

MARCH 2016

# State *and* Market in Contemporary China

Toward the 13<sup>th</sup>  
Five-Year Plan

EDITOR  
**Scott Kennedy**

A Report of the  
CSIS FREEMAN CHAIR IN CHINA STUDIES

**CSIS** | CENTER FOR STRATEGIC &  
INTERNATIONAL STUDIES



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ISBN: 978-1-4422-5943-0 (pb); 978-1-4422-5944-7 (eBook)

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202-887-0200 | [www.csis.org](http://www.csis.org)

Rowman & Littlefield  
4501 Forbes Boulevard  
Lanham, MD 20706  
301-459-3366 | [www.rowman.com](http://www.rowman.com)

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# Acknowledgments

This volume comprises essays that were originally presented at a CSIS conference in November 2015 entitled, “The Chinese State & Market: Toward the 13th Five-Year Plan.” We are deeply grateful to all of the conference participants and to each memo writer who permitted us to include their pieces in this report. That meeting is part of a one-year study on China’s 13th Five-Year Plan being carried out by the Freeman Chair and its Project on Chinese Business and Political Economy. We would like to express our gratitude to the project sponsors: Microsoft, Walmart, Cummins, Rubicon Strategy Group, the U.S. Chamber of Commerce, and the Japan External Trade Organization (JETRO). Without their support, the conference and this report would not have been possible. Our final report on the 13th Five-Year Plan will be issued in May 2016. Finally, a special thanks goes to Freeman Chair Program Manager Nicole White, who played a crucial role in managing the logistics of the conference and this volume. A more steady hand could not be found.

# Introduction

*Scott Kennedy*

The trajectory of China's economic governance appears to be more in doubt now than at any time in the last quarter century. The fundamental prism through which the People's Republic is typically viewed is one of a transition from plan to market, in which market forces gradually supplant state intervention in determining investment, production, and consumption, as well as China's involvement in the global economy. But it would be an understatement to say that this transition has taken many years, far longer than the "shock therapy" approach pursued in central Europe and the states of the former Soviet Union. China's Reform Era has now stretched to 38 years, and although China's economy is far more market oriented now than it was in 1978, 1998, or even 2008, national and local authorities are still deeply involved in many aspects of the economy, both as regulators and direct participants in economic activity.

Understanding where China is headed is more important than ever. China's economy now accounts for almost 15 percent of global GDP, and the country's ups and downs have enormous effects beyond its borders. Nations across the globe have seen their fortunes improve as China has grown, and many are suffering as China's economy has slowed. The troubling management of China's stock market and its currency have also contributed to greater volatility and raised doubts about whether the country is still on the path of "reform and opening" set out by Deng Xiaoping or whether we need an alternative prism through which to understand the dynamics shaping China.

In this spirit, CSIS's Freeman Chair in China Studies convened a group of leading experts in Washington, D.C., in November 2015, for a conference entitled, "The Chinese State & Market: Toward the 13th Five-Year Plan." During the daylong discussion, the participants critically examined the government's evolving role in the economy, the key actors and institutions in the policy process, trends in industrial policy, and to what extent Chinese involvement in global institutions help constrain such policies. This was all preface to a conversation about China's 13th Five-Year Plan, which will be adopted and issued in late March 2016.

To aid the discussion, participants prepared brief memos in advance of our meeting. These prompts were so illuminating in framing the conversation that we determined there would be tremendous value in sharing as many of them as possible with a wider audience.

Authors revised their pieces in light of the discussion, and CSIS then edited the contributions for production purposes.

## Findings

We aimed at the meeting to bring together a wide spectrum of opinions. No one perspective has an exclusive grasp on the truth, and only by engaging a range of views can we sharpen our own and move the discussion forward. The pages that follow reflect that vigorous debate. No crisp consensus emerges from these pages, but there is a general sense that although markets have become more important and will continue to grow in significance, at the same time the Chinese state, national and local, is not going anywhere, and, in fact, is reasserting itself. This applies not only to the government, but perhaps even more so to the Chinese Communist Party (CCP). The task is for us to keep our eyes not on either the state or market but simultaneously on both and their interaction with each other.

The opening section features a discussion about general trends in the Chinese state's approach toward the market. **Daniel Rosen** suggests that even though China still intervenes in many areas of the economy, most within the state have come to accept, some only grudgingly, the core role that the market must play in the economy. Just as Winston Churchill noted that democracy is the worst form of government except for all of its alternatives, Chinese officials appear to be relenting to a similar understanding of how economies function. Our two other contributors recognize that the China of 2015 is not the China of 1975, but they highlight the limits to which free-market reforms can go under current political circumstances. **Arthur Kroeber** argues that the CCP has accepted the value of markets for allocating goods, but it has not reached the same conclusion with regard to state assets. **Peter Martin** goes one step further by arguing that economic liberalization will always be “haphazard, inconsistent, and prone to setbacks” because the CCP's primary goal is to keep itself in power, a goal that takes precedence over what a pure economic-rational approach would suggest. The CCP leadership's perspective, Martin suggests, is to see the entire enterprise of economic reform as “a turnaround project at one of the world's most powerful multinational companies,” intended to strengthen the CCP and its governance institutions, not undercut them. If Martin is correct, then the original “transition” approach often applied to China loses much of its explanatory power.

The discussion of the key actors in the policy process also yields a mixed picture. **Chen Ling** provides an overview of the increased centralization of policymaking that has occurred under Xi Jinping, with the CCP having much more direct authority in regulating the economy than under previous leaders.<sup>1</sup> The result is that economic and political goals have increasingly become intertwined, local governments have lost their initiative to experiment, and policy gridlock now can only be broken by direct central government interventions. **Margaret Pearson's** focused look at local governments reinforces this

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1. For additional perspective, see Christopher K. Johnson and Scott Kennedy, “China's Un-Separation of Powers: The Blurred Lines of Party and Government,” *Foreign Affairs*, July 24, 2015.

analysis. She notes that the system for incentivizing local officials to follow national guidelines has become increasingly dysfunctional. Local governments are discouraged from taking much initiative, and they are being asked to achieve multiple goals that do not always align with each other. As a result, she finds that current circumstances “leave local cadres little bandwidth to focus seriously on structural reforms that require long-term investments.”

**Jamie Horsley**’s contribution on policy consultation stands out from Chen and Pearson, as she describes a policy process in which extensive consultation across bureaucracies and among experts, domestic and foreign, has become routine. Moreover, such debate is not simply for show but has a substantial effect on the content of laws and regulations. The apparent inconsistency in perspectives may be explained by the likelihood that extensive consultation, even lobbying, is most vigorous around issues that are less politically sensitive, more technical, and do not reach the desks of top leaders. In addition, everyone recognizes that no matter how intensive the consultation process, there are no formal accountability mechanisms in China’s political system requiring officials to heed external advice.

Not surprisingly, there is consensus that the Chinese government still intensively uses industrial policy to promote certain sectors, technologies, regions, and companies. Such efforts to affect competitive outcomes differ from regulation all governments, including China’s, use to promote public health, safety, the environment, national security, and the social safety net. At the same time, the discussion shows that industrial policy has not been uniform across time and space. **Roselyn Hsueh** helpfully distinguishes between “strategic” and “nonstrategic” sectors, noting that in the former the government has repeatedly taken an “open-door-closed-door approach to foreign investment,” at first opening the sector to foreign participation and then slowly reducing market access once Chinese companies obtain the necessary technology and knowhow. **David Hathaway** and **Jesse Heatley** stress that the tools of intervention have become more sophisticated, including the use of competition policy and investment funds. Ironically, though, they also note that industrial policies may constrain private and foreign actors, but that they often do not result in success for favored firms. **Yan Chunlin** reinforces this last point by noting that intervention is also often ineffective when trying to solve the mistakes caused by previous interventions. Administrative measures to combat overcapacity have failed equally in sectors populated by private and foreign companies as well as those dominated by state-owned enterprises (SOEs).

Regardless of whether industrial policies are successful, they usually involve discrimination against foreign business interests. In her contribution, **Claire Reade** suggests that China’s membership in the World Trade Organization (WTO) and other international bodies has had a major effect on constraining Chinese industrial policy, both as a result of the regulatory changes China had to make to gain entry and the dispute settlement system that members have taken advantage of to deal with ongoing market barriers. Nevertheless, substantial challenges for foreign business remain or have become more problematic, particularly in areas not covered by existing agreements. **Dan Markus** writes that the

ongoing negotiations over a U.S.-China bilateral investment treaty raise the prospect of a fundamental reduction in Chinese government intervention by China's adoption of the negative-list principle, which in theory would require China to provide national treatment to foreign businesses across the economy except in a small, targeted list of specified sectors. Although negotiations have shown progress, there are reports that China's latest offer includes a negative list 70 pages long, in contrast to the U.S. list of just a single page.

Perhaps the largest single sign China could give about the trajectory of economic governance comes in the form of the 13th Five-Year Plan (FYP), the subject of the last section of this report. The plan's summary Proposal was issued in late October 2015, and the full plan will be released in late March 2016. **Oliver Melton** reminds us that unlike in earlier times, the plan now represents a "continuous cycle of policymaking, not a discrete master blueprint." **D. D. Wu** suggests that this process helps demonstrate the CCP's leadership and provides clear signals for how the government, industry, and others should align themselves with the plan's objectives. Turning from process to content, **David Kelly**, **Scott Kennedy**, and **Nicholas Consonery** all express skepticism that the 13th FYP will clearly signal a shift toward a free-market approach. Kelly puts his emphasis on the tension between the CCP's monopoly on power and a more open, competitive economy. My own emphasis is less theoretical and more empirical; early signs are that some elements of the plan will promote fairer, more liberal market institutions, but other elements focus on strengthening Chinese industry potentially at the expense of foreign business, reinforcing the CCP's authority and expanding China's global influence. Consonery concludes that if we are correct and the FYP underwhelms, it will "undermine confidence" of the investment community and be another source of volatility going forward, not only for China but for the global economy as well.

One can hope for a better outcome in which market forces become more dominant, but the contributions to this volume collectively suggest that it would be wise to prepare for a future in which the state *and* market in China exist in an uneasy relationship, with intervention remaining a permanent cornerstone of China's economic governance.



**Part I. General Trends:  
The Chinese State's Approach  
toward the Market**

# 1 | The CCP and Free-Market Principles

*Daniel H. Rosen*

**H**as the CCP become more accepting of free-market principles, as outlined in the November 2013 3rd Plenum “Decision on Major Issues Concerning Comprehensively Deepening Reforms,” and to what extent does it still believe that intervention in the economy is necessary and good? The CCP’s relationship with free-market principles is a complicated one, and a simple formulation of its appetite in this regard is not possible.

Worldwide—not just in China—how we think about market principles has shifted. This is a moving target and no longer a fixed polestar of practices that Beijing can use to navigate or that we can use to judge its course. Fundamentals long taken for granted in Western classrooms, such as the interaction between employment and inflation, no longer work as we once expected. And all along, Western governments have in fact been profoundly involved in managing our economies, not aloof from the marketplace. Central banks have leaned in against economic cycles since the 1930s—or tried to. In fact, it is not the specter of intervention but the failure of traditional intervention (the Fed’s ability to brush back stagnation by lowering interest rates) that rattles American policy cages today. None of this is hidden from Chinese policy analysts or the party leaders they serve, and that is critical to understand as we parse what Beijing intends when it talks about marketizing to a greater extent.

It is not just the pitfalls recently displayed by free-market capitalism that China aspires to avoid, but the myriad useful interventions characteristic of the Organization for Economic Cooperation and Development (OECD) that it intends to embrace. China reports its government’s share of gross domestic product (consumption for public goods such as defense and civil services and investment in assets like highways and bridges) at around 14 percent of GDP in 2013, versus 20–40 percent in the advanced economies. So reform and marketization in *our terms* does not mean *withdrawal* of government from the economy but rather redeployment in public goods and an enlargement in participation. And too, China is just coming around to believe that intervention in the economy as a pro-competitive regulator is necessary and good.

We can all—both in Washington and Beijing—agree that China’s government must step up labor market regulation and protection of workers, environmental protection,

competition policy enforcement, intellectual property rights policing, provision of adequate rule of law and judicial recourse, regulation of the capital market, and numerous other government services. A wealthier China needs government to step in and provide the basics we take for granted, not declare victory and go to the beach.

These observations are preliminary: I don't mean to skirt the intended thrust of the issue but rather set the scene to better address it. The CCP clearly has deep divisions over unleashing the market. On the one hand, a broad cohort of leading economists who hold positions of importance within the debate absolutely believe that China's potential growth is deteriorating and withering for want of implementation of basic market mechanisms. These individuals are represented on the leading small groups, at Beijing's equivalent of the Council of Economic Advisors, on the People's Bank of China (PBOC) Monetary Policy Committee, in leading academic circles, and in some business groups. At the same time, state-enterprise sector interests are digging their heels in deeply to resist what they know will be an onslaught of change. They know this because it has already begun: dividend payments to the central coffers have been ratcheted up, and the writing is on the wall that this extraction will increase. The state is draining the fun out of being an unfettered state oligopolist able to abuse your position to enrich yourself at the expense of comprehensive national power and public welfare. This is not to say that Beijing plans to relinquish the commanding heights of the economy; but it is owning up to the dysfunctionality of much of the SOE system and the incompatibility of its performance with the party's interest, the national interest, and consumer interest.

