Kong article noted, Mr Zhou has also been a prolific public speaker, taking it on himself to extol financial reform, both in China and overseas.

Such activism inevitably invites a backlash. In the latest open attack on financial reform, the mainland-based Business Watch magazine said this month that the emergence of foreign hedge funds as strategic investors in the state-controlled Bank of China would be a "huge scandal" and would damage the listings.

Mr Zhou has not strayed from the orthodox party line on politics, but a number of prominent economists who are broadly aligned with his reforms have suffered in the crackdown on liberal think-tanks and non-governmental organisations in the past year.

Economists Mao Yushi and Wu Jinglian have both had research institutes closed, in Beijing and Shanghai respectively. Others, such as Zhang Weiying of Peking University, have been taken to task for being too close to China’s new breed of entrepreneurs.

Such attacks, says Stephen Green of Standard Chartered in Shanghai, have “echoes of Russia in the nineties”.

While president Hu Jintao and Wen Jiabao, prime minister, have engineered a stifling political climate, which has seen numerous newspapers closed and editors sacked in their three-year rule, their views on economics and on issues such as privatisation and foreign investment in banks are much less clear. Some see that as a product of weakness and indecision.

“We used to think Jiang Zemin was clownish but, in retrospect, he got all the big decisions right,” a Beijing-based investment banker says of Mr Hu’s predecessor.

The absence of strong leadership has allowed the conservatives to step into the vacuum and get a greater airing for their views than for many years. “We are all very much on the defensive right now,” says another well-known economist with close connections to the liberal camp.

The economist, who asked not be named, was stunned by the reaction to a recent speech he delivered in Beijing to a university economics faculty, a group that he thought might be open to ideas and debate.

He says he told them not to blame foreigners for China’s finance industry woes. After all, he reminded his audience while recommending a look in its own backyard, who made all the bad loans and ran the securities companies into the ground?

Members of the faculty rose not to debate but to denounce him. “We must keep in mind our [foreign] enemies,” one professor told him, to wide applause. “We are still a socialist country.”

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