Rebalancing, Restructuring and Reform:

China 2016

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Paper presented to Reserve Bank of Australia Annual Conference 2016, "Structural Change in China: Implications for Australia and the World," Sydney, March 17-18, 2016.

ROUGH DRAFT, Circulated for preliminary comment only.

Since 2010, China has grappled with the consequences of the end of the "miracle growth" era. The challenge of adaptation to a radically new set of economic circumstances means that the old vocabulary of "rebalancing" is no longer appropriate. From 2005 to 2010, Chinese policy-makers advocated "rebalancing," but they never achieved it, and now the opportunity to pre-emptively "re-balance" is gone. The challenge now is to respond to a far more dynamic set of changing conditions, unlocking new sources of demand while buffering the shock to declining industries. We know from the experience of Japan and Korea that this adaptation is complex and multi-dimensional, and that finding the appropriate policy mix in this transition is extremely difficult.

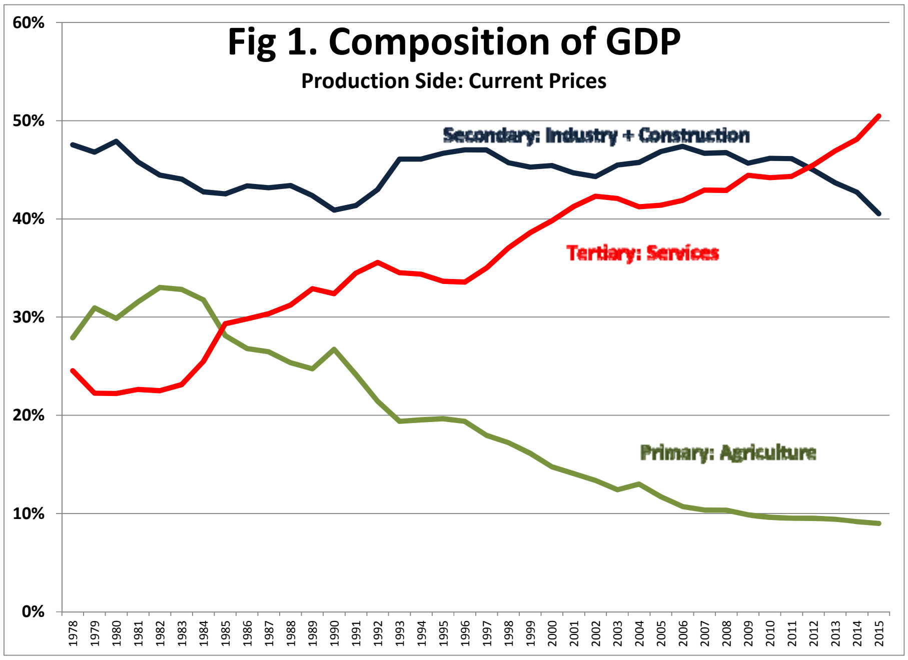
Ideally, during this slow-down phase, policy-makers assist the transition with a combination of structural and reform policies. Structural policies help shift the structure of demand (primarily) and supply (secondarily) in order to facilitate a new sustainable medium-high speed growth phase. Reforms adapt institutions and liberalize access to resources in order to facilitate the structural shifts and unlock new sources of growth. There is no evidence that China has begun to make the necessary adaptations effectively.

In this paper, I start by showing that existing aggregate data do not provide convincing evidence of significant restructuring. I bring in newly released 2015 data to show the limitations of the process and the data. I then discuss the policy background to this apparent lack of rebalancing. The focus is on economic reform policy over the past two years. Selecting state enterprise reform and local government debt restructuring, I demonstrate a pattern of inconsistent and unsuccessful economic reform policy-making. While it is impossible to show a direct link between reform policy failure and slow restructuring, the linkage is plausible. A new policy, "Supply-Side Structural Reforms" has been introduced in recent months. I argue that the adoption of this policy is a logical response to the failure of existing reform and restructuring. The new policy mix is an improvement, but is unlikely to be adequate to the challenges faced. However, the fact that Chinese policy-makers are still adaptable and learning from experience means that we should not be too pessimistic.

1. The End of "Miracle Growth" and Structural Change

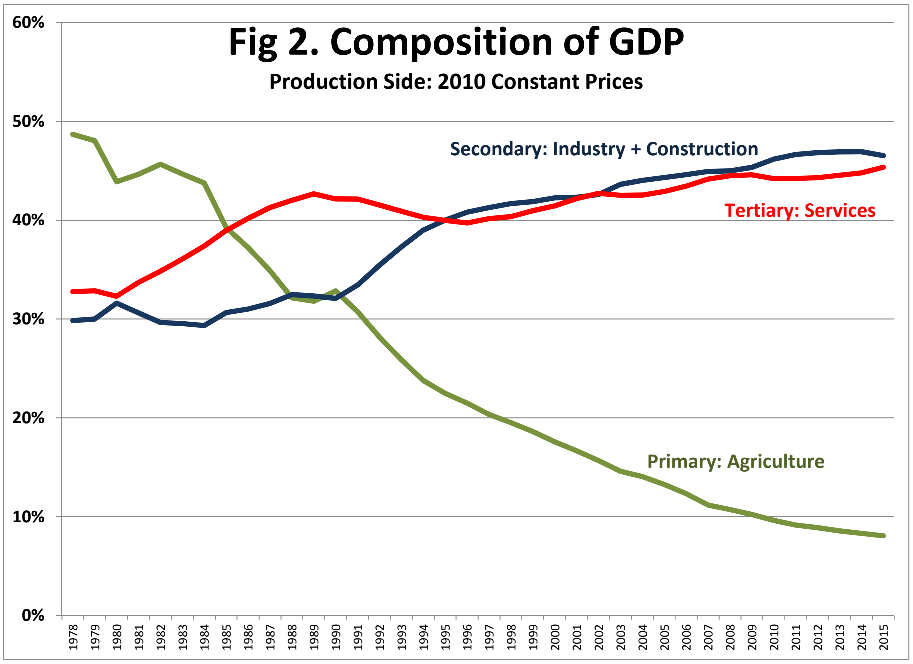
The end of miracle growth provides enormous challenges to policy-makers. Even the adjustment that should be easiest—adapting growth expectations downward—flies in the face of normal human habits and aspirations. These adaptations were very difficult for policy-makers in Japan and Korea to make at the end of their growth miracles. For China, with 2015 purchasing power parity GDP per capita, in the new World Bank 2011 price base, just over $13,000, or 26% of US GDP per capita, there is lots of catch-up still remaining (as Justin Lin frequently points out). However, in other respects, China faced an especially abrupt transition. The transitional period known as the "Lewis turning point" has just been reached, while at almost the same time, the population at working age has already begun to decline. At exactly the same time, the share of labor-force entrants with college educations has soared. All these changes took place at widely separated periods in Japan and Korea. Externally, trade has dropped, so the growth generated by export growth has vanished, even though China's share of world exports has not yet declined. These changes mean that investment profitability (and productivity) must also be changing very rapidly. Certainly we would expect the growth rate of investment to drop dramatically, and the composition of investment should also change. Taken together, these forces mean that the Chinese economy is being whipsawed by extremely rapid changes in factor supplies, structure of demand and, probably, productivity growth. It would not be surprising to see rapid structural change right now.

Broadly speaking, there is agreement about the type of structural change needed: demand should shift to domestic sources, consumption should increase as a share of GDP, and a larger share of growth should come in services, high technology sectors, and with a large boost from productivity improvement. The Chinese government has lately been releasing data which, it argues, show that these transitions are already underway. On closer inspection, however, the data do not support this claim. The first such assertion is that China has shifted to service-sector driven growth, and that services now account for more than half (50.5%) of GDP. Figure 1 shows graphically the data on which this argument is based. At first glance, it appears to strongly support the assertion, since between 2011 and 2015, the service sector share of GDP jumped from 44.3% to 50.5% more than six percentage points in four years, which looks impressive. However, a look at the longer-term trend shows that the service share has been increasing since 1980, when it was an abnormal 22.2% of GDP. Using this indicator would tell us that China's miracle growth has *always* been driven by service-sector development! In fact, looking at current price shares of GDP can be extremely misleading.