In my view, it is precisely because the party—at least, as reflected in the choices of President Xi Jinping—has become more accepting of the necessity of enlisting market forces that efforts to shore up state control and government authority over regulation, society, and foreign influences are mounting. The debate now is not about whether market forces must be accepted: they must. The debate is whether they can be saddled and yoked to the party's preferences, or whether they are beyond controlling—and if the latter, whether the party is ready now to deal with the consequences of letting these forces loose. Last summer's equity markets fiasco and the running battle the PBOC must now fight in the trenches of the CNH offshore market over exchange rates are teaching President Xi and company that at least some essential elements of the higher-income Chinese market economy are largely beyond manhandling. This bird won't sing in a cage.

These debates are not new, but they are now coming to a head. Financing costs—primarily debt service—now represent over 50 percent of the value of all profits for many SOE-dominated industries. Premier Li has stated that one out of six provinces is nearing fiscal insolvency. Growth, as we've recently seen, has required running debt up to more than 200 percent of GDP and growing fast. As surely as party economic strategists know that Western nostrums for welfare have tarnished in recent years, they have far more concern with the decrepitude of their own ballyhooed system. Free-market principals may be the worst—except for all the others. The party accepts marketization to the extent that it has exhausted and continues to rediscover the exhaustion of other approaches to

maximizing output, value-added, competitiveness, and power. The CCP is in the process of conceding the relative efficiency of market forces for organizing the commerce in much of agriculture, raw materials, and basic manufacturing. Shortly the market-state balance in erstwhile “strategic” industries must be reckoned—including semiconductors, aircraft, telecommunications, steel, autos, and chemicals, among others. Still beyond that lie a host of other industries seen as tied up with national interests but that the state is loath to cede to private competition for fear of losing control. While the principle of enlisting or saddling free-market forces to promote development is increasingly accepted, the practice of letting go and accepting the consequent shift of power and influence is not. Only time and necessity will reveal the balance that offers an equilibrium to the party and—moreover—the Chinese people.

# 2 | Reform of Prices, Not Ownership

*Arthur Kroeber*

The economic reform roadmap laid out in the *Third Plenum Decision* of November 2013, expresses contradictory views about the relationship between state and market. It identifies “handling the relationship between government and the market well” as the “core issue” for economic reform. The document then goes on to identify roles for market and state that are not obviously compatible. The market “should have a decisive role in resource allocation”; but at the same time, “We must unwaveringly consolidate and develop the publicly owned economy, persist in the dominant role of the public ownership system, give rein to the leading role of the state-owned economy, incessantly strengthen the vitality, control and influence of the state-owned economy.”

To Western eyes, “a decisive role for market forces” and “the dominant role of public ownership” are clearly incompatible. If market forces are really decisive, then the dominance of state enterprises cannot be guaranteed: they might lose out in competition to private firms. Conversely, if state enterprises are guaranteed a dominant role, then market outcomes must sometimes be suppressed and therefore cannot be called “decisive.”

There are basically two ways to make sense of this contradiction, both of which find some support in the evolution of policy in the two years since the publication of the *Third Plenum Decision*. The first is that, despite assertions of the “comprehensive nature” and “top-level design” of the reform program, Xi’s economic policies are a grab bag of measures satisfying a panoply of bureaucratic and commercial interests. The reform program has no real coherence: the commitment to state ownership is necessary to reassure the powerful SOEs and party conservatives suspicious of a drift toward capitalism and Western values; the support for market forces is meant to encourage the growing class of private entrepreneurs and reform-oriented bureaucratic interests such as the Ministry of Commerce and the PBOC. This diverse and contradictory *mélange* results from the political fact that the CCP claims to represent all interests in an ever-more-diverse and contradictory society.

The second explanation, not necessarily exclusive of the first, is that the Communist Party leadership has a more instrumental view of markets than is the case in most industrialized nations. In advanced economies, the market is considered the “default setting” for organizing economic activity. Governments may intervene to correct market failures—and

**Table 2.1. Size of SOE Sectors in Selected Countries: Assets and Revenues Held by SOEs as Percentage of GDP (2011)**

<i>Country</i>	<i>Assets</i>	<i>Revenues</i>
China	145	26
India	75	16
Russia	64	16
Brazil	51	12
South Korea	48	7
France	23	8
Indonesia	19	3

Source: OECD.

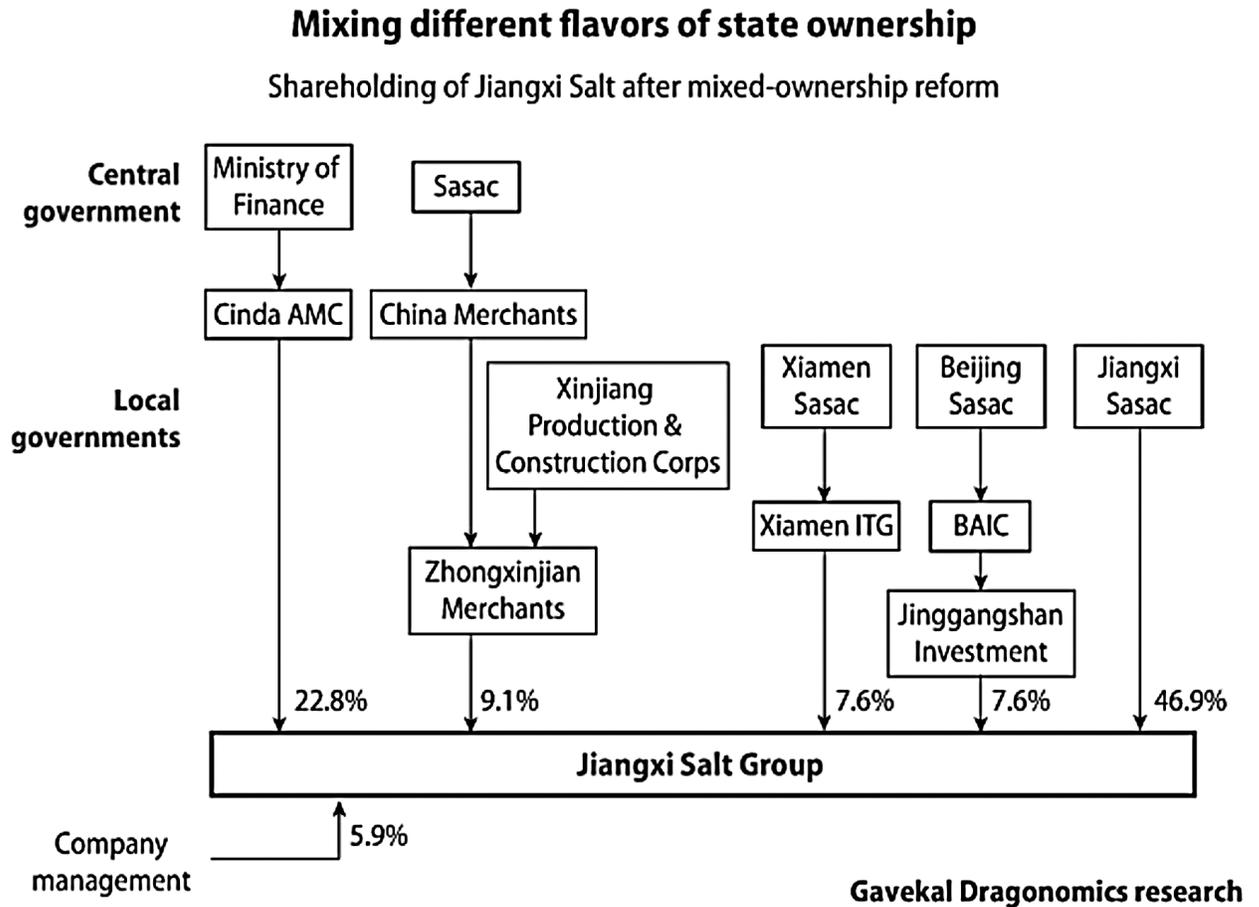
definitions of market failure vary in their breadth—but such interventions must be justified, and direct state ownership of assets is relatively modest (see Table 2.1).

In China, however, the default setting for the economy is direct control by the party-state of a wide range of strategically important industries. One reason for this is a belief in a positive political-economy feedback loop. The political stability provided by the party creates the conditions for rapid economic growth. Direct control of a large swathe of SOEs in turn ensures that independent, economically powerful interests never become strong enough to undermine political stability by challenging the party’s authority. In addition, SOEs provide a means for macroeconomic management and for regulation of individual sectors. In effect, the SOE system substitutes for (and prevents the emergence of) the modern “regulatory state” found in the advanced economies.

In this context, the role of markets is to: (a) organize economic activity in areas where the state does not find a need for a large ownership role; and (b) act as a tool for improving the economic efficiency of SOEs. By subjecting them to greater pressure through competition for inputs and market share, the government hopes the SOEs will maintain a reasonable degree of productivity and minimize their need for direct government subsidies or other financial support. With regard to SOEs, therefore, the market serves to create incentives for squeezing a higher financial return out of assets. But the market may not arrange for the transfer of ownership of assets from the state to the private sector (at least not on a large scale). This perhaps explains why party documents specify that the market’s “decisive role” is in *resource allocation*. In other words, in China the market is a mechanism for setting prices but not for reassigning control of assets.

The consequences of this arrangement of the roles of state and market show up in two important policy areas, one of them an area of active reform and the other generally considered a reform laggard. Financial-sector reform has proceeded at a rapid pace. Just in the last year, interest rates have been fully deregulated, the exchange rate has shifted to a mechanism that the International Monetary Fund (IMF) deems to meet its minimum

Figure 2.1. Template for “Mixed Ownership” Reform



**Explanation:**

- In September 2015 the Jiangxi provincial government announced a “mixed ownership” deal that reduced its holding of local SOE Jiangxi Salt from 100 percent to 47 percent.
- In the restructured company, 47 percent is owned by four state-owned investment companies, none of them from Jiangxi. An additional 6 percent is held by company management.
- The Jiangxi government did not sell shares (and hence received no income). Instead, the new shareholders injected new capital into the company and were awarded shares based on the existing book value of Jiangxi Salt’s assets.
- The evident intention is to improve the company’s performance by the introduction of new shareholders that, although state-owned, are more commercially oriented and less hampered by local political concerns than the previous government owner.

definition of “market-determined,” new fixed-income instruments such as local government bonds and asset-backed securities have been launched on a large scale, foreign central banks have been given unlimited access to China’s fast-growing bond markets, and foreign investors were granted broader access to the Shanghai stock market under the Shanghai–Hong Kong Connect program. One reason that financial reform has progressed so far is that it is led by a well-organized group of long-serving and politically astute bureaucrats under the informal leadership of PBOC governor Zhou Xiaochuan. Another reason, however, is that these reforms relate almost entirely to liberalization of prices (interest and exchange rates) and not at all to changes in asset ownership. Virtually all significant financial institutions in China are state owned; there are no plans to privatize any of them, and little has been done to enable market entry by large-scale private competitors.

By contrast, SOE reform is widely considered “disappointing.” After much delay, a roadmap for SOE reform was published in September 2015. It contained little or no support for privatization of underperforming state firms; instead it contained a lot of language about preventing the “erosion of state assets,” reiterated a long-standing prohibition against the sale of state assets at below book value, and promoted a “mixed ownership” program whose main purpose appears to be the transfer of SOE shares from local governments to commercially oriented SOEs (but not to private shareholders; see Figure 2.1). The clear intent is to maintain the current structure of state ownership of assets but to improve the performance of these assets by increasing the influence of state-owned shareholders who are more concerned with financial returns than with sustaining local patronage networks.

In sum, the evidence suggests that the Xi Jinping administration is more accepting of free-market principles than its predecessor, at least so far as price liberalization is concerned. But it does not accept a significant role for markets in reassigning ownership control of state assets.

# 3 | Why Patchy Progress on China's Economic Reforms Is Inevitable

*Peter Martin*

We know, as President Obama tells us, that Xi Jinping “has consolidated power faster and more comprehensively than probably anybody since Deng Xiaoping.”<sup>1</sup> And yet progress on Xi’s economic reform program seems to constantly modulate between momentum, paralysis, and drift. Real progress has been made in the financial sector, on fiscal reform, and on deregulation for small businesses, but movement in other areas from the *hukou* system to SOE reform and the liberalization of key industries has been patchy, slow, and disappointing. In fact, the spottiness of China’s reforms shouldn’t surprise us: it is hardwired into the nature of the reform program itself. A look at the priorities and goals of the reformers, the means they are using to drive their agenda, and the political system within which they continue to operate suggests that implementation was always likely to be haphazard, inconsistent, and prone to setbacks.

