Xi's Anti-Corruption Campaign Is Key to China's Prospects

By George Magnus, 2 July 2015

President Xi Jinping's anti-corruption campaign has been underway now for almost three years and shows no sign of relenting. One major bank has estimated that the cost of the campaign in terms of lower luxury goods purchases and less ostentatious consumption may have been about 1.5% of GDP in 2014, but even if this were really measurable, it would only skim the surface of significance. For it is now undeniable that China's economic prospects are inextricably bound up with the substance and consequences of the anti-corruption campaign. Any short-term effects on consumption pale into insignificance against the weightier matter of whether the campaign serves to stimulate or stifle the entire economic reform agenda. China's economic performance in coming years, its chances of avoiding the middle income trap into which most emerging countries have lapsed over the last 60 years, the fate of President Xi and perhaps even of the Communist Party, itself, depend on nothing less.

Party purity as major weapon of governance

Anti-corruption measures are not new in China, but in the past they were short-lived and their principle purpose was to punish or remove foes. The current campaign is different. It is both a traditional purge and a major weapon of governance, designed to bolster the power and legitimacy of the Communist Party at a time of change that is considered threatening. It is probably no exaggeration to say that the current leadership sees the campaign as a sort of do-or-die moment for the Party, specifically to save it from the fate of that of the former Soviet Union. The prevailing narrative is that China must not succumb to the Soviet Communist Party's failure to stick with Leninist discipline, which allowed political rot, ideological heresy and military disloyalty to undermine and destroy it.

The campaign actually started before Xi came to power. At the Party school in Beijing in March 2012, Vice-President Xi spoke at length on the very familiar Leninist topic of 'party purity', which is about the integrity, reputation and effectiveness of Party members at all levels. Cadres were told to take their Marxism seriously and to implement the programmes, regulations and policies of the Party, and shun all interest in personal gain and influence.

'Party purity' essential for China

This was no run-of-the-mill political speech. Xi insisted then and since that 'party purity' was essential if China was to succeed in building a prosperous society, implementing reform, and changing the development model. This could only happen if members opposed and struggled against all forms of corruption, and defended the health of the Party.

Two weeks after the speech, Bo Xilai, governor of Chongqing who was also vying for the job of President, was removed from office. Over time, as is now known, he was stripped of all his Party posts, expelled from the Party, found guilty of corruption, bribery and abuse of power, and sentenced to life imprisonment. This was the curtain-raiser to an unrelenting and comprehensive anti-corruption campaign that shows no sign of winding down.

Implemented by the extra-legal Central Commission for Discipline Inspection (CCDI), the campaign has targeted over 200,000 'tigers and flies', that is high and lower level officials in the Party, People's Liberation Army (PLA), and state enterprise system. In 2014 alone, 68 top officials and over 70,000 lower level officials were investigated for violations of anti-graft rules. Roughly 36 tigers have been brought down, including Zhou Yongkang, former Minister of Public Security and member of the Politburo Standing Committee, and Xu Caihou, former general in the PLA, who died from illness in March. Also being investigated for corruption is Zhang Dongsheng, a former director of the finance department in China's powerful National Development Reform Commission, China's top macroeconomic management agency. In December 2014, Ling Jihua, once Political Secretary to former President Hu Jintao and Director of the Party's General Office was put under investigation for disciplinary violations. This move showed that Xi had no inhibitions about going after close associates of both Hu and former Party General Secretary Jiang Zemin, who, at 88, continues to wield influence, and actually supported Xi for the job of President.

Scores of PLA officials, up to 16 generals, placed under investigation

In the first three months of 2015, the chief of military intelligence Xing Yunming was removed from office, scores of PLA officials, including up to 16 generals, were placed under investigation, and senior commanders in the PLA were in the process of being reshuffled. The CCDI announcement that it would target state-owned enterprises (SOEs) in a new intensification of the campaign resulted in the removal or investigation of senior personnel, including Song Lin, the Chairman of China Resources, and Xu Jianyi, the Chairman of the FAW automotive group.

The anti-corruption campaign, therefore, is certainly designed to fight foes, and favour friends. Indeed, one of the objectives is to sideline past leaders and others who continue to wield power in the Party so that the current leadership gets a clear run in getting its nominated members on to the elite Politburo Standing Committee at the 19th Party Congress 2017. Five of seven will stand down having reached the age of 68. The other two members are Xi, himself, and Premier Li Keqiang, both of whom will serve until 2022.

But the campaign is also designed as a weapon of governance to make the Party and the state sector more responsive and efficient, as leaders try to guide China through a very important, and potentially unstable economic transition. To this end, they have raised an enormous flag of economic reform. The broad goals were laid out at the Party's Third Plenum at the end of 2013, and subsequently, including at the Fourth Plenum in October 2014, which focused on the 'rule of law', which is better referred as rule by law, or rule according to law. There is no possibility of the re-ordering Chinese society to make the state and party subservient to an independent judiciary.