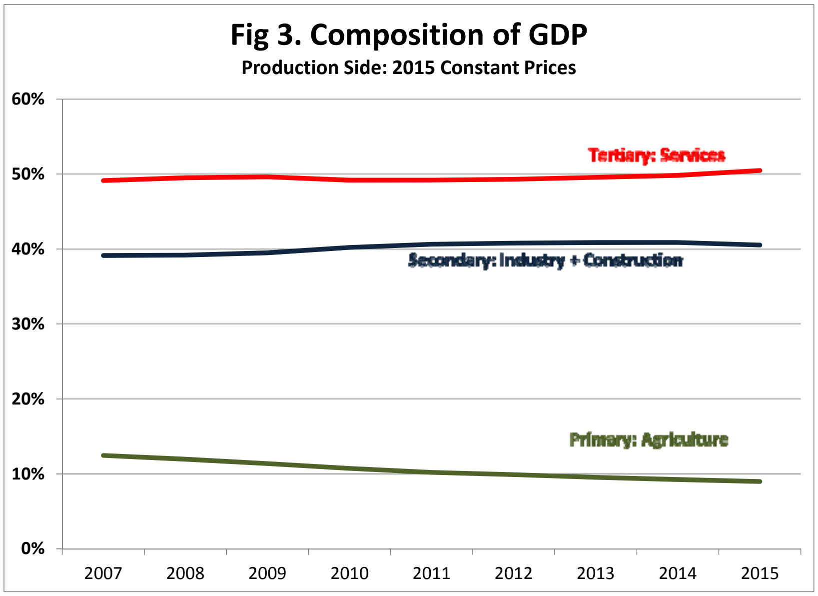


The reality is, this is almost entirely a story of changing relative prices.[1] Between 2011 and 2014, the implicit price deflator for services was just over five percentage points more than that for the secondary sector, and in 2015 the gap was almost eight percentage points. This difference in price trends accounts for almost all of the change in share. Figure 2 shows the constant price data, deflated by the sector implicit deflators. The increase in service sector share between 2011 and 2015 is only 1.2 percentage points (or just 0.8 percentage points from 2008). Of the increase in service share from 2011 to 2015, less than 20% of the increase is driven by differential real growth rates, and over 80% is driven by changes in relative prices. In fact, the official data say that the real growth rates of industry and services were quite similar, so the change in shares has to be a price phenomenon. In fact, industrial ex-factory prices have been falling for four years now, and the secondary sector implicit deflator has been falling for the last two..

[1] In itself, the shift in relative prices is a positive phenomenon, since it indicates that relative profitability is improving in services, and therefore services might in the future attract more rapid entry and more investment.



This pattern of relative price changes is the reverse of what you expect to see in a healthy structural growth process. Generally speaking, productivity growth is more rapid in fast-growing sectors, so that current-price changes in structure are *less* marked than constant price changes (Indeed, this is why the current price share of industry in China didn't increase between 1978 and 2008: productivity growth was rapid and the relative price of industrial goods was declining). This is also why production indexes calculated with initial period weights almost always show faster growth than indexes calculated with end period weights. The fact that this is not true in China tells us that something other than gradual structural change is going on. Figure 3 shows "nothing." It uses 2015 constant prices, and demonstrates that structural change since 2007 is virtually imperceptible. Despite the enormous changes sweeping the Chinese economy, we see almost know change in the constant price relative share of the three large sectors.



China's national accounts have significant problems: they are a kind of masterpiece of improvisation, adequate for rough generalizations, not sufficient for detailed structural analysis. It may be that errors of measurement or deflation vitiate any conclusions. However, some aspects of China's national accounts lead us to expect that service sector growth rates are over-estimated.[2] Generally speaking, China's statisticians collect income (revenue) data and then deflate through various expediencies. Among services, the two largest sub-sectors are retail and wholesale trade (9.8% of GDP in 2014), and financial services (7.3%). In retail and wholesale, value-added is deflated by the retail goods price index. In an economy where wages are rising while ex-factory prices have been falling since February 2012, the resulting deflator is obviously biased downward and real growth biased upward. Financial services have four components money and banking service, capital market services, insurance services and others. For capital market services, income data is collected and an implicit deflator computed using the volume of turnover on the stock market as the only physical output indicator. For 2015, when stock market turnover exploded, this measure obviously overstated the real growth of capital market services. The capital market implicit deflator is then combined with a consumption-investment price index to deflate insurance services, biasing growth of that component upward. Real financial service

[2] These following two examples come from the vice-head of the National Bureau of Statistics. Xu Xianchun许宪春. "China's growth rate has not been overestimated." Sina Chang'an Forum, March 4, 2016. Accessed at http://finance.sina.com.cn/sinachanganforum/2016-03-04/doc-ifxqafha0361499.shtml

growth calculated at 15.9% in 2015 is a significant part of the overall service sector growth rate.[3] It is striking that nominal wages (rising rapidly) are never used as part of the deflation strategy for labor-intensive services. Overstatement of growth in retail and wholesale plus financial services would significantly exaggerate the pace of structural change.

To be sure, there are service sub-sectors that are growing rapidly, particularly those related to internet services and sales. It is entirely possible that Chinese statistics undercount these services, and no doubt there are errors in various places that offset the overstatement in wholesale-retail and financial services. But a quick look doesn't turn them up. Indeed, the NBS recently published the following remarkable statement: "Among above-scale service sector firms, the business income of those in high technology services, technology consulting services, strategic emerging services, and cultural and related services grew in 2015 by 9.4%, 8.6%, 12.0% and 11.1%, all [sic] higher than the 9.5% growth rate of all service sector firms."[4] Such relatively small growth rate differentials for the (small) highly dynamic sectors are not going to drive major structural change. Whether or not the quality of China's data are deteriorating is not clear; but the quality of communication does seem to be declining.

China's job data are equally problematic. The statement has been made repeatedly that the addition to urban jobs over the past three years was 13.1 million, 13.2 million, and 13.1 million respectively. These numbers are completely spurious. They come from local labor bureaus reporting the results of their work supporting employment, and are not net of job losses (which are clearly significant: in fact, secondary sector employment declined by a net 4 million in 2015). A somewhat more plausible number is that total urban employment increased 11 million in 2015, identical to the average for the preceding 3 years. This number of course includes all the workers who get incorporated into the urban category by any means, including expansion of urban boundaries (this series has many other problems).[5]

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[3] National Bureau of Statistics, "The scope of the service sector has expanded and newly emerging sectors are growing rapidly: the development of services since the 18th Party Congress," March 7, 2016, accessed at http://www.stats.gov.cn/tjsj/sjjd/201603/t20160307_1327678.html

[4] Above-scale firms report their revenue data directly to the State Administration of Industry and Commerce. National Bureau of Statistics, "The scope of the service sector has expanded and newly emerging sectors are growing rapidly: the development of services since the 18th Party Congress," March 7, 2016, accessed at http://www.stats.gov.cn/tjsj/sjjd/201603/t20160307_1327678.html

[5] The aggregate urban number is just a rough estimate; the components of employment by ownership and sector have not been published in full for several years now; and the government encourages confusion caused by the rapid increase in newly registered businesses, most of which come from previously unregistered informal sector businesses.