## Ends

To understand why progress on economic reform is patchy, we need to start by examining what China’s reforms are all about. The reforms are unified by a common goal that is supported by collection of messy and often contradictory policies. The goal is to ensure that the CCP is around to take credit for the “great rejuvenation” of the Chinese nation, and in this sense its key goals are primarily political. Achieving them means imposing two distinct forms of discipline on the Chinese body politic: political discipline and market discipline. Political discipline aims to make the party work like a more legitimate, effective organization, while market discipline aims to help China avoid the middle-income trap and to make Chinese firms globally competitive. Both are seen as essential to the CCP’s continued grip on power, but they often act in contradiction.

Of the two, political discipline has been pursued with greater consistency and vigor. It has involved a huge anticorruption campaign and purge; a campaign to rectify wayward behavior within the party; and aggressive moves to curtail Internet freedom, social

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1. Jeff Mason and Steve Holland, “Obama Says China’s Xi Has Consolidated Power Quickly, Worrying Neighbors,” Reuters, December 4, 2014, <http://www.reuters.com/article/us-usa-china-obama-idUSKCN0JH21420141204>.

activism, and nongovernmental organizations (NGOs). All of these moves are an integral part of the reform project as Xi and others conceive it (a mission to save China and the Communist Party), but they are distinct from what we usually think of when we talk about reform: market economics. These measures take precedence over market reform and therefore limit its scope. They also limit its effectiveness by cutting China's government and citizens off from the important sources of information and accountability that accompany political openness.

The way that the government thinks about markets also means that reforms were always likely to look patchy from the outside. Xi and those around him think of markets as an important tool for achieving political ends, but they are clear about the limitations of markets and believe that they should work alongside a strong, vibrant state sector. We saw this very clearly when the *Third Plenum Decision* called for providing markets with a “decisive” role while maintaining the state at the economy’s “core.” It is also consistent with arguments about the complementary nature of markets and the state sector that Xi Jinping has made in public for more than a decade.<sup>2</sup> These views mean that pro-market reforms and moves to maintain a significant role for the state in the economy (through an aggressive industrial policy and moves to make SOEs more competitive) are perfectly consistent in the eyes of the Xi administration.

## Means

It's not just the aims of the reformers that set limits on the pace and scope of market reforms. It's also the way that Xi and those around him have chosen to implement them. Reforms are being pushed through in a highly centralized manner, partly to minimize the risk of instability and partly because of reformers' distrust of existing government bureaucracies (including provincial governments). The centralization of decisionmaking has seen Xi place himself at the center of key areas of policymaking through the various small leading groups, the prioritization of party over government organizations, the dressing down of key ministries such as the National Development and Reform Commission (NDRC), and the use of the anticorruption campaign to scare the bureaucracy into action.<sup>3</sup>

This approach has yielded some significant results, especially fiscal and financial reforms, but it also has significant drawbacks. Leaving crucial decisionmaking in the hands of such a small group creates a bottleneck for all major decisions. Time constraints

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2. Peter Martin and David Cohen, “Mao and Forever: Xi Jinping’s Authoritarian Reforms,” *Foreign Affairs*, June 3, 2014, <https://www.foreignaffairs.com/articles/china/2014-06-03/mao-and-forever>; and David Cohen and Peter Martin, “A Mandate, Not a Putsch: The Secret of Xi’s Success,” *China Brief* 15, no. 3 (2014), [http://www.jamestown.org/programs/chinabrief/single/?tx\\_ttnews percent5Btt\\_news percent5D=43500&tx\\_ttnews percent5BbackPid percent5D=25&cHash=089fb56a35d08ccdd2a88105935d6a4d#.VnAomkorLq5](http://www.jamestown.org/programs/chinabrief/single/?tx_ttnews percent5Btt_news percent5D=43500&tx_ttnews percent5BbackPid percent5D=25&cHash=089fb56a35d08ccdd2a88105935d6a4d#.VnAomkorLq5).

3. Peter Martin and David Cohen, “Inside Xi Jinping’s Reform Strategy,” *National Interest*, March 20, 2014, <http://nationalinterest.org/commentary/inside-xi-jinpings-reform-strategy-10087>; and Peter Martin, “The Humbling of the NDRC: China’s National Development and Reform Commission Searches for a New Role Amid Restructuring,” *China Brief* 14, no. 5 (2014), [http://www.jamestown.org/programs/chinabrief/single/?tx\\_ttnews percent5Btt\\_news percent5D=42057&cHash=8866680e4f4e57e8997beb2cfbaa7aaa#.VnApr0orLq5](http://www.jamestown.org/programs/chinabrief/single/?tx_ttnews percent5Btt_news percent5D=42057&cHash=8866680e4f4e57e8997beb2cfbaa7aaa#.VnApr0orLq5).

on this group limit its ability to supervise reforms and thus reduce accountability. And, as Barry Naughton argues, this situation creates space for policy entrepreneurs to hijack reforms to suit their own agendas, as demonstrated most clearly in the case of the SOE reform plan.<sup>4</sup> Finally, the political discipline campaign has also left many in the bureaucracy scared to act and in some cases paralyzed. In other words, the way that Xi and the reformers have set about enacting reforms almost guarantees their patchy implementation.

## Systems

Beyond the goals of the reformers and the way reforms are being implemented, the Chinese political system continues to impose major constraints on reforms. We are used to seeing China get things done with the speed that it constructs a road or a high-speed rail line. Yet we know that China's political system, even under Xi, is a different beast from that of the Mao era. It is more complex, more rules based, and (on its own terms) more accountable. We also know that the vested interests opposed to reform are "unimaginable."<sup>5</sup> And we also know that pushing through economic reforms is incredibly tough—like "taking a knife to one's own flesh," as Li Keqiang put it—and necessitates expending tremendous amounts of political capital.<sup>6</sup> That was true in Thatcher's Britain; it is true in Modi's India and Abe's Japan; and it is true in Xi's China, even if decisionmaking is more centralized now than three years ago.

## Perspectives

Finally, when assessing reforms, we need to ensure that what we mean by reform aligns with what Xi and those around him mean. Reform is not a wish list for Western commentators. Nor is it a wish list for Western multinational companies. It is a project aimed at keeping an authoritarian party that is committed to an activist state in power. That means that, even if wildly successful, there are going to be key elements of the reform program that we find distasteful (strengthened political authoritarianism, a stronger state sector, aggressive industrial policy, etc.).

Perhaps the best way to think about reform is to imagine it as a turnaround project at one of the world's most controversial multinational companies. If it succeeds, China's state-capitalist authoritarianism will emerge as a leaner, stronger, and more competitive version of itself, but its core vision and values will remain the same. In much the same way

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4. Barry Naughton, "Reform Agenda in Turmoil: Can Policy-makers Regain the Initiative?," *China Monitor*, no. 48 (2015): 1–8, <http://www.hoover.org/sites/default/files/research/docs/clm48bn.pdf>.

5. Kaira Lu Huang, "Xi Jinping's Reforms Encounter 'Unimaginably Fierce Resistance,' Chinese State Media Says in 'Furious' Commentary," *South China Morning Post*, August 21, 2015, <http://www.scmp.com/news/china/policies-politics/article/1851314/xi-jinpings-reforms-encountering-fierce-resistance?page=all>.

6. "China to Streamline Gov't Administration to Boost Vitality," *Xinhua*, March 15, 2015, [http://news.xinhuanet.com/english/2015-03/15/c\\_134068191.htm](http://news.xinhuanet.com/english/2015-03/15/c_134068191.htm).

as environmentalists view clean coal technology, any progress that is made will leave all of us with plenty to gripe about.

## Conclusion

To sum up, the implementation of economic reform has so far been patchy and has proceeded in fits and bursts. The reasons for this are inherent in the reform project itself: in its goals, the way it is being implemented, and in the political system within which reformers operate. Given these constraints, progress will continue to be slow, inconsistent, and reforms will not always proceed in the direction we might wish.

We should hope that enough promarket measures go through to have a positive impact on growth and that the political goals inherent in Xi's reform project do not limit their effectiveness. But Xi won't be evaluating the program in the same way we do. For him and those around him, success means a more efficient version of China's authoritarian state capitalism. We may not like that fact, but the reforms were never designed to please us.

## Part II. Actors: Shaping the Policy Process

# 4 | Centralization of the Economic Policy Process under Xi Jinping

*Chen Ling*

There is no doubt that the economic policy process under Xi Jinping has become increasingly centralized. The trend of deepening centralization is illustrated in four aspects. First, the political authorities have expanded their responsibility from general decision-making toward detailed administrative policies and implementation. Second, economic and political criteria for evaluating policy have become increasingly intertwined. Third, China's local governments have increasingly lost policy initiative. Fourth, the gridlock created by governmental bureaucracies and interest groups increasingly creates an objective need for intervention from the top political authorities.

First, in the successive stages of the policy process from decisionmaking to policy implementation, the coverage of the political authorities has expanded into areas that were traditionally handled as part of administrative decisionmaking and policy implementation.

The policymaking process is a balance between political authority and administrative capability. During the Hu-Wen administration, when political authority was widely considered to be relatively weak, the administrative capability (of ministries and local governments) was correspondingly strengthened. However, this trend has been reversed in the Xi era, as political authority has seized the dominant position in the economic policymaking process from the administrative bodies. As is well known, the top decisionmaking body in economics is the Finance and Economics Leadership Small Group (LSG). The evolution in the position of the LSG clearly shows that the role of the political authorities has been strengthened. During the 1990s, the rules for setting up LSGs in the party and government were standardized and carefully restrained. The function of most LSGs was explicitly defined as “discussion and coordination,” making clear that they were not decisionmaking bodies, even less monitoring and implementation agencies. In this spirit, the main task of the Finance and Economics LSG was to set the “main theme” of annual economic policy. After the Third Plenum of the 18th CCP Congress, the Comprehensively Deepening Reform LSG was established and is led by Xi himself, while the Office of the Finance and Economics LSG has become one of the six major specialized subunits of the Deepening Reform LSG, taking over some of the most important tasks of economic reform design.

What needs to be emphasized is the important change that has already taken place from the former system, in which the party center released guiding policies, while the government ministries and provinces interpreted those guidelines with much more detailed policies and specific instruments and then implemented them. Now, the intermediate steps of explanation and specification of policies leading to the creation of actionable policies are in the hands of the party. This is clearly evident in that the responsibility of Xi Jinping's Deepening Reform LSG and its subordinate specialized groups has already been expanded beyond a "top-level" reform design to include "overall planning, all-around coordination, moving the whole process forward, and supervising implementation" of reform. As of late 2015, this LSG had already met 19 times, almost monthly. In each meeting, 3 to 5 documents have been discussed and approved, with a maximum of 10 documents at one meeting. In total, more than 90 documents have been approved so far. Besides various "suggestions" and "opinions," there are also many extremely detailed policies, such as "programs," "plans," "methods," "regulations," and so on. For example, this LSG approved the "Overall Program for Chinese Soccer Reform" and the "Plan to Support Teachers in Rural Areas."

Second, under Xi Jinping's leadership, the objective of economics no longer has absolute priority in the economic policymaking process.

In the more than thirty-year history of reform and opening in China, the Chinese Communist Party placed the demand for economic development in first place. In the Xi era, this priority for economic development is already gone, or at least it is not particularly evident. Correspondingly, there are the "Four Comprehensives": comprehensively build a moderately prosperous society; comprehensively deepen reform; comprehensively govern the country through law; and comprehensively strictly govern the Communist Party. This implies that more noneconomic considerations constrain economic policymaking, particularly political criteria, including rooting out corruption, improving environmental conditions, and ensuring social stability. The Central Discipline and Inspection Commission, under the leadership of Wang Qishan, has already sent out scores of inspection groups to each ministry, local government, and central SOE to investigate corrupt behavior and inappropriate decisionmaking among bureaucrats. Because of this, every bureaucrat must now think first about political risk, rather than economic objectives, in the process of economic policymaking. In the second half of 2015, even though the slowdown in the Chinese economy has become more and more obvious, local governments have done very little to stimulate their local economies.

Third, local governments have gradually become passive, losing their former initiative in economic policy innovation.

Under conditions in which political authority is greater than administrative capability and economic objectives cede priority to political considerations, the relationship between the central and local governments has undergone a qualitative change. In the past, Chinese local governments displayed initiative in economic development; today, economic policy

innovation in the localities takes place only in selected pilot zones under central government control. For example, real estate taxes, conversion of business tax to value-added tax (VAT), and circulation of rural construction land all fit this pattern. At the same time, a few local policy innovations that were not in accord with the spirit of central guidance were quickly shut down.

Fourth, in the economic policy process, resistance and obstruction from bureaucracies and interest groups has increased, and in response the center has unavoidably increased the force of its interventions in setting policy.

Reforms of SOEs and the state asset management system over the past several years are clear examples. Compared with the previous round of reforms (in 2002–2003, symbolized by the establishment of the State Asset Supervision and Administration Commission [SASAC]), the current round of SOE reform has run into much more resistance. Over the past 10 years, China's state-owned managerial departments have become much bigger and more concentrated and have eliminated the situation at the end of last century in which SOEs were small, dispersed, and low profit. As a result, reform of these powerful departments has inevitably run into greater opposition. At the end of 2013, the Resolution of the 18th PC Third Plenum put forward objectives and demands for SOE reform. Just as would normally be the case, SASAC, the agency in charge of SOEs, promptly set up a specialized LSG and began drafting a reform program. The intention was to undergo a process of consultation with other departments and ultimately have the State Council finalize and issue a document. However, most of 2014 was spent in fruitless discussion; SASAC and the Ministry of Finance continuously disagreed; and instead of producing one overall program with 10 supporting specialized documents, no document at all was produced. The State Council, dissatisfied with the deadlock between SASAC and the Ministry of Finance, then established the State Council-Level SOE Reform LSG in October 2014, headed by Vice-Premier Ma Kai. This LSG took responsibility for drafting the overall program. As a result, the "Guiding Opinions" approved by the Standing Committee of the Politburo on July 23, 2015. On September 13, these "Guiding Opinions" were finally openly published. Since then, five of the supporting specialized policies have been promulgated.

In summary, there is a clear tendency toward concentration of power in the economic policy process under Xi Jinping. At the same time, this tendency is an essential guarantee of China's carrying out the deepening of reform. Otherwise, it would be extremely difficult for reform to produce any specific outcomes at this stage. Simultaneously, government is experimenting with a number of standardizing reform measures, such as the negative list and reform of the Administrative Approval System,. Clearly, an important challenge over the next few years is how, in the wake of centralization, to rebuild a new system of effective policymaking and the related implementation mechanisms.

# 5 | Local Government: Friend or Foe of the Market?

*Margaret M. Pearson*

Virtually all economic policy initiatives in China flow through local governments. Local officials can plausibly help improve economic policy and performance insofar as they have the means to flexibly implement central policy to meet local conditions and have the resources to support entrepreneurial firms and investment in economy-enhancing public goods (such as high-technology zones). However, local governments are—and will remain—largely an impediment to many economic reforms (such as rebalancing) due to agency problems and perverse incentives that are hardwired into China’s bureaucratic structure. To the extent that reform programs from the center (e.g., Third Plenum efforts to address local debt) alter the incentives for local actors, the situation may improve. Nevertheless, the fact that the structure that gives rise to problematic incentives remains fundamentally intact under Xi Jinping suggests local government behavior will remain an impediment.

The relationship between China’s central government and local governments (central-local relations) is one of the most poorly understood dynamics in Chinese politics, perhaps second only to the inner workings of the top leadership.<sup>1</sup> The behavior of local governments is structured by the overall political system. Important structuring factors include the fact that China has a unitary rather than a federal system, that most officials are appointed rather than elected, and that the party plays the primary role in managing personnel. These are also the key tools through which the central government in Beijing (the center) enforces top-down control. I find simplistic the assertion that Beijing is weak in the face of local power. Yet it is also true, on the other hand, that local governments maintain the means to assert a degree of autonomy. These means include a party-sanctioned tradition of local experimentation, some fiscal autonomy, and a lack of transparency of local finances, among others. Local experimentation and discretion are seen as crucial for allowing central initiatives to be shaped by local conditions.

Beijing’s fundamental challenge is how to encourage “good” discretion (that which ultimately aligns with Beijing’s guiding intentions) and ex ante to discourage “bad”

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1. In this essay, local governments include those below the provincial level—particularly county and municipal levels.

discretion. Beijing has used many ad hoc measures—notably the ongoing anticorruption campaign and sporadic punishments designed to “hold local officials to account” (e.g., those deemed responsible for the Tianjin explosions)—to address “bad” discretion. The October 2014 Fourth Plenum on “Rule of Law” was designed to attack “bad” discretion by local cadres in one relatively narrow realm, the interference of local officials in judicial processes. Despite the opportunities afforded local officials by Beijing’s difficulty in fostering only “good” discretion, local officials too face problems in this relationship. These problems go beyond the fact that many of Beijing’s mandates are unfunded. Local officials’ careers depend on demonstrating an enthusiastic response to “the spirit” of Beijing’s dictates. They are under pressure to show that their region has if not outpaced other jurisdictions, then not lagged behind. But Beijing’s signals are often vague, and they frequently shift.<sup>2</sup> New initiatives are layered onto told ones, loading local officials with multiple and often competing mandates. Ever-increasing criteria range from economic growth to jobs creation to promotion of social stability to protecting the environment to successes in new forms of public goods provision. So local officials operate in a context of substantial uncertainty and face constant decisions about what behavior is condoned and what is risky. Decisions by local leaders to slow-walk investments lest they be accused of malfeasance in the recent anticorruption campaign are good examples.

Why respond to these “signals” at all? The main tool cited by scholars is the CCP’s cadre management system in which officials are promoted according to criteria assessed by party superiors. Sometimes those judging are in the vertical hierarchy that sends down the mandates, but more often local officials are judged for promotion by party leaders at the same level (or one level up). Because cadres are in an office for only a short term—ranging from two and a half to four years—prior to being considered for promotion, they usually have short time horizons to demonstrate results. They may use local protectionism to accomplish some of these results. Beijing provides many additional incentives to local cadres to show quick results, including offering publicity to cities that are early adopters of new policies (such as innovative or “green” cities). At the same time, local officials don’t always know whether Beijing will enforce threatened ad hoc punishments for “bad” discretion (such as through duplicative and wasteful investments); if just one “chicken” is killed to scare the other “monkeys,” once the first chicken is killed it may be worth continuing to pursue the “bad.”

The 13th Five-Year Plan, and earlier initiatives since the 2012 18th Party Congress meeting, have done little, if anything, to change the structure local governments operate in, or the incentives it produces for local officials. By my count, the lengthy 13th FYP Proposal, issued in October 2015, mentions local governments as an agent only eight times, and in each case only in passing and consistent with the context described above, despite the fact that Beijing will rely on local governments to a significant extent for most of the initiatives discussed. The system will continue to leave local cadres little bandwidth to focus seriously on structural reforms that require long-term investments, including those con-

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2. Although “hard constraints” (e.g., for population control) are often clearer than “soft constraints,” both are frequently vague and shifting.

sistent with “rebalancing.” Thus, the past obstacles local governments have posed to improvement in economic policy and performance will remain salient.

Let me close by suggesting two pieces of evidence that point in a more positive direction than that laid out above. First, the 13th FYP Proposal did not specify numeric growth targets (e.g., 6.5 percent). This may reduce some pressure on local cadres to promote growth by hook or by crook. Still, we will have to see whether the stated goal of “doubling GDP by X year” that remains in the plan continue to be interpreted as requiring quick payoffs. I suspect they will. Second, and more promising, are reforms to local budgetary rules. Following the Third Plenum, opening of bond markets to local governments, in concert with rules restricting local debt issuance and repayment schemes, may structure some incentives for local government toward greater transparency and more responsible lending that potentially auger for better fiscal performance.

# 6 | Participation in Economic Policymaking in China

*Jamie P. Horsley*

To what extent does economic policy rely on economic experts and businesspeople, domestic and foreign, and has their role and influence grown over time? Stepping back to look at policymaking and legislation more generally, the role of nongovernmental actors has been evolving as Chinese leaders recognized the need to move from the command-and-control decisionmaking model of the planned economy to a more open and participatory process that taps into expertise among China’s increasingly diverse and engaged society and international experience. Informal, selective, and closed-door consultations of domestic and foreign academic experts, business associations, and businesspeople had become an important part of the policymaking and legislative process by the time Scott Kennedy published his 2005 study of business lobbying in China.<sup>1</sup> Recent government reforms have sought to modernize governance through “transforming government functions” and fostering public participation in and “supervision” of both the market and government decisionmaking through greater transparency and increasingly institutionalized government-designed consultation mechanisms.

China’s Constitution has provided since 1982 that the Chinese people are supposed to administer state affairs and manage economic and other matters through various channels, which traditionally were largely limited to the people’s congresses and people’s political consultative conferences. However, the Communist Party has been promoting the gradual development of transparency of and public participation in government affairs over the past 30-plus years, calling for decisionmaking at all levels to be more open and more “scientific and democratic” shorthand for a process that engages experts and the general public in decisionmaking—and endorsing in the year 2000 for the first time “citizens’ orderly participation in politics.” The Legislation Law adopted in 2000 also calls for the people to participate in lawmaking through various channels, and China committed in 2001 as part of its WTO accession to provide increased regulatory transparency and an opportunity for citizens of member countries to comment on trade-related regulations before they go into effect. The 12th Five-Year Plan incorporated the theme of strengthening open, scientific, and democratic decisionmaking, as did the 2013 *Third Plenum* and 2014 *Fourth Plenum Decisions*.

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1. Scott Kennedy, *The Business of Lobbying in China* (Cambridge, MA: Harvard University Press, 2005).

The proposed 13th FYP also promotes scientific and democratic legislation and scientific decisionmaking. The recently revised Legislation Law requires convening experts to debate draft laws involving technical issues or questions in which there are stark differences of opinion; provides that experts, scholars, research institutes, and social organizations (including business associations) should participate in discussions during the drafting process and may be entrusted to prepare a draft law for consideration; and specifies that the National People's Congress (NPC) should normally publish draft laws for a minimum 30-day public comment period.

The State Council has also instituted regular notice-and-comment rule making at the central government and local government levels, encouraging draft rules to be posted on a central government website for at least 30 days, although these guidelines are not consistently followed. A 2007 State Council rule specifically instructed agencies, before adopting major policies or measures involving the development of an industry, to vigorously solicit the suggestions and opinions of the relevant trade associations and encouraged trade associations and chambers of commerce to get involved in research, advocacy and formulation of pertinent laws, regulations, macro and industrial policies, standards, development plans, and other requirements pertaining to business. In order to help promote a favorable environment for the development of private enterprise, the State Council in 2012 instructed all government legislative affairs offices to consult industry associations, chambers of commerce, and private enterprises when drafting rules involving private investment, adopt their reasonable suggestions, and provide feedback. Drafts relating to foreign trade are also to be specifically shared with the Ministry of Commerce for publication through its particular channels.

No similar national legal procedure is in place for what the Chinese call “major administrative decisionmaking,” which covers policymaking and other nonlegislative decisions including for major investment projects. While policymaking has been handled on a more *ad hoc* basis, State Council and party documents call for a standardized procedure that is to include public participation, expert debate and risk assessment, a procedure the State Council is in the process of drafting and some local governments have adopted on a trial basis. Recent opinions issued by the CCP and the State Council on strengthening the roles of mass organizations, independent think tanks and business associations specifically call for their participation in relevant policymaking as well as legislation.

While economic policymaking is particularly seen as an arena for selective expert input, a degree of broad public participation has also been introduced gradually. As early as 2001, China's government sought public opinions via the Internet in drafting the 10th FYP (2001–2005) and reportedly adopted 300 of some 10,000 suggestions. The formulation of China's 11th FYP looked to both domestic and international expertise, including consultation with the World Bank and a 37-member Expert's Commission that included some prominent critical Chinese economists, some of whose publicly discussed views were incorporated into the final document. For the 12th FYP, the National Development and Reform Commission (NDRC) undertook what was called the “largest policy consulting and research activity conducted anywhere in the world,” enlisting 60 organizations and

thousands of experts to conduct research. Another State Council-selected National Experts Committee (NEC) was consulted, a draft to collect opinions from local governments, ministries, industries and other selected stakeholders was circulated, and ordinary people were invited to leave messages with their suggestions on the NDRC's website.

The drafting of the 13th FYP has been even more participatory and open. The NDRC established a website in 2014 to post updates on the process and a monthly selection of comments received from the public, published a call for bids to conduct research on identified issues, for which 27 institutions, including a Hong Kong institute, were selected, and discussed issues under consideration through the traditional media, Internet, and WeChat. As the process moved to Central Committee control in 2015, further research projects were commissioned and many internal discussions held. A 55-member National Economic Council (NEC) comprised of many noted Chinese economists, half of which—including four business leaders—had not served on the 12th FYP NEC, was again convened, and “Western brains” such as the OECD and the Asian Development Bank were consulted. The plan's summary Proposal document was publicly released in full shortly following adoption by the 18th Central Committee's Fifth Plenum in October 2015, to promote broader public discussion and participation prior to consideration and final adoption of the full plan at the NPC meeting in March 2016.

Although there are no formal mechanisms specifically for soliciting foreign comments, the current Chinese leadership continues to endorse learning from the “beneficial” experience of other countries. The NPC, State Council, and local governments regularly study foreign economic, regulatory, and legal experience when drafting legislation and policies, sending study groups, and visiting scholars abroad. China's economic and regulatory agencies regularly seek foreign expertise on draft measures that will impact business from resident foreign chambers of commerce and business associations. They and foreign businesses also comment through institutionalized as well as less formal channels on major laws and regulations, occasionally enlisting assistance from their governments to lobby with some success against burdensome requirements.

In sum, China's leaders and policymakers clearly recognize the value of soliciting outside expertise and experience from business circles in China and abroad, as well as academia, other experts, and the general public, to inform decisions on increasingly complex economic and social issues. It is, to be sure, difficult to assess the exact influence of economic experts and businesspeople on economic policymaking, especially when the practice of explaining final decisions is only beginning to be explored. Nonetheless, both domestic and foreign businesspeople, associations, and economic and other experts are regularly consulted and can also proactively provide input through both formal and informal channels. Moreover, the trend appears to be toward slowly increasing institutionalization of both transparency and public participation in lawmaking and government decisionmaking, including on economic policy, in China.