This number cannot be dismissed out of hand, but it raised many questions and contradicts other data series. First, the full picture painted by the employment data includes two anomalous features. Broadly speaking, the population at labor force age (15-59 in Chinese data) has been declining about 7.4 million annually since 2011, while total employment (urban and rural) has been increasing 2.6 million annually (in all these data, 2015 is very close to the average of the past four years). This implies that China is drawing 10 million workers a year from increased labor force participation of younger workers (despite increase in college attendance) and from workers 60 and above. This is quite an unusual pattern. A further implication, moreover, is that the increase in urban workers must be coming predominantly from a reduction in agricultural workers. In fact, the employment data claim that agriculture has shed 12 million jobs annually from 2011 through 2015, as many as during the 2003-2007 peak, and the fastest ever in percentage terms. Agricultural labor, by this accounting, declined 18% in the four years to 2015, compared with 16% in the four years to 2007, when workers were flooding into export-oriented manufacturing. This does not accord with (admittedly anecdotal) reports from the Chinese countryside.

More importantly, the broader picture painted by the employment data contradicts the data on migration and non-agricultural rural labor force. Figure 4 and Table 1 show that according to this data, the growth of non-farm labor has slowed dramatically since 2012. In my judgment, this data is to be preferred. It is collected through a large household-based survey, and is relatively transparent. The data were first collected in 2009 in response to worries about the impact of the Global Financial Crisis. Unlike the other employment data, it is not linked to a local bureaucrat’s success indicators. These data show structural change slowing dramatically after 2010-2012, presumably due to the combined impact of slower labor force growth and weaker labor demand.

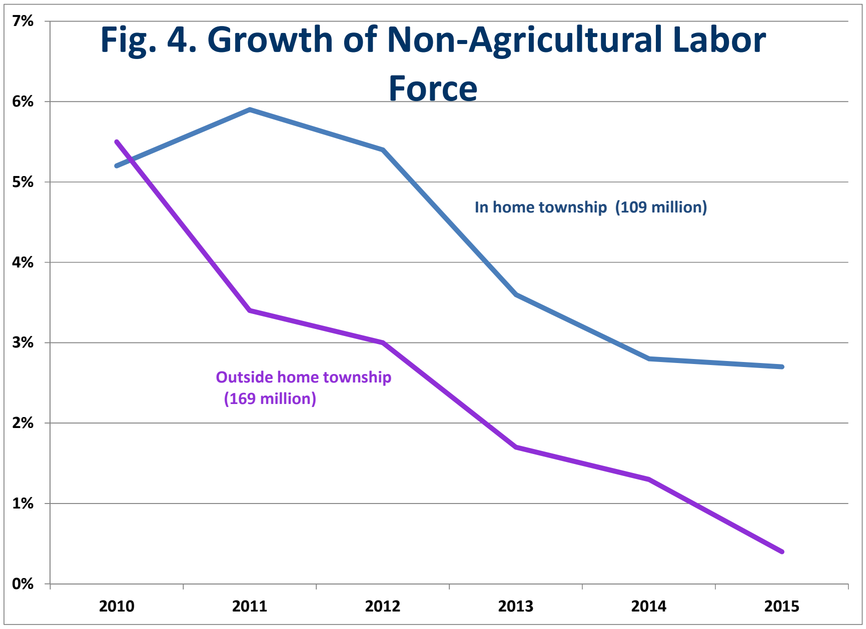
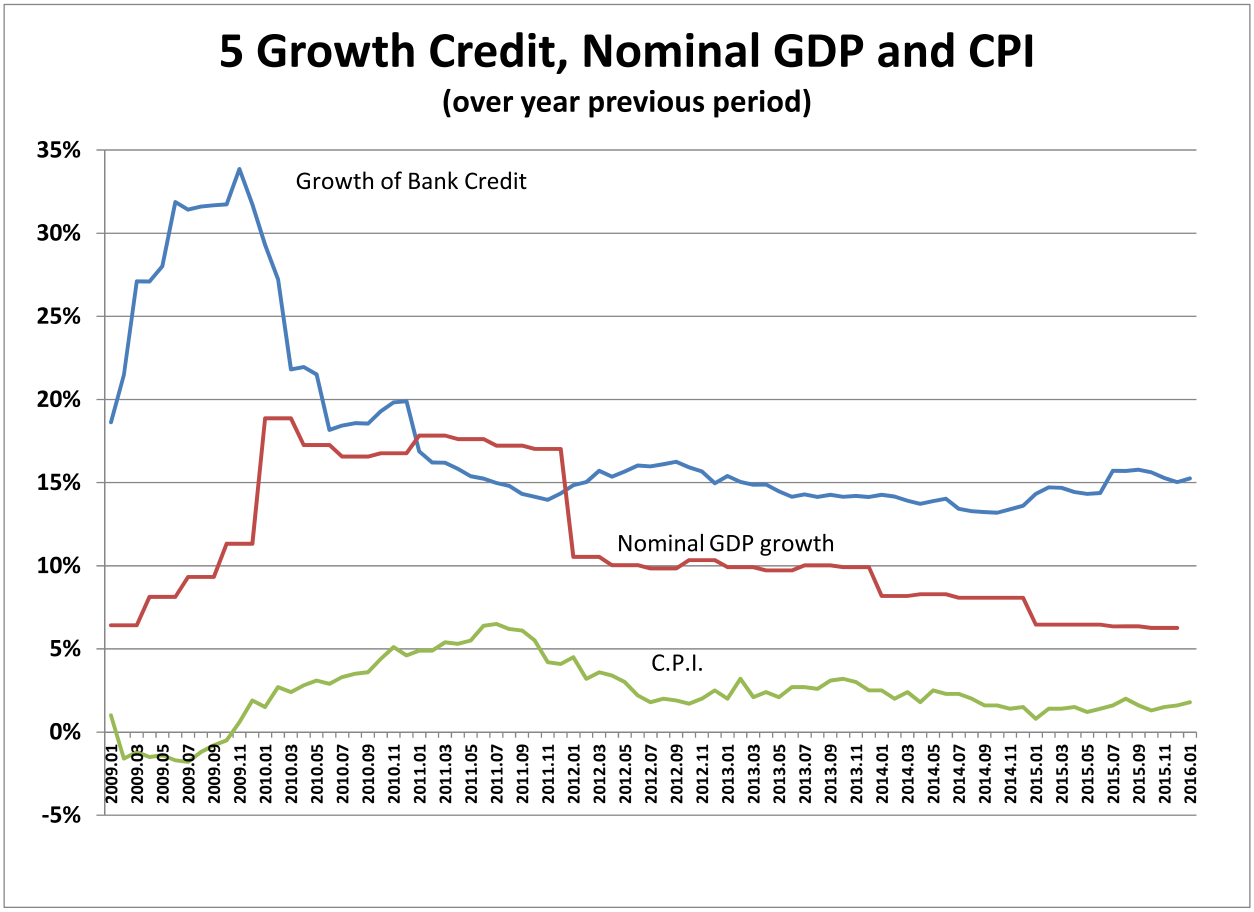


Table 1 Increment to Non-farm Workforce (Million)							
	2009	2010	2011	2012	2013	2014	2015
Out-Migrant	4.92	8.02	5.28	4.73	2.74	2.11	0.63
Local	-0.56	4.43	5.27	5.1	3.59	2.9	2.89
Total	4.36	12.45	10.55	9.83	6.33	5.01	3.52

Other indicators show that labor force conditions are fairly stable in most parts of the country. Other than troubled rustbelt and coal mining towns, there is no evidence of widespread distress in labor markets. But labor markets are lagging indicators. If labor demand flags below shrinking labor supply, this will occur after problems are already apparent in other indicators. What is clear is that the indicators that have been advanced to show that structural change is occurring are remarkably weak. Some of these indicators of structural change are simply spurious, while others do not stand up to closer scrutiny. I am not arguing that the available data prove the *absence* of structural change: The data currently available are not robust enough to do this. However, none of the available data demonstrate robust structural change.