**Part III. Industrial Policy:  
Trends and Constraints**

# 7 | Strategic and Nonstrategic Sectors

*Roselyn Hsueh*

Media hype surrounding recent antitrust actions and intellectual property enforcement in China depicts what foreign investors view as actions taken to support indigenous Chinese industry. And the Chinese government has devalued its currency and undertaken sweeping measures to prop up the country's stock market, the ups and downs of which have reverberated globally. Scholars and media analysts alike link these moves to Chinese president Xi Jinping's quest to consolidate his own political power and safeguard the survival of the Chinese Communist Party. They also attribute these developments to growing nationalism and protectionism. All the same, the CCP's 3rd Plenum in 2013 notably affirmed China's "opening up" and promised "comprehensively deepening reforms."

I recently argued that these seemingly contradictory practices reflect the *modus operandi* in the last several decades of China's globalization.<sup>1</sup> Unless Xi's ambitious anticorruption campaign at home fails miserably and the legitimacy of the Chinese political system is called into question, we can expect more of business as usual in state intervention in markets. These actions date back to Deng Xiaoping's reopening of the country to foreign investment in 1992. My recent article in *Governance* shows that Chinese-style capitalism involves two primary components.<sup>2</sup> First is market coordination, which combines competition with regulation to achieve industrial modernization and economic and security goals. Second, the CCP works to ensure that industries it sees as particularly valuable—especially in external and internal security, technology, or for overall economic competitiveness—are owned primarily by Chinese businesses, whether state owned or private. China first introduced competition, and soon after the government started regulating businesses to limit the influence of foreign investment, as I have argued in my first book.<sup>3</sup> That especially affected businesses in industries perceived to be strategic for national security and infrastructural development, such as automobiles, finance, renewable energy, and telecommunications. Beginning in the early 1990s, after initial market liberalization, Chinese companies started collaborating with foreign partners. Once they benefited from technol-

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1. Roselyn Hsueh, "China Manages Capitalism for Its Own Gain: This Explains How," *Washington Post*, September 24, 2015.

2. Roselyn Hsueh, "State Capitalism, Chinese-Style: Strategic Value of Sectors, Sectoral Characteristics, and Globalization," *Governance* 29, no. 1 (January 2016).

3. Roselyn Hsueh, *China's Regulatory State: A New Strategy for Globalization* (Ithaca, NY: Cornell University Press, 2011).

ogy and knowledge transfers, however, the government has time and time again restricted the ownership structure and business scope of foreign direct investment (FDI) and intervened to promote indigenous technology, incubate Chinese business in fledgling industrial sectors, and ensure their long-term market foothold.

For instance, Beijing broke up the country's telecommunications monopoly in 1994 and allowed foreign telecommunications service providers and equipment makers to invest in joint ventures and sell in the domestic market, exposing Chinese industry to foreign expertise and knowhow. Later in the decade, foreign investors, including Sprint, Motorola, Deutsche Telekom, and France Telecom, teamed with newly formed state-owned telecommunications carriers to build new-generation communications networks. Fearful of relinquishing control of the communications infrastructure, the government soon forced the divestment of FDI, restructured the state-owned operators, and merged the then-separate telecommunications equipment and service ministries.

China became a member of the World Trade Organization (WTO) in 2001. Yet the government permits competition in telecommunications value-added services (VAS) only among domestic companies, such as Alibaba, whose initial public offering (IPO) on the New York Stock Exchange in Fall 2014 received more investment than did Facebook, Google, and all previous Internet IPOs. In the fiercely competitive VAS market segments, the leaders are Alibaba and other domestic companies with ownership structures and corporate governance connected to Chinese elites. In 2010, China forced Yahoo to divest itself of Alipay, Alibaba's e-payment subsidiary, in which it had become a major investor. This was yet another display of China's open-door-close-door approach toward foreign investment, allowing its companies to take advantage of foreign investment to upgrade Internet services and then constraining the market scope of those foreign companies.<sup>4</sup>

Today Yahoo, Google, and other foreign companies are limited to minority shares in service segments, such as online advertising, that are less important to security and less financially lucrative. Moreover, all telecommunications service providers are expected to follow censorship laws, self-police their content, and to operate on the networks owned and managed by the government. These methods allow the government to consolidate its control over the business of the Internet, including profits and the dissemination of information, to enhance the national technology base, maintain political stability, and ensure national security. The new laws on national security and counterterrorism and the proposed law on cyber security fall along the same lines.

Inviting and then restricting the ownership structure and business scope of foreign investment is half of the use of markets. China also takes a more aggressive role in governing the market in a way that gives Chinese-owned companies an advantage and ensures the country's hold on critical technologies. In telecommunications equipment, the government postponed the licensing of foreign technologies for nearly a decade when technical

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4. Roselyn Hsueh, "Nations or Sectors in the Age of Globalization: China's Policy toward Foreign Direct Investment in Telecommunications," *Review of Policy Research* 36, no. 6 (November 2015).

difficulties delayed the release of China's homegrown third-generation networking standard. It then restructured the state-owned carriers to ensure the smooth implementation of TD-SCDMA, the research and development of which involved collaboration between Chinese state-owned companies and foreign ones.

In the last couple of years, Beijing has brought antitrust actions against foreign automakers and auto parts manufacturers, including Daimler and Volkswagen, and high-technology companies such as Qualcomm and Microsoft, accusing them of overcharging, price manipulation, and abusing their market position. Legal decisions that were ruled in favor of Chinese companies in intellectual property disputes, such as a recent case involving American company Vringo and ZTE, a Chinese state-owned telecommunications equipment maker, further reveal how China governs markets to enhance the national technology base.

The 13th Five-Year Plan will not change the direction of China's strategic use of markets through liberalizing and regulating industries based on a strategic-value logic. The plan seeks to modernize infrastructure, guarantee national security, and ensure social and political stability. The plan also aims to boost economic growth during a period of slowed growth and sustain China's increasing per capita income. This will be achieved through competition and deliberate regulation (of market entry, business scope, investment, ownership, capital markets, and standards setting), employing new and time-tried methods to support industrial upgrading and indigenous innovation in agriculture and emerging industries, such as those in renewable energy and civil-military integration, and including service sectors, such as health care and information communications technology. In other words, it will be Chinese business as usual.

# 8 | State Intervention in Industry: New Strategy or New Tools?

*David Hathaway and Jesse Heatley*

State intervention in industrial development takes many forms in China, and it has been present since the earliest days of the Reform era. The nature of that intervention has evolved over time. From the perspective of foreign business interests, China's earliest interventions drew on fairly blunt (and predictable) policy tools such as sectors closed to foreign investment and participation. Today, however, we see more complex interventions such as application of China's antimonopoly law (AML) and standards or policies that more indirectly limit foreign players or that pick winners. These new forms of intervention have created the perception of reduced visibility into risks and regulatory treatment. In some ways, it can be argued that the increased complexity of newer forms of intervention also brings a new learning curve for state implementers. Perhaps analogous to recent stock market and currency interventions, these new and more complex policy levers bring challenges to those implementers, who are at a very early stage of learning how to best apply them. These implementation challenges may be contributing to some of the increased lack of transparency and predictability. Finally, the newer forms of intervention also raise questions in some key sectors about the role of state intervention in innovation. In the case of standards, there may also be questions relating to the impact of China-driven standards on China's ability to innovate, increase productivity, and lead in global (not just Chinese) markets.

In terms of newer and more complex policy tools, China's recent AML enforcement is a good example. While certain moves such as the drive to address monopolistic practices in, say, auto parts can be seen to have positive effects on competition, pricing, and consumers generally, other recent cases suggest broader goals. The highly public AML case involving Qualcomm is one example where China was able to enforce a unique interpretation that other countries have been unable to apply. The outcome of that case was generally a boon to Chinese mobile device manufacturers and has resulted in weakening of an industry giant at the same time that other policies are supporting domestic innovation and growth, both organic and acquisitive. Similarly, China's use of the AML process to hold up Western Digital Corporation's acquisition of Hitachi Global Storage Technologies served to significantly delay WDC's growth strategy at a time when Chinese official policies have encouraged domestic competitors. In that case, China was the only market in which an objection

to the acquisition was lodged. Interestingly, the case also surfaced challenges among state implementers attempting to use this new form of intervention.

In terms of effects on specific industries, recent movements in the integrated circuit (IC) chip industry provide interesting examples of state intervention and how certain types of intervention can combine to drive outcomes. In the wake of policy moves seen as potentially detrimental to foreign technology providers in China, including the new banking and cyber-security regulations, the Chinese government is moving to invest as much as 1 trillion yuan to develop a domestic IC chip industry through its National IC Industry Investment Fund. The fund also represents a new approach to attracting both government capital and private investors to support industry. This combination of financial and regulatory support could upend the IC industry, bringing domestic capacities into the fore and pressuring foreign players to operate differently. Foreign IC chip makers see a choice of helping and investing in China's domestic IC chip industry or exiting the market. It is interesting to consider whether this result is different from older policies limiting ownership, requiring joint venture partnerships, and promoting technology and intellectual property (IP) transfer.

The Chinese government's moves toward leveraging multiple forms of intervention may also be seen as a recent evolution. China's basket of official levers—including ownership, market access, financing, and standards—is increasingly being used to shape industries. Ownership continues to come into play in more traditional forms (ownership restrictions in key sectors such as automotive to build domestic capacity), but it is also being seen in recent AML enforcement practices, where decisions may bring other benefits to industries in China (such as lowering prices and building local capacity). On the financing side, moves such as the IC Fund offer a strong subsidy to build domestic capacity in a key industry, as well as complementing other regulatory moves. Unique standards are also being used, in combination with other levers.

These policy levers at times also coincide with political themes. Spurred by the Snowden revelations in 2013 about U.S. cyber-espionage activities against Chinese targets, as well as a steady stream of major global data breaches, President Xi and others have reiterated forcefully that China must reduce its dependence on foreign technology for national security reasons and for economic stability. The Chinese government has increasingly introduced stricter ICT requirements and called for stronger cyber-security policies, while denouncing the U.S. cyber intrusions. One of the more controversial developments has been the government's push for "secure and controllable" requirements found across several new Chinese technology policies. While these requirements remain somewhat vague and undefined, American technology executives (and our clients in a range of technology-dependent industries) are growing fearful that the policies will represent new barriers to the Chinese market. The barriers, moreover, could amount to potential game changers. The requirements on foreign companies could force them to create parallel standards to remain in the China market. Furthermore, foreign firms remain concerned that an oversight body to review cyber-security issues could favor Chinese companies.

It is interesting to consider the effect of these new forms of intervention on innovation. For example, while previous industrial policies in automotive manufacturing served to transfer manufacturing capacity, it did not necessarily result in positioning Chinese industry at the fore of the global industry. Chinese auto firms became complacent, relying for many years on their foreign partners to bring new technology to their joint manufacturing facilities. Now, however, in industries such as IC chips, China is staking out industries at the leading edge of innovation. One could ask whether plentiful financing and acquisition alone can sustain the level of innovation necessary for Chinese industry players to reach, and to stay, at the forefront of these dynamic high-technology sectors. Additionally, the use of unique Chinese national standards could bring unintended consequences. Taking the example of Japan's unique standards to protect its domestic telecommunications industry, in hindsight, this use of standards can be viewed as having constrained Japan's ability to lead globally in that industry. If the Chinese government decides to mandate the use of unique standards to advantage Chinese firms in the home market, will it reduce the ability and incentive of its national champions to develop the technologies that will succeed in the global market?

While state intervention presents challenges and can impact industries for foreign businesses, particularly when nontransparent, we note that official intervention can also bring positive outcomes for both foreign and domestic businesses. The clean-technology sphere is one where negatives are far less evident. The prominence of green growth in the 13th FYP is in fact a very transparent signal on industrial policy and may broadly expand the market for many products and technologies, both foreign and domestic. For example, the push for new energy vehicles (NEVs) is almost certain to greatly expand the market for electric, hybrid, or other clean vehicles. Financial incentives for NEVs have been offered to both foreign and domestic manufacturers. While some NEV subsidies are available only to domestically manufactured vehicles, the overall package of policy support and financial incentives is helping to create a new market. For manufacturers who are prepared to take the well-trodden path to localizing manufacturing, these measures provide support for growth. Other clean technologies have likewise benefited over the past decade, during which energy and environmental policies have shifted broadly, and these technologies have been supported quite clearly through FYPs and other policy guidance.

In summation, we observe that China's state intervention is evolving into more complex forms and is in some cases being implemented in combination or in line with other broader political or policy themes. While the shaping of industries and supporting domestic capabilities remain, as for many years, key elements of state intervention, the use of more complex levers for intervention has led in some cases to a heightened lack of transparency and predictability. As China's interventions evolve, working within certain industries where the government has staked out key interests will be more challenging. The interplay between intervention, innovation, and global industry leadership is also worth considering.

# 9 | Visible and Invisible Hands in Creating and Reducing Overcapacity

*Yan Chunlin*

Since 2006, the Chinese government has raised alarm bells about overcapacity in several industries, such as steel, cement, flat glass, coal, chemicals, polysilicon, and wind power. In each instance, they have issued a series of policies to address the problem, including limits on new production capacity, eliminating outdated capacity, and encouraging industry consolidation. These administrative efforts are almost always unsuccessful regardless of whether the sectors involved are dominated by state-owned enterprises.

Take for example the paper sector, where market demand during high economic growth periods and overly optimistic projections for future markets caused impulsive enterprise investment. Starting in 2009, paper production increased by double digits for three consecutive years. With Chinese economic growth slowing to around 6.0 percent or possibly even lower, production rose only 4.7 percent, 0.9 percent, and 2.8 percent in 2012, 2013, and 2014, respectively. Growth was around zero in the first half of 2015. Given the circumstances of free-market access and low technical threshold, most of the players are small and medium enterprises (SMEs) with limited production volume and little investment in environmental protection. It is estimated that the overcapacity situation will remain for some time.

Local governments across the country encouraged massive investment in 2008–2009, which was the main cause of the overcapacity in the paper sector. Private SMEs and even some bigger foreign companies were adding capacity based on optimistic business projections. By contrast, in other sectors such as cement and steel, local governments contributed to overcapacity through investments by state-owned enterprises. Additionally, the approval of cement projects was undertaken by provincial or even lower level government authorities, and many local governments put effort into attracting cement investment, as such projects can quickly turn into production without huge investment.

As Table 9.1 shows, sectors with differing industrial structures still had similar problems with overcapacity. Since 2006, the central government has issued different policies depending on the sectoral characteristics to deal with the problem.

**Table 9.1. Overcapacity in the Cement and Paper Sectors**

	<i>Cement</i>	<i>Paper</i>
<b>Industrial Characteristics</b>	Raw material, traditional heavy industry	Daily consumption good, traditional light industry
<b>Treatment by Government</b>	Strong governmental control; one of the nine key industries restricted for new capacity	Weaker government control, not top priority for overcapacity control
<b>Players</b>	Mainly giant SOEs, such as China National Building Materials Group	No big SOEs, mainly private companies
<b>Administrative Measures</b>	SASAC encourages consolidation of giant SOEs, focus on controlling new capacity	Local governments (EPB and EIC) required to take the lead in control; focus on eliminating outdated capacity
<b>Results</b>	Ineffective	Ineffective

In the paper sector, the central government has required local governments to approve new production when an equivalent amount of outdated production capacity is eliminated. But official data show that the newly built factories have outnumbered those eliminated in almost every year since 2006. Local governments seem not to be following the central government's directives. We have heard of cases of local governments reporting false closure data, supporting outdated capacity, preventing companies from being eliminated, and not enforcing environmental requirements so as to keep small and inefficient capacity running. Considering the false reporting of eliminated capacity by local governments, the gap between newly built and eliminated factories is likely larger than official data suggest.

Broadly speaking, local governments are not fully following central policies because local officials' performance has been mainly evaluated by economic growth. So they sometimes pursue short-term economic interests at the expense of long-term economic, social, and environmental interests.

This situation will be improved only by allowing a greater role for the market. The *Third Plenum Decision* of the 18th Party Congress states that the market should play a decisive role in resource allocation. The government should not be directly involved in business activities, whether by intervening in business decisions or conducting business activities through SOEs. That is, let the market itself solve the overcapacity issue.

What does this mean in practice? First, SOEs should withdraw from all of the competitive industries. The cement industry is an example in which SOEs not only restrict the development of private companies but also make unwise investment, which contributes to overcapacity. Second, administrative measures to address overcapacity will not work. There is no indication that the government knows the market better than enterprises. We should let companies decide if they will stay, close, or merge. Third, the government should fulfill its duty in enforcement to ensure a sound business environment and level playing field for all players. Local government failure to enforce environmental protection in some

cases is an example of protecting bad companies and distorting market power. And finally, more radical reforms should be introduced to increase supervision of the government, disciplining its behavior. An independent judicial system, free media, and stronger industry associations fully representing business interests will ensure stronger government supervision. Premier Li Keqiang once said that the government must fulfill its obligation required by law, while not doing anything unauthorized by law. That is the right direction. But the question is when we will get there, or rather, will we ever really get there?

# 10

## How the WTO and FTAs Constrain Chinese Industrial Policy

*Claire Reade*

Chinese leaders demonstrated their serious interest in changing many elements of Chinese industrial policy by joining the WTO in 2001. The hugely positive economic effects of China's WTO entry reflected the value of the economic regulatory and structural changes required by WTO disciplines, including obligations to open up large areas of the Chinese economy to outside competition; eliminate discrimination against foreign goods, services, and investors; create and enforce stable, fair, and clear rules, both to protect rights and regulate behavior and to govern the flow of government resources; and protect and enforce intellectual property rights.

WTO dispute settlement also has played a useful role, operating both as a tool for the international community to ensure fair treatment and as a weapon for China to change old-style policies that are impeding broader progress. WTO cases have applied disciplines across the Chinese industrial policy arena, eliminating protectionist export restraints on key manufacturing inputs, as well as prohibited export subsidies; attacking monopolistic actions blocking foreign service supplier competition or demanding technology transfers; eliminating discriminatory restrictions on product distribution; and disciplining Chinese trade remedy procedures that did not meet fair standards. These cases both solve a specific problem and offer the broader opportunity to educate Chinese policy makers about how *not* to make future policy.

Joining the WTO, of course, also protected Chinese firms from other economies' protectionist barriers. Highly entrepreneurial and competitive elements in Chinese culture welcomed and thrived in the new environment, providing a counterweight to those in China still interested in protecting the status quo. However, as in all societies, various powerful Chinese groups pursued their specific self-interests, which sometimes clashed with the broader vision of what China needs to do for optimal economic development and global leadership. Accordingly, not all the changes desired by economic reformers came to pass with WTO membership. Further, some controversial Chinese policies with perceived

short-term benefits to China—such as currency undervaluation and use of prohibited export subsidies—seemed to persist, despite international criticism.

Over time, the threat to sustainable economic progress from certain of China’s stubbornly persisting industrial policies seems to explain why the Xi administration made such specific points in its *Third Plenum Decision* about the need for further, difficult reforms. At the same time, the contradictions/ambiguities in the *Decision* may well reflect the political limitations of “reform and opening up.”

Issues still on the table related to trade and investment include the outsized SOE role in key parts of the economy, with poor market-based performance; tolerance of monopolistic practices; and the government’s inability to wean itself from using SOEs to implement top-down policy mandates instead of having available more sustainable market-based disciplines. In addition, financial and other policies block market signals, leading to problems such as persistent overcapacity in key manufacturing industries, with poor industry exit mechanisms, and inadequate flow of funding to the private sector, including SMEs. Limited WTO commitments regarding opening key services sectors have helped preserve the inefficient status quo in some areas, as have persistent regulatory barriers even where a sector is “open.”

The business environment overall represents a work in progress, with stable, transparent, and fair laws and enforcement still unattained goals. For example, IP laws are quite good overall, but some legal gaps remain, and enforcement is weak. Antimonopoly law, regulatory approvals, procurement rules, and other internal regulations still seem subject to local vagaries and nationalist instincts. In fact, persistent nationalist thinking, mixed with policies seeming to reflect efforts by the bureaucracy to assert power, have generated problematic preferential policies for national firms. These policies—whether couched as innovation policy or a 10-year plan to achieve Made in China 2025—can significantly interfere with the competition and innovation drivers that would help Chinese economic development in the longer term.

China’s free trade agreements (FTAs) and bilateral investment treaties (BITs) historically have been incomplete, with relatively little ambition relative to the WTO rules. Accordingly, China’s existing international agreements will not push it forward toward more reform. However, as China has gained confidence regarding the value to its development of more rigorous and extensive rules, some increase in ambition has occurred. China’s 2013 embrace of the concept of a “negative list” approach and preestablishment market access protection in the context of the U.S.-China BIT is a strong example of this new attitude. The key now seems to be the ability of a highly centralized decisionmaking group in China headed by President Xi to find the bandwidth to fight the individual sectoral and industry interest groups, as well as political conservatives at both the national and local levels, so that the negative list is narrow and limited—and that it functions as it should to open up investment. It also will be critical to negotiate strong rules that will allow a healthy flow and growth of investment in the two countries. There is some

evidence that China's companies with significant ties to the global system recognize the value of strong initiatives to drop trade and investment barriers, but politically strong industrial and bureaucratic players without these ties still seem to pose a challenge to achieving more comprehensive "reform and opening."

# 11 | China and the Negative-List Principle: Possibilities and Uncertainties

*Dan Markus*

The negative-list principle is gradually becoming more accepted in China, but uncertainty remains as to whether these initiatives will substantially reduce Chinese government intervention in the economy. Since 2013, the negative-list concept has gained prominence in China's domestic policies, bilateral investment treaty (BIT) negotiations, and free trade zones (FTZs). Although this is a positive step in achieving a stated goal of the Third Plenum, the ultimate reduction in government intervention will depend not only on the number of industries and sectors on the negative list but also on China's expansive definition of national security.

This memo will discuss the evolution of China's foreign investment regime from a positive list to a negative list as well as concerns over the potential limitations to the negative-list approach.

## Background

Since 1995, the *Catalogue Guiding Foreign Investment* (CGFI) has set the parameters for the entrance of foreign investment into China. Using a positive-list approach, the CGFI divides foreign investment into three categories: encouraged, restricted, and prohibited. Items in the encouraged category are open to foreign investment and generally receive preferential treatment, including tax incentives or simplified approval processes. Items in the restricted category may be subject to extra steps in the approval process or face restrictions on the scope or ownership of operations. Items in the prohibited category do not allow foreign investment. If an industry or sector is not on the CGFI, it is subject to other relevant Chinese laws and regulations.

China continues to use a positive-list approach to managing foreign investment, and it recently updated the CGFI in March 2015. However, the government has been gradually introducing the negative-list concept over the past few years. A negative list requires that discriminatory measures affecting all included sectors be liberalized unless specific

measures are set out in the list of reservations. Below is a brief timeline of agreements and policies that have expanded the use of negative lists in China.

- *July 2013*: At the U.S.-China Strategic and Economic Dialogue, China agrees to negotiate the BIT under a negative list. This marks a turning point in and accelerates the pace of BIT negotiations.
- *September 2013*: The State Council officially launches the pilot Shanghai FTZ using a negative list to manage foreign investment. This is China's first attempt at a negative list.
- *November 2013*: In the *Third Plenum Decision* document, the party calls for implementing a unified market access system on the basis of a negative list.
- *June 2014*: The State Council issues *Several Opinions on Promoting Fair Market Competition and Safeguarding Normal Market Order* in an effort to reform the market access system and create a market access negative list consisting of a prohibited and restricted section.
- *April 2015*: The FTZs are expanded to Tianjin, Fujian, and Guangzhou, all using the same negative list.

## Recent Developments

More recently, on October 19, 2015, the State Council issued *Opinions on Implementing a Market Access Negative List System* in an effort to map out plans to draft and implement a unified market access negative list. The market access negative-list system will be piloted in select regions—Shanghai municipality and the provinces of Fujian, Guangdong, and Tianjin—from December 1, 2015, through December 31, 2017. Starting January 1, 2018, the market access negative-list system will be implemented nationwide.

The *Opinions* call for a market access negative list and a foreign investor negative list. One tier will focus on areas from which both domestic and foreign investors will be excluded, while the other will provide details of areas from which only foreign investors will be excluded. Areas that may face restrictions and prohibitions include industries and sectors touching upon economic, financial, and cultural security. As mentioned above, the negative list is expected to be released by December 1, 2015.

## Effect on Government Intervention

As the above reveals, the negative-list concept is gaining wider acceptance in China. But its impact on reducing government intervention in the market depends on the number of industries and sectors on the negative list, the scope of China's national security definition, and the timeline for implementation.

The length of China’s negative list is the clearest signal of the country’s interest in reducing government intervention in the economy. China’s current FTZ negative lists as well as reports on the U.S.-China BIT negative list offer two guides for assessing China’s position on market openings. China’s initial 2013 Shanghai FTZ negative list contained 190 prohibited and restricted sectors and was met with disappointment from foreign investors. Since then, the FTZ negative list has undergone two rounds of revisions: the first round in July 2014 reduced the number of prohibited and restricted sectors to 139, and the second round in April 2015 further reduced the number of prohibited and restricted items to 122. In both cases, however, many of the revisions reflected a streamlining of the negative list with other national regulations guiding foreign investment rather than a significant liberalization of the investment environment. In terms of China’s BIT negative-list offer to the United States, it has been rumored that it is more than 70 pages long and includes 30–35 industries. By comparison, the U.S. negative list is one page.

An overly broad definition of national security that includes economic, cultural, and societal security, as well as public morality, may limit any potential openings provided in a negative list. When read together with other draft and existing Chinese regulations relating to the screening of inbound foreign investment, China’s national security definition may result in an expansive approach to national security reviews that will further restrict and discourage foreign investment. Such an interpretation of national security may result in a negative list that restricts or prohibits industries and sectors not typically associated with national security. For instance, Chinese literature on the “Internet Power Strategy” refers to the Internet, cloud, and big data—used in sectors ranging from energy to rail transportation—as the nation’s most important basic infrastructure. Should Internet products and services be classified going forward as basic infrastructure, they would fall under Article 19 of China’s new National Security Law, with potential implications for future coverage under a U.S.-China BIT and the unified negative list. Outside of the essential security interest, China may also use circular or vague language in an investment treaty text or negative list to allow discretionary government intervention. This may manifest itself in unequal licensing processes for foreign investors, even in industries that are neither restricted nor prohibited.