2. The Policy Environment

The overall policy environment in China is consistent with the picture of limited structural change sketched in the previous section. Despite enormous attention paid to the reform agenda and the adaptation of policy to the "new normal," the actual policy environment has been relatively slack, and is not sufficient to drive major changes in behavior. Figure 5 shows some of the main macroeconomic magnitudes: credit growth, nominal GDP growth, and consumer price inflation. Growth of RMB bank credit is not the only component of credit or monetary policy, to be sure, but the intent here is not to discuss debt or credit policy, but simply to establish a macroeconomic policy baseline for the discussion of economic reform, which is the main topic. Figure 5 shows the essentials: The credit stimulus of 2009 succeeded in pulling up nominal GDP growth (approximated with quarterly real GDP growth grossed up with the annual GDP deflator). Policy became moderately tight during 2011, as the PBC sought to drain excess liquidity from the system and inflation looked worrisome. Credit growth fell below nominal GDP growth for the only time this decade. However, since 2011, nominal GDP growth has fallen steadily, while credit growth has remained roughly constant around 15% per year, even accelerating somewhat from its low point in mid-2014. The result is that credit growth in was about five percentage points above nominal GDP growth in 2014, and the gap increased in 2015 to eight to nine percentage points. In and of itself, credit policy has been broadly accommodative, and arguably is becoming more so.



3. Reform Policy

It is now more than two years since a broad program to revitalized market-oriented economic reforms was laid out at the Third Plenum in November 2013. There has now been sufficient time to evaluate the implementation of specific reforms. Important steps have been taken in many areas.[6] Nevertheless, I argue that, *generally speaking*, the implementation of reforms has been disappointing. In many cases, reform outcomes have been modified during the implementation process in a way that reduces or eliminates the pressure that reforms could potentially have created for more thorough restructuring. To be sure, firms and local governments are under pressure anyway from rapid growth slowdown and changing prices. However, the actual outcome of these reforms, so far, has been to buffer local governments and

[6] I would highlight as broadly successful steps to simplify the registration and oversight of private companies; and steps toward liberalization of capital markets, accompanied by greater transparency. In the latter case, mis-steps in implementation mean that important aspects of the reforms have been suspended, so our ultimate judgment will depend on the speed with which reforms are reinstated.

firms, especially state-owned firms, against the restructuring pressures created by rapid economic change.

3a. State Enterprise Reforms

The November 2013 Third Plenum document laid out a number of important, challenging, but vague, principles for state enterprise reform. The document stirred excitement because the principles advanced addressed fundamental issues of state enterprise governance in fresh ways that potentially had real significance. It took almost two years for the ideas in the Third Plenum document to be expressed in an official document "Guiding Opinion," which was publicly released on September 13, 2015.[7] This is a typical "keystone" document that lays out broad principles; a large number of implementing regulations have also been successively appearing. This pattern has been dubbed "1+N" because while between ten and fifteen implementing regulations have already been issued, there are several more still in the pipeline, so no one is sure what the ultimate "N" will be. This adds to the complexity of the changes, particularly since the initial "Guiding Opinion" is vague and contradictory, even by the standards of this type of document.

Overall, this is essentially a program to normalize management of state enterprises. It calls for dividing SOEs into commercial and public service classes, transforming "nearly all" SOEs into corporations, clarifying relations between the government, the agency that exercises the powers of ownership, investment companies, and firms, strengthening Boards of Directors *and* Communist Party control, and inviting in non-state investors under certain conditions. These are mostly sensible things to do: In fact, many of these things were actually on the government's agenda from 2003 until 2005-6 and then just sort of faded away. In many respects, the document says, "it's time to restart the old SOE reform agenda that stalled out for ten years."[8] Better late than never. Unfortunately, the provisions beyond this reform resumption are disappointing or worse.

7Communist Party of China and State Council, "Guiding opinions on Deepening Reform of State-owned Enteprise (中共中央、国务院关于深化国有企业改革的指导意见). August 24, 2015, Published Xinhua News, September 13, 2015. Accessed at http://news.xinhuanet.com/politics/2015-09/13/c_1116547305.htm

[8] For example, the document calls for organizing "virtually all" SOEs as corporations under the company law and piloting listing some top-level conglomerate companies and strengthening Boards of Directors. The reorganization of SOEs under the company law has been policy *for 21 years* since the Company Law was passed in 1995, and both listing top-level conglomerates and strengthening Boards of Directors were pilots in 2005-6, notably with Baoshan Steel. For example, October 2005, SASAC announced eleven state wholly-owned corporations, with outside

The reforms do introduce a new—or at least newly important--layer of management into the state enterprise sector, the "State Capital Investment and/or Operations Companies" (国有资本投资、运营公司), hereafter abbreviated as SCIO companies (or just SCIOs).[9] The Chinese term is shown here because it contains an unusual comma, between "investment" and "operation." When this type of investment company was first suggested in the Third Plenum document, there was speculation that it would refer to a relatively, passive, investment-return-oriented entity like a sovereign wealth fund, or "Temasek model." The title given to SCIOs indicates the repudiation of any conception in which the company is *limited* to passive, return-oriented investment. The explicit incorporation of "Operation" shows that these investment companies are expected to take on a much more activist role. In fact, everything in this 1+N package is designed to allow an active role for "investment and operation" companies. The following Table shows the new structure overall. In some cases, however, pilot projects will test eliminating "asset supervision agencies" and delegating ownership powers directly to the SCIOs.

Table: New State Capital Management System

Government
|
Asset Supervision Agency
|
State Capital Investment and/or Operation Company
|
State Enterprise
|
State Enterprise Subsidiaries

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directors on the Board of Directors, led by BaoSteel. (whose directors included Victor Fung 冯国经and Stephen Lee 李庆言).

9 State Council, "Views on Reforming and Improving the States of Managing State Capital," (国务院关于改革和完善国有资产管理体制的若干意见). Article 9. October 25, 2015. 国发〔2015〕63号. Accessed at http://www.gov.cn/zhengce/content/2015-11/04/content_10266.htm

This new structure is extremely problematic, and in many respects represents a major step backwards. This can be seen most clearly by looking successively at (a) the classification of SOEs, (b) the responsibility of SCIOs, and (c) the powers delegated to SCIOs and SOEs. The classification of enterprises begins with a straightforward differentiation between commercial and public services enterprises, which are to have different management and incentive systems. Among commercial enterprises, however, there are further clear distinctions that are much less straightforward. For one sub-group of commercial enterprises whose main business is in fully competitive sectors, they should accelerate corporatization, they may take in outside investors even allowing state ownership to become a minority position and they should list on stock markets.[10] This is progressive. However, there are many firms who do *not* fall in this sub-group: any firm whose main business is in sectors that "relate to national security, or the commanding heights of the national economy or important sector or keypoint areas," and should be incentivized to "better served important national strategies and macroeconomic control" and specifically "develop forward-looking strategic sectors and well as any specially assigned responsibilities."[11] In other words, pretty much any firm can be placed in an ill-defined and ill-demarcated "other" sub-group. Who makes this important discretionary decision? The answer is clear: the "owner" makes the decision, meaning the asset supervision agency (but possibly delegated to the SCIO in the future). The designation should be "relatively stable," but should be "dynamically adjusted" to accord with changing conditions, including changes in economic development, national strategies, and enterprise capabilities.[12]

The extremely elastic and decentralized definition of this "other than competitive" class of enterprises is of central importance. First, the government is supposed to maintain a controlling stake in any firm in this category.[13] Second, the incentive structure for this category is supposed to contain a substantial element reflecting the special tasks and social responsibilities the firm has, in contrast to firms in the "competitive" category, for whom the incentive structure is supposed to be based predominantly on profitability and increased asset value. Specifically, "while giving appropriate weight to profitability and increased asset value, these firms should

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[10]SASAC, Ministry of Finance and NDRC, "Views on Demarcating and Classifying SOEs,"(关于国有企业功能界定与分类的指导意见). December 29, 2015, accessed at http://www.sasac.gov.cn/n85881/n85921/c2169765/content.html
[11] Ibid., Articles 2.1, 2.3, and 2.4.
[12] Ibid., Article 3.
[13] CCP and State Council, Article 5.

increase the weight given to "examining conditions relating to serving national strategies, guaranteeing national security and the operation of the national economy, or developing prospective strategic sectors."[14] In other words, the SOE reform specifically includes classifying a category of SOEs that will stay state-controlled and will increase the attention given to political objectives and reduce the importance of profitability.

What about the SCIO Companies, then? As stated above, SCIOs are expected to play an active role: "push state capital into important industries and key sectors that affect national security, the commanding heights of the national economy and the people's livelihood; concentrate on keypoint infrastructure; concentrate on prospective strategic sectors; concentrate on outstanding enterprises with core competitive strength. Fully bring into play the SCIO companies to liquidate a batch of companies, reorganize a batch of companies, and innovate and develop a batch of companies…..Fully bring into play the core and exemplary function of SOEs in realizing the strategy of innovation-driven development and become a manufacturing power; strengthen the predominant position of enterprises in technological innovation; attach great importance to training scientific personnel and highly skilled personnel."[15] Of course, what is most remarkable about these passages is how incredibly elastic the definition of other-than-competitive enterprises is. In truth, an SCIO can clearly define any SOE that it wants to as other-than-competitive, because there will always be some important or emerging role it can lay, if only as a model of the most technological and competitive firms.

Perhaps this would be less important if China were not engaged in an extraordinary effort to promote innovation and high-technology enterprises as the key to the growth transition. However, everyone knows that China has invested enormous, perhaps unrealistic, hopes in the development of new technology. The policy emphasis, already strong, has been ramped up in the Thirteenth Five Year Plan. This means that every local government will be under a certain amount of pressure to show they are contributing to the effort, by establishing a SCIO Company and having it be actively engaged in concentrating state capital in key sectors, i.e., investing and taking stakes in high tech enterprises. For example, Gansu province—not generally regarded as a hotbed of the start-up economy—elaborates its SOE reform program by incorporating most of

[14] SASAC, MOF and NDRC, Article 2.4.
[15] CCP and State Council, Article 14. Notice that the second to the last clause is a "fudge." It is established national policy that the enterprise should be the predominant actors in technological innovation; by squeezing this accepted policy into this context, the drafters are creating the impression that this naturally refers to SOEs, whereas SOEs were actually secondary players in this respect seven or eight years ago.

the existing provincial plan: increasing the amount of state capital in one of five named development zones, supporting the provincial industrial policy, developing five strategic emerging industries, "information technology, biopharmaceuticals, smart manufacturing, new energy and new materials." More than 80% of the increase in state capital should be in "strategic emerging industries, infrastructure, public services, and the externally oriented economy."[16] Clearly, the SCIOs are expected to be the instruments of this policy.

In general, SCIOs are supposed to be under trial implementation in 2016. Central SASAC is ready: they have designated two existing SASAC top level firms as State Capital Operation Companies (国有资本运营公司), i.e., they are not investment companies. These are the Chengtong 诚通集团 Group Company and the Guoxin 国新公司 Group Company. Both of these firms have been in existence for a while. Chengtong was formed in 1992 out of the subordinate companies of the old Ministry of Material Supply. When SASAC was formed in 2004, Chengtong was made into a pilot Asset Management Company 资产经营公司. SASAC favored it as an instrument for restructuring SOEs, using it to purchase and restructure ailing subsidiaries of other central SOEs. It had a flurry of activity in the mid-2000s, but then became much less active, and concentrated on its ongoing logistics and packaging businesses. Guoxin was set up by SASAC in 2010, and was supposed to clean up the assets and liabilities left over as the big SASAC firms were listed on the stock market. Again, after initial activity, Guoxin subsided into a status quo place-holder. Both Chengtong and Guoxin have an odd mix of subordinate companies that include firms that sell goods and services as well as an asset management business. Both were favored instruments of SASAC in the past, who gained experience in restructuring distressed assets, but never played the larger roles that had been expected of them. Now they have returned.[17]

The re-structuring of the state enterprise system needs to be put in the context of initiatives emerging from other parts of the policy apparatus to foster technological innovation. Numerous new state-owned "private equity" funds are being set up to foster dynamic industries. In the most advanced and highest priority case, integrated circuits, these government PE firms

16The document even gives aspirational targets for the number of provincial firms reaching specific thresholds of internationalization. Gansu Provincial Party Committee and Government, "Practical Views on Deepening State Enterprise Reform," January 8, 2016, Articles 3, 37 and 39. Gansu Provincial News Network, February 18, 2016, accessed at http://gansu.mofcom.gov.cn/article/sjshangwudt/201602/20160201257319.shtml

[17] This is one of many signs that the fully elaborated state enterprise reform strongly reflects the positions and interests of SASAC.

are expect to total about US$150 billion, including some contributions from private investors. Already, Beijing Municipality has put up US$10 billion and the national government has advanced US$30 billion for two different IC buy-out funds. These buy-out funds are expected to be flexible, to be willing to take risks and bear losses, but also to emerge with (state-owned) stakes in the successful firms. They are conceived as playing a similar role to the SCIOs, but arriving there by a different route.

Finally, "mixed ownership" encourages state capital to expand its investment in, and control of, private firms. Ownership stakes in private firms are encourage, through multiple forms.[18] SCIOs should serve as platforms for buy-outs, taking strategic stakes, forming incubators, co-investment, strategic partnerships, and generally "compensating for market failures." SCIOs with preferential access to capital will expand into the private economy.

Evaluation

The envisioned role of the SCIOs as pro-active drivers of change is deeply problematic. Government is to withdraw from all operational decision-making, but those decisions will be delegated to the SCIOs, which are intended to act as developmental institutions, internalizing the developmental objectives of the government.[19] SCIOs set the evaluation and reward functions for their subordinate enterprises, but who sets the evaluation and reward functions for the SCIOs? Implicitly, the superior Asset Supervision Agency does so, but the process and principles of this are not addressed in any of the documents. In the initial 2013 Third Plenum document, there was some hope that the SCIOs might function as a type of sovereign wealth fund, with multiple funds bench-marked by total returns. As the reform has evolved, it is quite clear that this will not happen. On the contrary, as SCIOs proliferate, so will their missions and evaluation benchmarks. We should anticipate the emerge of (literally) thousands of well-resourced SCIOs, seeking to rationalize the distribution of state capital by developing a broadly defined array of priority sectors and industries. Oversight is likely to be weak. Just as insider control is now a problem in state enterprises, insider control will become a major problem for SCIOs.

In addition, the implementation process very much privileges the existing government departments that exercise ownership rights over state firms. All the key decisions about

[18] CCP and State Council, Article 18; Gansu, Articles 52-54.
[19] In the first step, this delegation is to the Asset Supervision Agency, which in turn delegates to the SCIO. But pilot programs will explore removing the Asset Supervision Agency from the equation.

classifying firms and sectors are made “in house.” This is particularly clear from the case of national SASAC, since the identity of the first two SCIOs is so intertwined with SASAC’s past and personnel. It is clear that this is an approach that conserves and utilizes existing expertise, but also that it is a reform that entrenches existing interests. There will be no radical shake-ups, and nobody will be under great pressure to change existing behaviors.