In addition to the uncertainty about the direction of reforms, there is uncertainty about their pace. Although the previous three years have seen a growing acceptance of the negative-list concept, there have been limited reductions in government intervention over the same period. Indeed, high-level plans such as Made in China 2025 and Internet Plus issued over the past year appear to support domestic companies and discriminate against foreign invested enterprises in an exercise of industrial policy. In recently issued policies on SOE reform and mixed ownership, it appears that even within “competitive” industries there will be restrictions due to economic security. Moreover, a host of competition concerns related to AML and IP continue to be barriers for foreign investors. Still over two years away from a nationwide negative list, there are concerns that near-term liberalizations will be parked in negative-list discussions. The surest way for China to display a commitment not to interfere in the economy would be to offer near-term investment openings.

## Conclusion

The negative-list concept has the potential to limit government interference in the market so long as it is short, clearly worded, and applies a narrow definition of national security to foreign investment reviews and commercial procurement. However, China's current negative-list offers in the FTZs and its expanding definition of national security may not result in a substantial reduction of Chinese government intervention. In addition to negotiating a narrowly defined negative list, it will be critical that changes are made to existing and future Chinese laws and regulations, including but not limited to the draft Foreign Investment Law. Adopting a negative-list approach in 2013 was an important step for China's evolving investment regime, but the languid pace of tangible market openings casts doubt on putting limits to government intervention.



## Part IV. The 13th Five-Year Plan

# 12 | China's Five-Year Planning System: Structure and Significance of the 13th FYP

*Oliver Melton*<sup>1</sup>

The language and ceremony surrounding 2016's FYP "Outline" will, by design, portray the central government as firmly in control of the nation's future. The litany of impossibly precise quantitative targets—ranging from GDP growth to urbanization rates, CO<sub>2</sub> emission caps to health care coverage—will be reminiscent of China's history of socialist planning. The cynicism of China watchers worldwide, well aware of Beijing's struggle to tame wayward local governments and a freewheeling economy, will be palpable.

Yet despite the rhetoric, the FYP has evolved dramatically to adapt to a highly decentralized government and an increasingly market oriented economy. Beijing formally abandoned the FYP's role of dictating economic activity in 1993 and has been steadily rebuilding the planning system as a tool to coordinate, implement, and evaluate policy across a wide range of issues. As Xinhua helpfully explained in a peculiar music video, the modern FYP is now a continuous cycle of policymaking, not a discrete master blueprint. It produces thousands of subplans and implementation guidelines, issued by at least three levels of government over several years. The State Council began formalizing the roles of these documents during the 11th plan period, institutionalizing a process of evaluation, consultation, policy coordination, and implementation. The 12th FYP was the first to fully employ this framework, and the 13th plan is expanding this process of institutionalization.

In addition to its role as a coordination mechanism—managed largely by the State Council, the National Development and Reform Commission, and their local equivalents—the FYP derives its political influence through its integration with the Communist Party's personnel management system. The 11th plan introduced "binding targets" (约束性指标) that are included in cadre and administrative performance criteria, which is how Beijing shapes incentives for local officials who are otherwise given wide latitude to set policy in their districts. These metrics appear to have a meaningful—if lagged—impact on policy priorities outside of Zhongnanhai. Yet they are meaningless without a credible way for

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1. The views expressed here are entirely those of the author. They do not represent the views of the State Department, the Bureau of Intelligence and Research, or the U.S. government.

Beijing to observe them objectively—which is why expanding oversight systems (for example, deploying air pollution monitoring equipment) was a major priority in the 12th plan. By contrast, the closely watched national growth targets are “predictive” (预期性指标) and have no apparent role in subsequent policymaking—though GDP targets, unlike other predictive targets, remain influential in many local evaluations.

This combination of a robust coordination system and an intense—but narrowly targeted—incentive structure produces highly uneven results. Its effectiveness depends on the importance of the issue to the CCP leadership, Beijing’s ability to monitor outcomes, and the resources available to central and local officials. The significance of the FYP for economic policy in the 13th plan period will therefore vary significantly depending on the issues and the evolution of Beijing’s policy priorities.

The planning system will be central for issues, such as environmental protection and social welfare spending, which are top CCP priorities and are relatively easy to quantify. These areas require robust interagency coordination, the development of complex supporting institutions, fiscal transfers, and, most of all, external political incentives—all of which the planning system can deliver.

Similarly, the major regional programs—such as the Beijing-Tianjin-Hebei development plan and the One Belt, One Road initiative—will depend on the FYP to facilitate cooperation between central and local governments and to authorize access to vast quantities of state-backed capital. For these regional plans, the FYP will be less a source of political pressure—the Chinese bureaucracy needs no new incentives to spin up investment—and is important mainly as a tool for central planners to set parameters for their local counterparts. Yet the FYP system has been less effective at enforcing investment restrictions, because local compliance with central ministries’ administrative decisions can be subjective and difficult to monitor. This is why Beijing is working to strengthen regional planning institutions during the 13th plan, including legal reforms. But it has not yet found a way to do so effectively.

Other issues, such as SOE reform, industrial overcapacity, household registration (*hukou*) reform, and rural land reform, would require very similar types of support from the planning system. But Beijing has signaled that it is comfortable with incremental progress in these areas—in part due to its own ambivalence about more aggressive strategies—and it is unlikely to impose political pressure on the bureaucracy to achieve ambitious results during the 13th plan. Instead, Beijing will use its planning institutions to track progress, experiment with policy approaches, coordinate across administrative boundaries, and ensure that supporting institutions—such as tax policy and legislation—keep pace with gradual reforms.

The most contentious aspect of China’s FYPs has been industrial policy, which will remain a core component of the 13th plan. Several “thematic plans” (专项规划) are already under development to coordinate the work of central and local industrial policy ministries, such as boosting the semiconductor industry and “upgrading” manufacturing. This will

lead to more government intervention in key sectors, yet Beijing has also outlined a strategy to overhaul the way it supports innovation and science and technology programs—including some market-oriented proposals—and has been working to reduce or clarify the government’s regulatory powers. The FYP system will be tasked with implementing these initiatives, but it will be deeply constrained by the fact that the planning bureaucracies tasked with implementing the reforms are themselves the source of the most severe economic distortions.

The most important macroeconomic issues of the 13th FYP will be addressed almost entirely outside the planning system. Beijing recognizes that interest rate and exchange rate liberalization and the elimination of price controls in resource markets are necessary for China to move to a more sustainable growth model. Yet these issues are largely controlled by officials in Beijing, without the need for extensive support across the bureaucracy. The planning system can help with supporting policies, but the brunt of the work will be managed directly by the State Council. FYP documents will outline consensus strategies, but decisions about the sequence, pace, and extent of reforms will be made at the time of policy implementation by the senior leadership.

# 13

## How China's Five-Year Plan Benefits Different Interests

*D. D. Wu*

China has experienced more than 30 years of market economy reform, but its five-year planning is still functioning delicately and systematically. Thus, many foreign scholars criticize the FYPs sharply. Their criticisms fall into four types: (1) the FYP is a relic of the Leninist planned economic system; (2) the FYP is irrelevant to people outside of the central government; (3) the FYP is only focused on economic stimulus; and (4) the FYP is a huge waste of public resources and energy. However, all of these points are debatable. But even with these critiques, many still see the FYP as useful because of its explicit and implicit benefits.

For the Chinese Communist Party, which is the dominant power in China's policymaking process, the reasons for preserving the FYPs are obvious: to justify its leadership by issuing new ideas, new strategies, new targets and new initiatives and to stabilize social expectations and enhance confidence. Yang Weimin (杨伟民), deputy director of the Leading Small Group on Finance and Economics, one of the main participants and authors of the FYPs, defines it this way: "The FYP is to tell the market, enterprises, and people what major policies would be adhered to unswervingly by the party. . . . It is to mobilize the people to work on the goal rather than to argue."<sup>1</sup>

For the Chinese government, which could be regarded as the administrative organ under the CCP, planning is a tool of macro adjustment and control under China's current system. For those liberal-minded Chinese officials, the FYPs can also help them realize top-level design: to reform the system in a manageable way. For example, the plan is a guidebook of government behavior: it prevents the government, especially local governments, from perpetrating too much unregulated intervention. The plan also guides the government to redistribute public resources accordingly by setting restrictive indicators involving energy conservation, environmental protection, public service, and public responsibilities. These indicators actually aim to restrict the government itself rather than the market. Additionally, the government made it very clear that the plan is designed for the uncompetitive business sectors of the economy rather than the competitive sectors. For

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1. Yang Weimin, "Medium-High Speed Growth of the Residents' Income Is More Important than GDP," *Sina*, February 14, 2015, <http://finance.sina.com.cn/hy/20150214/144021555102.shtml>.

competitive sectors, companies are expected to make decisions according to market conditions; the FYP provides only limited direction at best.

For Chinese state-owned enterprises, the FYPs are directly relevant to them, because the SOEs have in the past and still do receive direct investment from the government. Under China's current system, most SOEs are actually state-supported enterprises. But this is a major issue of contention and one that is sharply criticized. As economist Fan Gang (樊纲), one of China's most active reform advocates, said straightforwardly, "The past experience has shown that the policy of government supporting some specific industries is unsuccessful. Once the central government defines one industry as an emerging strategic industry, government at all levels will fund it and the industry finally becomes one with overcapacity."<sup>2</sup>

The three groups above can be seen as directly relevant to the central policymaking process. How are FYPs still relevant for those outside of the system?

For ordinary Chinese people, the FYP is relevant for two main reasons. The first is its direct relevance. The FYP is directly related to people's everyday lives, such as health care, education, and other social welfare issues; for example, the reform of the One-Child Policy was contained in the 13th FYP's Proposal. Second is how critics use the government's promises against it—what has been called "rightful resistance."<sup>3</sup> In China, many citizens seek to legitimize their causes not by challenging the legitimacy of rulers but by making use of the state's own laws, policies, or rhetoric in framing their protests. The FYP, which always draws the best picture for the nation, supports those rightful protesters to some degree when they protest against local governments.

For the private sector, the motive for engaging the FYPs is similar to SOEs. Most Chinese big, private companies, if not small or medium-sized companies, are eager to be in line with the central policies of the FYPs. The private sector might not get direct investment from the government, but there is always opportunity for them to be included in those "emerging strategic industries." This is another factor leading to China's overcapacity.

For foreign investors, the FYPs preview the potential future market. Almost every FYP has one chapter and related information on opening the Chinese market, and the plan can be very specific. For example, the 13th FYP has specifically mentioned that China would open up the financial sector to foreign and private capital.

For scholars, the FYP is one of the best sources of information to understand China's political system and how the CCP governs the nation. Almost every significant national strategy or ideological campaign issued by the CCP could be traced to a FYP.

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2. Fan Gang, "Fan Spoke Out against the Government's Subsidy in Particular Industries," *Sina*, February 14, 2015, <http://finance.sina.com.cn/hy/20150214/152821555156.shtml>.

3. Kevin O'Brien and Lianjiang Li, *Rightful Resistance in Rural China* (New York: Cambridge University Press, 2006).

For Chinese public intellectuals, the planning process is also one of the few chances to express themselves to the government as well as to the public. As Xu Lin (徐林), Director of the NDRC's Planning Division, said, "The planning process is much more important than the plan itself, because it gives every party a platform to achieve consensus."<sup>4</sup>

For example, since the Ninth FYP, China claims to have transformed its economic development structure. But until recently, the structure had failed to transform. Wu Jinglian (吴敬琏), one of the most preeminent economists in China, argued publicly, "The main obstacle is the institutional obstacle: the government, with too much power and public resources at hand and regarding GDP growth as a major achievement of its performance, will necessarily use its power and resources to pursue for high economic growth."<sup>5</sup>

This public criticism, in fact, leads to a fundamental paradox of China's FYP: Can the government really make plans to reform and regulate itself without some kind of checks-and-balances system?

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4. Xu Lin, "Making State Plans with New Ideals," *Caixin*, October 14, 2015, <http://opinion.caixin.com/2015-10-14/100862855.html>.

5. Wu Jinglian, "Implications of the 13th Five Year Plan," *Southern Weekly*, November 13, 2015, <http://www.infzm.com/content/112918>.

# 14 | The CCP's Acceptance of Market Principles

*David Kelly*

This topic divides into a number of main threads. One basic analytical division is between the acceptance of market principles in the party itself and in its engagement with other agencies and interests. Another is between the domestic policy zone, where the party holds decisive power, and internationally, where it demands it. I shall argue that the party-state has a weak incentive in the domestic area.