For firms judged to be in competitive industries, the current wave of reforms will likely improve transparency, clarify accountability and contribute to the development of equity markets. In essence, China is finally getting around to completing the SOE reforms initiated between 1996 and 2006, and this will have productivity benefits. However, these gains are likely to be more than overshadowed by the inefficient use of resources created by the proliferation of new SCIOs with vague and constantly changing mandates. On one hand, there simply aren’t that many state firms left in the really competitive sectors, since they have already been out-competed by private firms, so the total efficiency gains may be limited.[20] On the other hand, in the current policy environment, decision-makers will perceive that the “action” is in displaying dynamic commitment to national goals, foremost among which is the promotion of high technology emerging industries. They are likely to devote far more of their time and energy to encouraging plausible interventions in those “new” sectors than they are to restructuring or liberalizing existing sectors.

3b. Local Government Debt Restructuring

Local government debt restructuring was an ambitious program drafted by the Ministry of Finance in 2014. It had three inter-related objectives: to stabilize and lower the debt burden on local governments; to credibly signal to local governments that they would henceforth have “harder” budget constraints; and to contribute to the development of capital markets by kick-starting a market for municipal bonds. Local government debt restructuring began in earnest in October 2014, when the Ministry of Finance issued substantive policies requiring local governments to update debt figures to end-2014, cap their total debt, and then receive quotas to sell municipal bonds for a portion of the debt. The Ministry was seeking to update and make

[20] To be sure, in some localities where policy-makers are more reform-minded, the program may give them the go-ahead to initiate more rapid restructuring. The broad framework of the SOE reforms, combined with delegation of operational decision-making to localities, may provide a window for some regional policy-makers, if they decide to move aggressively ahead with the restructuring of the competitive sector.

more precise the figure for local government debt calculated by the State Audit Bureau as of the end of June 2013, 10.89 trillion RMB, or just over 19 percent of 2013 GDP. Now, the provinces were instructed to self-report and update the debt figure to December 31, 2014. Moreover, they were told to report to the Ministry during January 2015. As described in *CLM* 46, the provinces now had an incentive to report the largest possible number at this stage, since this would be the basis both for loan term concessions and for their new bank debt ceiling.[21] At this stage, local governments had a tendency to maximize the value of reported debt, and classify most of it as "government debt," rather than "enterprise debt," since this would be the basis for debt resolution aid. The aggregate debt reported by localities jumped 47 percent to 16 trillion (or 25 percent of 2014 GDP).[22] The Ministry did not officially accept this number, and mandated a new audit process, but in the meantime the restructuring could not wait. By the narrowest calculation, 1.85 trillion in debt was coming due in 2015 (based on the Audit Bureau's mid-2013 calculation).

The original program called for the distribution of 1 trillion in municipal bond quota among the provinces, based on their debt coming due, to be followed by another trillion quota later in the year. Provinces would then prepare debt offerings and sell them in the market, with customers including investment banks and mutual funds, and even the National Social Security Fund. Beyond these municipal bond sales, local government debt was to be capped, with additional borrowing quotas to be distributed (carefully) by the national government. However, the very first municipal bond offering failed, in April 2015, when Jiangsu offered 64.8 billion and found no takers. Local governments wanted low interest rates (to reduce their funding costs), while the market wanted to be compensated for the risk and uncertainty of these new products with high interest rates. After all, why should anybody buy low-interest bonds when

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[21] Details of the process are described in Barry Naughton, "Is There a "Xi Model" of Economic Reform?--Acceleration of Economic Reform since Fall 2014," *China Leadership Monitor* Issue 46, Winter 2015, and "Local Debt Restructuring: A Case of Ongoing Authoritarian Reform," *China Leadership Monitor*, Issue 47, Summer 2015. Access at http://www.hoover.org/publications/clm/issues

[22] Li Xiaoyu 李晓喻. "Ministry of Finance: The Total of Local Government Self-Reported Debt is 16 trillion RMB" (财政部：中国地方政府自行上报债务总额 16 万亿元), *China News Net Weibo* (*中国新闻网 微博*), April 25, 2015, accessed at http://finance.sina.com.cn/china/dfjj/20150425/185322044899.shtml; Du Tao 杜涛, "A trillion RMB of local debt will be exchanged; the Ministry of Finance's 'combination punch' to control debt," (万亿地方债务置换 财政部控债"组合拳). *Economic Observer* (经济观察报), March 14, 2015, accessed at http://www.eeo.com.cn/2015/0314/273639.shtml.

there were still plenty of medium high-yielding "urban construction" bonds with implicit guarantees?[23]

The program was dramatically revised after this setback (and after an April 30 Politburo meeting which signaled alarm at the slowing economy). Within two weeks, cooperating with the PBC and CBRC, the Ministry of Finance rolled out a revised and very different version of a debt swap.[24] Instead of debt being offered on the open marketplace, the new debt was allocated to those who held the existing bank loans. The principle was "whoever cooked it, eats it." Existing debt-holders, overwhelmingly banks, were responsible for taking the bonds that replaced the loans they had originally extended, and hold them on their books for an unspecified period. The bonds do not circulate. Regulations specified benchmarks for the range of acceptable interest rates: the new debt was to be priced with interest rates between central government bonds and China Development Bank bonds, that is, at interest rates consistent with low risk levels. The government threw in some important sweeteners: government deposits were placed at banks that participated, and the PBC declared that the new bonds would be accepted as collateral in any future re-lending or repo operations.

Under these conditions, the debt swap proceeded rapidly. By year-end, a total of 3.2 trillion in new municipal debt had been issued. Moreover, figures floated at the National People's Congress confirmed that another 5 trillion in municipal debt would be placed in 2016. The program as revised has a much bigger bailout component. Local governments receive much lower interest rates and longer repayment periods, without having to worry about packaging and disclosing their debts and making them attractive to the market. Banks, on the other hand, surrender high-interest short-term debt for an illiquid low-interest asset. To be sure, there are some upsides for the banks: the new local government debt has only a 25% weighting in risk-

[23] There are 3.4 trillion in circulating "urban construction," so-called *chengtou* (城投), bonds. These are the most important subset of LGFV fixed-income securities. Their average interest rate in April 2015 was 5.63 percent.

[24] There is already a large literature on this policy. The account here draws mainly from the following sources. Ministry of Finance Information Office, "The Ministry of Finance, PBC and CBRC Jointly Issue a Regulation Specifying the Fixed Placement with Lead Underwriters Method for Local Government Debt" (财政部 中国人民银行 银监会联合印发通知明确 2015 年采用定向承销方式发行地方政府债券有关事宜), May 15, 2015, accessed at http://www.mof.gov.cn/zhengwuxinxi/caizhengxinwen/201505/t20150515_1232661.html; Du Tao 杜涛, "Three Ministries/Commissions Push for Fixed Placement; the Document doesn't mention accompanying increases to liquidity by the Central Bank" (三部委强推定向承销 文件未提及央行流动性配合), *Economic Observer* (经济观察报), May 17, 2015, accessed at http://finance.sina.com.cn/china/20150517/002822196942.shtml; Xu Gao 徐高, "Four perspectives for understanding the fixed placement of local government debt" (理解地方债定向发行的四个角度首席经济学家论坛 | 作者:徐高 |), May 14, 2015, accessed at http://www.21ccom.net/plus/wapview.php?aid=124694.

adjusted asset classifications, so the banks can hold less capital and still satisfy capital requirements. Jiangsu returned to the market and sold a tranche of five-year bonds prices at 3.12 percent interest, and the flood gates were opened.[25]

As realized, the debt swap did nothing to differentiate between prudent and reckless local governments. The debt is issued by the local governments themselves (rather than the corporate LGFVs that in many cases initiated the debt). China is not a federal system: local governments are subdivisions of the central government. Moreover, the whole process of issuing the bonds had been set up by the central government, and structured from the top down: All the bonds clearly have the implicit backing of the central government. Moody's (for instance) rated the bonds AAA, the highest investment grade, explicitly because of the central government backing, rather than the fiscal soundness of the individual provinces.[26] To be sure, the Ministry of Finance will attempt to institute procedures to prevent additional debt, but the implementation of the program in the first instance signals local governments that their activities are not yet subject to significant restraint or oversight.[27]

The program tends to undermine the financial standing of the banking system. In principle, there should be no aggregate affect on the size of the banks assets, only a reduction in the rate of return. In practice, however, the program seems also to have expanded the banks' balance sheets. Bank holdings of fixed-income securities increased by 5.27 trillion in 2015, increasing from 11% to 12.8% of bank assets; more than 2 trillion of this would be new municipal bonds. In theory, this 2 trillion should have been exchanged for 2 trillion in bank lending that would be retired, which would have been 2.5% of loans outstanding at year-end 2014. Credit growth at year-end 2014 was running at 13.6% over year previous (shown in Section 2a above); if 2 trillion in bank debt had been swapped for bonds in 2015, then credit

[25] "The first batch of local debt is 1.6 times oversubscribed, and demand is relatively good," (年内首单地方债获超 1.6 倍认购 需求结果较好), May 18, 2015, accessed at http://money.163.com/15/0519/01/APUKJ96300253B0H.html.

[26] "Moody's: Why is all the local debt rated AAA?" (穆迪：地方债评级为什么都是 AAA？Citing Moody's vice-general manager Zhu Shuning 诸蜀宁), *China Business News* (一财网), June 12, 2015, accessed at http://bond.cnfol.com/zhaiquanzixun/20150612/20926553.shtml.

[27] Shang Jing 商灏, "Liu Shangxi says Debt Swaps will revitalize the stock of debt and stimulate the initiative of localities" (刘尚希：置换债激活存量激发地方积极性), *China Times* (华夏时报), May 22, 2015, accessed at http://bond.hexun.com/2015-05-22/176076255.html.

growth for 2015 would have dropped to 11.1% if credit policy were unchanged; instead it accelerated to 15%, even without counting the increase in bank bond holdings.

It's not clear exactly what happened with these municipal bond offerings. There is anecdotal evidence that in some provinces, cash-strapped local governments simply did not turn over to the banks all the money they received from the bond sales. However, this is unlikely to account for the bulk of the expansion of credit. Also unclear is what will happen in 2016: will the sale of 5 trillion of municipal bonds end up injecting an equivalent amount of liquidity into the economy?

4. Supply-side Structural Reforms

Supply-side Reforms have been given a great deal of attention in the last few months, and figure prominently in the current National People's Congress meeting. Supply-side reforms may prove to have an important impact on the Chinese economy, and it is difficult to predict how the bundle of inter-related programs will evolve in the face of serious economic challenges. What should be apparent is that Supply-side Reforms have no roots in the Third Plenum reform program. They are an innovation, a change of policy course. It is reasonable to conclude that supply-side reforms are a response to frustration with the existing policy mix: ineffective demand side policies and bogged-down institutional reforms have not produced the kinds of structural changes desired.

Formally, supply-side reforms include five elements, or "keypoint responsibilities":

1. Eliminating excess capacity;
2. Reducing stockpiles;
3. De-leveraging;
4. Reducing costs
5. Strengthening weak points.

The fifth point seems tagged on at the end to make the program sound more cheerful and to legitimate ad hoc interventions. Each of the first four elements is straightforward conceptually, but practically full of challenges and difficulties.

A. Excess Capacity

As the Chinese economy has slowed, heavy industrial capacity has continued to grow, and the result has been massive over-capacity in many sectors. Reductions in excess capacity have been given clear priority over the other elements of Supply Side Reform. The two hardest-hit are coal and steel, which have been earmarked as the first targets for reduction in capacity. The State Council on February 1, 2016 promulgated two documents on steel and coal industry restructuring respectively.[28] The Steel Industry document stresses that the reduction of capacity is to be driven by five regulatory standards: pollution, energy consumption, output quality, occupational safety, and technology (effectively a minimum size requirement). If this is actually carried through and results in a strengthening of the regulatory agencies responsible for these standards, that would certainly be a benefit of the program. The coal program lacks the strong emphasis on regulatory standards, and presents a much more differentiated program of different local governments improvising programs.

A basic approach has coalesced over the past few months that is likely to be the main form of this initiative. In this approach, the central government provides a modest amount of subsidies to facilitate the closing down of capacity. With this funding as sweetener, local governments are being pressed hard to (a) fulfill quotas for closing down capacity; (b) stop subsidizing money-losing firms; and (c) concentrate on assisting laid-off workers through welfare and job-switching programs. A particular focus of this approach is on closing down "zombie firms," that is, companies with debts and no profits that are kept alive by local government support.[29]

In the case of steel, the government has established an "Industrial Structure Adjustment Fund" and a target of 100 to 150 million metric tons (MMT) of capacity reduction.[30] This will provide about 20 billion RMB in subsidies to close down 40-50 MMT of capacity annually for

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[28]State Council 国务院 Opinion on Resolving Coal Industry Excess Capacity and Returning to Healthy Growth," 关于钢铁行业化解过剩产能实现脱困发展的意见. Document 6 of 2016国发〔2016〕6号, February 1, 2016. Accessed at http://www.gov.cn/zhengce/content/2016-02/04/content_5039353.htm; State Council 国务院 Opinion on Resolving Coal Industry Excess Capacity and Returning to Healthy Growth,"关于煤炭行业化解过剩产能实现脱困发展的意见 Document 7 of 2016. 国发〔2016〕7号, February 1, 2016. Accessed at http://www.gov.cn/zhengce/content/2016-02/05/content_5039686.htm.

[29] The concept of zombie firms was initially popularized by the economist Takeo Hoshi, who demonstrated their harmful impact on the Japanese economy in the 1990s.

[30] Capacity is about 1,050 MMT, so this would amount to approximately 14% reduction in capacity. Golden State Policy United Industry 国金策略联合行业. "The specific policies of Supply Side Reform Will Emerge around Chinese New Year," 春节前后或有供给侧改革政策陆续出台. Phoenix Comprehensive Finance凤凰财经综合, January 26, 2016. Accessed at http://finance.ifeng.com/a/20160126/14190061_0.shtml

about three years. For coal, problems are much more regionally differentiated. The provinces of Henan, Shandong and Anhui are taking the lead, but their problems are less severe; later Inner Mongolia, and eventually Shanxi and Shaanxi will tackle the most intractable problems. It is expected that a special national policy will be enacted for them.[31] After steel and coal, over-capacity is to be tackled in cement, electric power and non-ferrous metals, with other sectors, such as petroleum refining and petrochemicals, and even export sectors like garments, cued up for a later round.

B. Reducing Stockpiles

Reducing stockpiles conceptually covers getting rid of any kind of surplus, but in practice is centered on reducing stocks of unsold housing in second and third-tier cities. While housing markets in top-tier cities like Beijing, Shanghai and Shenzhen are relatively healthy, smaller cities still have an enormous backlog of unsaleable housing. Policies under this rubric have not yet been fleshed out, but they include efforts to make them affordable to rural-urban migrants. An interest approach is to create local housing authorities and fund them to purchase housing in order to rent to low-income residents (including, but not limited to, migrants).[32]

C. De-leveraging

De-leveraging means restructuring debt. It is an enormous task. Not only is China's debt burden huge and worrisome, nobody is entirely sure where in the economy this debt is held and by whom. The banking system is certainly at the center of the debt problem, but many other financial markets are also involved. Shutting down zombie firms means writing off their debts, including debts to banks, to local governments, and other obligations in other capital markets. Exactly how this is to be achieved as part of supply-side reform is far from clear.