Expressed as a matrix, market incentives are distributed as follows:

	<i>Domestic</i>	<i>International</i>
Party	Weak	Strong
Others	Strong	Strong

## The Domestic Scene

The party itself is deeply conflicted on the role of the market. The private sector, to the extent that it exists, remains market positive. It is, however, more than ever penetrated with party interests. Taking “party” as the “party-state” composite, we may use Liang Jing’s pessimistic analysis of the five-year plan as a baseline.<sup>1</sup> To get within striking range of answering the questions placed before us, it will be most helpful to work through the following set of assumptions he makes:

- The government is—contrary to much commentary—able to maintain a high rate of investment.
- This is intertwined with gaining a space for autonomy in monetary policy, de-dollarizing base currency issuance, etc.
- China could then take advantage of investment opportunities in advanced technologies.

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1. Liang Jing, “‘Shisan wu’ nan leguan de zhen liyou” [Genuine Reasons Not to Be Optimistic about the 13th Five-Year Plan], *Ziyou Yazhou diantai*, October 22, 2015.

- Given appropriate governance, there is no shortage of such opportunities.
- Liang’s closing argument is that this promising policy orientation will be rendered ineffective because baseline insistence on maintaining CCP rule is given priority over the principle of effective incentives.

Huang Qifan’s recently publicized successes in Chongqing provide Liang with an “exception proving the rule” supporting a further proposition: the global environment is not the key reason to expect slackening growth rates. If this and the previous points are broadly correct, his argument goes, the critical factor is the drive and ability of local leadership.

Other interlocutors in Beijing hold deep reservations about the “exceptional” qualities of Chongqing and Huang Qifan. Taking these as given for the sake of argument, the question remains, is this drive and ability market positive? Or is it administrative-interventionist? An answer to this would go some way to answering the question before us.

A hybrid of the two can’t be ruled out. Some of our earlier work on the current relevance of the “tournament system” and other work on bureaucratic incentives is useful here. Market competition has grown in intensity, but bureaucratic competition never goes away (despite performance indicators switching from production quotas to GDP to other mooted possibilities).

This is linked to the interest group perspective developed at a forum organized by Indiana University in Beijing in November 2015. Officials have alternatives to market growth as a source of career incentives. Marketizing socialist-era targets turned local governments into corporate actors, but *market forces may no longer coincide with local officials’ career interests*—the interest silos fail to mesh into a generic market interest.

Can a top-down reform via the FYP mechanism address this? Interest silos will have to be paid off first.

## The International Scene

The story here is simpler. Most of China’s international partners are market positive. In this context, the party-state is in word and deed supportive of market mechanisms, criticizes faulty market governance, and pledges to support the existing governance institutions.

The 13th FYP proposal contains new language asserting China’s “institutional voice” or right to speak (*zhiduxing huayu quan*, 制度性话语权). This conveys an intention (1) to produce international public goods; (2) to do so *from within* the accepted international institutions; (3) to do so according to Chinese norms, protocols, and definitions; and (4) to pursue China’s national interest as other states, not least the United States, are deemed to pursue theirs.

This important doctrinal shift does not in itself constitute a risk to or restraint on global markets. Risk lies rather in the potential leakage or “export” of China’s internal

frameworks to the international area, recognized in Chinese in the expression, “internationalization of domestic issues” (*guonei wenti de guojihua*, 国内问题的国家化).

Liang Jing has recently raised the possibility of China “exporting” its rural-urban divide to other jurisdictions. Other “deep troubles” of the China model—the center-local disconnect, state-market duality, preemptive hierarchy—may follow suit. Even if not as entire functional models, the institutional legacies and assumptions that these troubles reflect may become embedded in joint (bi- or multilateral) development schemes. The prospects of this new policy orientation should be a major topic of research.

# 15

## Impressions of the 13th FYP Proposal

*Scott Kennedy*

The broadest purpose of CSIS's project on the 13th FYP is to use the plan as a window into understanding the evolving nature of the Chinese party-state's approach to economic governance.

In Communist Party-run systems, documents are central to governance, as they identify and define problems and lay out the authoritative policies and solutions to address these problems. These documents are then relayed throughout the system and studied in detail by everyone in the political community. Some of the most important documents are confidential and not available to the broader public, let alone to foreigners. But many of these documents are intentionally disseminated as widely as possible so that everyone gets the message. Although the party-state goes to great lengths to clarify the meaning of these documents through commentaries and speeches, documents are often written in general and vague language. This provides the system flexibility in implementation, but it also means that the audience has to work hard to interpret the true meaning of these documents. That includes us.

Since the 1950s, the Five-Year Plan has been *the* defining document of the party-state's approach to economic governance. It is the most authoritative statement of the leadership's economic priorities and identifies broad policies on how to achieve them. The central plan is accompanied by hundreds of other five-year plans issued by the NDRC, several ministries, local governments from provinces down to cities, state-owned enterprises, and government-run industry associations.

There is some element of "going through the motions," or as Chinese like to say, "running across the stage" (走过场). The plan in some ways provides the appearance of a clear vision and guidance but to some extent is then ignored by everyone in the system, even the leadership itself as it goes about the daily work of governance. Nevertheless, the plan acts as a big flashing neon sign with lights pointing the way for everyone to go, and these signals are then absorbed by central and local officials as they draft more specific policies and create and disperse budgets. This does not mean companies and others must fully incorporate the plan into their business strategy, but it is both good defense and good

offense to be aware of and align with the plan in some way. Those inside and outside the system ignore the plan—or plans—at their peril.

Some thoughts about the 13th FYP in particular are worth noting. There has always been a division of labor between the CCP and the government in drafting. This time it appears that the CCP has taken on a larger role and that the NDRC has had less of an independent role in the process than before. It appears that the Leading Small Group on Finance and Economics and the Leading Small Group on Comprehensively Deepening Reform have been involved from beginning to end. Xi Jinping appears to have personally played a very direct role in the plan's creation. He gave at least three critical speeches in the spring and summer of 2015 about the plan, and when the Proposal was presented at the Fifth Plenum, it was Xi who unveiled the plan. This is the first time ever that the general secretary and not the premier has done so. This is Xi's plan. He owns it.

As Jamie Horsley wonderfully describes in her essay, there is a great deal of input into the plan from thousands of sources, with experts from Beijing and elsewhere, from every discipline, providing analysis and ideas. Some scholars, such as Tsinghua University's Hu Angang, try to become heavily involved in the planning process. However, this is not an open, pluralistic process; participation is by invitation and is highly constrained and controlled. And at the end of the day, the top political leadership decides on their own the content of the plan.

Over the Reform era, the plan has shifted from a mandatory-planning document to a guidance document, hence the shift from the term *jihua* (计划) to *guihua* (规划). At the same time, the plan has become longer, the number of targets has grown, and they have become more specific and technical. Those related to the environment and social welfare have expanded the most. I expect targets along these areas to continue to be more numerous and detailed in the 13th FYP. At the same time, the overall growth target is still the most important indicator in the plan. There was debate in 2014 about potentially removing this target, but that idea was abandoned in favor of keeping a target, the thought being that if the leadership didn't set a target, others would, and the leadership does not want chaos or have to pursue someone else's goals.

The stated goal for this plan—for China to be a moderately prosperous society—is unchanged from other recent plans, and like those, there is attention given to innovation, protecting the environment, and social welfare. And there is expanded attention to regional integration, internally and between China and elsewhere. But at its heart this plan is about innovation first and foremost. There is a long list of policies meant to promote innovation, and they are not all necessarily protectionist. The focus is clearly on addressing financial, legal, and institutional obstacles to innovation. This is mostly for the good; there is not, however, clear attention to addressing the “soft” side of innovation—fundamental education reform and opening access to information. A key unanswered question is what specific targets will be in the plan to measure progress toward China becoming a more innovative society.

Marketization and liberalization are mentioned in the Proposal, and they will be highlighted in various elements of the full plan when it is released. But the Proposal strikes me as less focused on these goals than the *Third Plenum Decision* from November 2013. I think it is telling that there is significant attention given in the latter part of the Proposal to party building, civil-military relations, global governance, and international security. This is a sign not only of possible “nonliberal” priorities being important to the leadership but that the role of the plan is gradually expanding to encompass a growing number of noneconomic issues.

The full plan will not be issued until late March 2016 after the conclusion of the annual meeting of the National People’s Congress. However, a full text of the plan has already been around for a while. Over the coming months, then, it appears that the main task will be to see to it that the more specific plans align with the general plan. At the same time, though, there may still be an opportunity to shape specific targets and policies. The Central Economic Work Conference, held in December 2015, was one important opportunity for those inside the system to do so, but informal opportunities to influence content will exist right up until the plan is printed. In China, although there is a lot of planning, it is amazing how much is left to the last minute and open to change.

# 16

## Wall Street, Financial Markets, and the 13th FYP

*Nicholas Consonery*

Financial market participants are closely monitoring the drafting process for the 13th FYP for any indication of a change of direction in Beijing's economic policies. China's emergence as the second biggest economy in the world and the biggest contributor to global GDP growth has significantly increased direct and indirect global investor exposure to the Chinese economy—and the exposure is myriad and complex.

China now plays a key role in shaping price expectations for a range of asset classes, from commodities to stocks of multinational corporations. Beijing's currency policy choices set expectations for exchange rate fluctuations across the emerging market world. Given China's role as a substantial consumer of natural resources and a major trading nation, shifts in its economic policy also influence growth outlooks across developed and developing markets.

As China's footprint on the global economy and capital markets is growing, uncertainty and confusion about its economic policy decisionmaking seem to be growing along with it. So is skepticism about the value of available statistics. Financial markets are straining to understand China's economic decisionmaking process under the Xi administration and to decipher real rates of growth in the economy. Concerns are high given China's significant levels of outstanding corporate and government debt, along with sharply diminishing returns on credit, which many financial analysts view as unsustainable. Even the IMF has concluded that past credit booms in other countries at the pace exhibited in China in recent years most often resulted in financial crises or prolonged periods of economic stagnation.<sup>1</sup>

As a result of these uncertainties, the investor community is increasingly negative about the outlook for China's economy. Investors are anxiously looking for signs that Beijing's economic decisionmakers are tackling the economy's underlying financial and fiscal ailments. They wonder whether regulators and policymakers in Beijing have the financial market expertise to adequately understand and address outstanding risks. Recent volatility has sharply increased negativity, particularly with the massive rout in the A-shares

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1. "People's Republic of China: 2015 Article IV Consultation," IMF Country Report, no. 15/234 (August 2015), <http://www.imf.org>.

market—which was blamed on government mismanagement—and the subsequent surprising shift in the valuation mechanism of the renminbi (RMB). That too was announced with no clear messaging about intentions to the financial community.

## Growth Targets, Capital Allocation, and the 13th FYP

The market conversation about these issues is now centering on the 13th FYP process, as it is the latest venue that might offer signals of policy intent. Investors are asking four primary questions: (1) Where will Beijing set its growth target for the next five years? (2) How committed is Beijing to actually hitting the target and how will they do so? (3) Is there likely to be any meaningful restructuring to the state sector? and (4) Will the government follow through with financial liberalization?

Signaling around the growth target was unambiguous at the Communist Party's Fifth Plenum in October: the party committed to “medium-high” growth and to doubling GDP and per capita GDP from 2010 to 2020. Explaining the plan, President Xi explicitly stated that China needs an economic growth of 6.5 percent per year to hit those goals. This strongly suggests the final FYP will include a 6.5 percent headline growth target.

For investors, these commitments undermine confidence that Beijing will address underlying risks and put the economy on a more sustainable growth path. Once seen as an important driver of confidence, headline targets are now seen as a driver of risk. Beijing's choice to avoid a business cycle that would feature consolidation in heavy industries and state firms, accompanied by subsequent job losses, is seen as unsustainable. To be sure, market participants appreciate the tough trade-offs Beijing faces in trying to increase consumption while scaling back investment to mitigate financial imbalances. But they are also seeking better insight into how the government assesses risk and plans to balance these trade-offs.

At the same time, an unequivocal commitment at October's Fifth Plenum to “making state firms bigger and stronger as tools of national strategy” makes clear that the state will remain active in corporate and economic governance, further undermining confidence than any restructuring or increased efficiency in the allocation of capital will take place. It will likely take a more significant financial crisis or hard landing to force Beijing to deal more comprehensively with these concerns.

Market participants are also monitoring the 13th FYP for any signals on financial reform. The Fifth Plenum did solidify pending goals: the party committed to a free-floating RMB and to dropping quotas on capital inflows and outflows by 2020. These are new and significant commitments. It also reiterated commitments to more efficient capital allocation, meaning interest rate liberalization.

A major question moving forward will be how the markets respond to signs of follow-through on these commitments. While such steps are vital for the longer term, many fear

that further openings will accelerate near-term risks around capital flight and financial instability. A particular concern is whether Beijing can manage interest rate and capital account liberalizations, amid perceptions of more serious nonperforming loan risks than the government is reporting, without undermining bank profitability and risking a potential financial crisis. The most recent example of this played out in August, when the alteration of the RMB's valuation mechanism ushered in a sharp increase in capital outflows, which continues today. Future signposts could include more reforms around the RMB's inclusion in the IMF's special drawing rights (SDR) basket in 2016 and additional capital account openings, such as launching the anticipated Shanghai-Shenzhen stock connect or relaxing limits on capital flows in and out of China's new free trade zones.

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