D. Lowering Costs

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[31] Li Huiyong李慧勇, of Shenwan Hongyuan Securities, quoted in "Supply Side Reforms will first affect these sectors; Analyzing the investment opportunities."供给侧改革将率先影响这些行业 投资机会解析 *Securities Daily Website*证券时报网February 4, 2016. Accessed at http://wap.stcn.com/article/79090

[32]Yang Weimin杨伟民"We need to establish a new housing system,"必须建立新住房制度 Sina Finance Weibo 新浪财经微博 February 19, 2016, accessed at http://house.sina.com.cn/news/2016-02-19/19496106414068758000294.shtml?wt_source=newshp_news_10

Closing redundant capacity and restructuring debt would allow firms to reduce their costs. This additional element refers to further policy measures that would help firms reduce costs and increase competitiveness. These could include tax reductions, reductions in burdensome regulation and, perhaps, reductions in social security contributions.

Evaluation

Despite the priority given to closing excess capacity, the Supply Side Reform program is consistently presented as a comprehensive, coherent program. Moreover, Supply side reforms are consistently presented as a justification for a moderate relaxation of monetary policy: because Supply side reform is expected to have a somewhat contractionary effect, and because funds are necessary to finance restructuring and labor re-allocation, monetary policy should be loosened. "For example, reducing housing stocks has an "additive effect," offsetting the "subtractive effect" of cutting excess capacity. Cutting excess capacity can also adjust supply-demand relations, preventing a macroeconomic contractionary response. Because of this the five main elements must be carried out together."[33] Most obviously, Supply side reforms are predicated on the notion that there is an overhang of capacity as well as an overhang of debt, and both need to be addressed together.

However, while the different strands and objectives of supply-side structural reforms are related conceptually, they are not at all related in terms of the institutions, procedures and policies needed to implement them. This is most obvious by looking at the relationship between two key planks, closing excess capacity and "deleveraging" or re-structuring debt. Closing down excess capacity is a traditional activity of the Chinese state. Since 1978, there have been several rounds of excess capacity consolidation, some predominantly market-driven, some predominantly administrative. In either case, there are bureaucratic instruments to hand that are accustomed to the operation. In essence, two things are done: the planners (today, the National Development and Reform Commission) target specific low-quality, polluting and/or backward capacity for closure; and the governmental hierarchy is used to pressure local governments *not* to subsidize or otherwise protect loss-making firms under their jurisdiction. Both of these policies

[33] Gong Wen, Xu Zhifeng and Wang Ke 龚雯、许志峰、王珂. "Seven questions about supply-side structural reform—'Authoritative person' discussed what to do in the current economic situation." 七问供给侧结构性改革——权威人士谈当前经济怎么看怎么干. People's Daily 人民日报. January 4, 2016. Page 2. Accessed at http://news.xinhuanet.com/2016-01/05/c_128594408.htm

are familiar and with clear institutional channels to make them happen. Indeed, NDRC has been engaged in significant rounds of capacity reduction for the past three years, at least.

By contrast, de-leveraging is fraught with difficulties and uncertainties. Writing off debt means assigning permanent losses to one party of another. There is resistance and opposition. Only an authoritative body, entrusted with significant power over creditors and debtors can carry out such a de-leveraging. It is true that China did this once before, between 2003 and 2005, when a massive write-off of bad SOE bank loans occurred.[34] That restructuring was a massive under-taking, beginning years earlier with the creation of Asset Management Companies, and proceeding through the listing on the stock market of the state-owned banks. It involved nothing less than a kind of mobilization of all the best economic minds of the Chinese administration across Ministries and departments. Moreover, at that time, virtually all the bad debt was concentrated within the traditional banking industry, and a top-down initiative affecting the entire industry was appropriate and feasible. Today, there is no "off the shelf" institution capable of leading or coordinating policies like this in the current environment. Perhaps one can be established, but it will be a prolonged process of institutional creation. The plan for coal industry consolidation envisions local governments taking the lead with debt restructuring, giving them enormous powers to provide funding, protect creditors' property rights, and achieve results.[35]

The difficulty may be exemplified by the sensitivity of the role of laid-off workers. Both the Steel and Coal industry programs contain an identical sentence: "No plan for re-assigning workers can be implemented if it is incomplete; if the funding for worker re-assignment is not in place; or if the plan has not been approved by the Worker Congress or a discussion by all workers." As in the late 1990s, when lay-offs were large, substantial programs are being rolled out to provide for retaining workers within the corporation (with new jobs), or for channeling them to new jobs or early retirement. Instructed to be highly sensitive to these issues, local governments will doubtless feel themselves squeezed between competing objectives: how seriously are they supposed to get rid of zombie firms?

Thus, while supply-side reform makes some sense as an economic concept, it lacks any coherent implementation structure or framework. Supply-side structural reforms are an

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[34] Barry Naughton, "Waves of Criticism: Debates over Bank Sales to Foreigners and Neo-Liberal Economic Policy." *China Leadership Monitor,* Issue 17, Winter 2006.
[35] State Council, "Resolving Coal Industry Excess Capacity," Article 15.

important policy initiative. To a certain extent, their adoption represents the fact that the reform program laid out at the 3rd Plenum in November 2013 has been failing. Policy-makers needed to come up with another approach, and Supply side reform is such an approach. Still, supply-side reform itself has a number of obstacles it needs to hurdle. It lacks clear implementation paths for many of its crucial components. There are built-in tensions between the way closing excess capacity (for example) depends on stronger regulation and more powerful market forces, on the one hand, and the fact that its implementation is pushed down onto local governments and Party secretaries through the Party apparatus. Moreover, the scope of Supply side reform is undefined and open to change as conditions change. It will undoubtedly go through many changes and different versions as implementation proceeds.

5. Conclusion

In the preceding, I have presented a coherent narrative about the fate of economic reforms in China over the past two years, selectively emphasizing state enterprise reform, local government debt reform, and supply-side reform. I have not discussed other financial reforms, or the equity market, but they could easily be woven into this narrative. In this narrative, economic reforms that were proposed in 2013 with considerable fanfare have in fact failed to generate pressure on economic actors to restructure and adopt new forms of behavior required to produce sustained medium-high growth in the "new normal." Indeed, fears about the growth rate implicitly have blocked effective implementation of critical reforms. In state enterprise reform, the desire to maintain state firms as catalytic economic agents (as well as elements of a supportive political system) was fundamental in determining the policy outcome. In local government debt restructuring, the desire to reduce debt burdens on local governments and get them investing again was similarly decisive. Stalled reform is plausibly related to slow progress in restructuring.

The analysis here points to heightened risks ahead for the Chinese economy. In essence, we see a picture emerging in which currently promoted government initiatives now seek to achieve:

1. Investment in new high-tech sectors funded by government money;
2. Government initiatives to shut down capacity in traditional industrial sectors;
3. A government insistence on maintaining annual GDP growth rates at 6.5% or above.

This configuration of policy objectives points to increased risk ahead. In the first place, financial instruments are increasingly devoted to these objectives, leaving fewer degrees of freedom for responding to crisis, defending exchange rates, or other objectives. Moreover, three ambitious initiatives inevitably add up to a government that is increasing its direct intervention in the economy. Rhetoric about letting the market play a definitive role and redefining the boundary between government and market is all to the good, but it simply doesn’t correspond to this new reality.

Of course, restructuring will occur anyway, but given the lack of progress it is much more likely to occur under the pressure of events, rather than initiated by foresighted policy. To be sure, supply-side reform still has the potential to morph into many different variants. Much more aggressive debt-restructuring programs are still feasible. Fiscal policy still has unexploited potential, including initiatives as simple as expanding the deficit in order to increase outlays for medical services and other public health measures. The Chinese government still has impressive resources of material, finance and human talent. However, to bring these resources into play will require getting out of the rut of habitual ways of behaving. In addition to overhangs of debt and industrial capacity, China today has an overhang of rigid and dysfunctional systemic elements. If these are not taken care of, the challenge of effective restructuring will not be met.