Changes are occurring

It is undeniable that changes are occurring. Progress has been most marked in areas that less politically contentious, for example, financial and capital account liberalisation, and the environment. The government has been reducing some of the red tape required for the approval of public projects, it has introduced important, if partial, reforms affecting the pension system and the household registration system in small and medium-sized cities, and more recently, it proposed fiscal reforms affecting local governments and measures to streamline SOEs.

The key issue, though, is whether the anti-corruption campaign succeed in facilitating the implementation of more substantive and politically sensitive economic reforms. These are widely acknowledged to be essential to rebalancing China's economy away from an excessive reliance on investment and credit, sustaining a new phase of high economic growth based on service industries, productivity and greater efficiency, and to avoiding the fabled middle-income trap.

Anti-corruption, the paradox of reform, and the economy

Optimists argue that even if anti-corruption measures are dampening down ostentatious consumption now, they will ultimately have strong, positive effects on economic growth. The argument goes that the purge of corrupt Party officials and business managers should lead to more efficient business enterprises. And by making the Party structure more effective, and members more compliant, the implementation of multi-purpose economic reforms and of greater 'marketisation' of the economy should lead to better resource allocation, and rising productivity and prosperity. But this is political rhetoric, not judgement.

To be sure, President Xi is using the anti-corruption campaign to amass and centralise power around himself in order to strengthen the Party's control and primacy. To further this process, Xi has expanded his existing authority over the State Council, the military and the Party by establishing 4 additional 'leading groups', which he heads, on national defence and the military, state security, cybersecurity and information, and 'deepening reform comprehensively'. These secretive groups are key to policy implementation, and the last of those listed is perhaps the most significant because it has a comprehensive portfolio, and unprecedented scope of power and responsibility.

Yet this strategy is also throwing up an intriguing paradox. On the one hand, the centralisation of power and cleansing of the Party are necessary to serve the prospects of successful reform. On the other hand, the same concentration of power raises significantly the danger that the political structure being created will stifle and suppress real reform. How so?

Likely to spawn consequences and could be dangerous

First, a major anti-corruption campaign isn't an engineering challenge with a neat beginning and end. It is likely to spawn consequences, and could be dangerous. Without an open, transparent and legally accountable campaign, picking off a few rotten apples may still leave an essentially diseased tree intact. It is simply impossible for the government to call an entire ruling class to account.

Second, it risks spreading conservatism throughout the Party and system, so that cadres fear stepping out of line, using initiative or experiment by being disruptive and innovative. Worse, it threatens vested interests that may dilute or stall significant reforms, even if they don't (yet) come out in open opposition. The latter, though, remains a distinct possibility, perhaps at a point when economic growth slows down more significantly or if and when Xi's corruption and economic plans should go awry in other ways.

The behaviour of vested interests is already evident in key reform areas, such as capital account liberalisation, where SAFE — the State Administration for Foreign Exchange rules the roost, SOE's that fall under SASAC — State-owned Assets Supervision and Administration Commission, and local and provincial governments.

Capital account liberalisation has been a Party goal for about 20 years but there is still strong resistance to giving citizens free rein to import and export capital. The capital account is actually more porous than one would imagine, but most of the changes that have occurred have been designed to facilitate capital inflows into China rather than out. Free trade zones have been created in Shanghai, Tianjin and Guandong and it is proposed to create a further 18, but Shanghai — a bellwether — has been criticised by some experts as unworkable because of spillover effects to the rest of the country, which would not be welcome. Businesses generally have expressed disappointment over the incremental and limited scope of liberalisation, and few foreign firms have set up in the zone.

SOE reform a key slogan

SOE reform is also a key slogan, and the new broom in the country is certainly making waves in getting SOEs to tow the line on outsized executive compensation and perks. SOEs are also being encouraged to become more efficient, pay higher dividends to the government, and merge. But the prime motive of reform isn't to transfer ownership to the private sector, put SOEs on an equal financial footing with private companies, or increase productivity and other growth-oriented outcomes. Rather it is to strengthen the Party in the iron triangle of Party-State-Business.

Local and provincial governments, which account for the bulk of public revenues and spending, were encouraged to raise copious amounts of debt after the financial crisis. They are now being brought into line a bit as the financing platforms they created are banned from new borrowing. They are being encouraged to refinance expensive and in some cases unserviceable debt through the fledgling municipal bond market though the degree to which they will save debt service costs is probably quite limited. In any event, the incentive system in local governments, in which there's a strong tendency to push for growth and compete with one another, isn't really being changed, and there remains a strong resistance to the kind of fiscal and financial reforms that might make them legally accountable and subservient to a central fiscal authority.

The drive for Party purity

Third, the drive for Party purity can already be seen to be leading to a dictatorial style based around the prestige and personality of the leader. While this enhances his authority and increases the 'fear factor' among opponents and underlings, it also runs the risk of alienating the urban middle class, on which so much of China's future success depends. With an on-line population of over 600 million people, a throughput of over 7 million college graduates a year, and a more significant exposure to foreign influence than ever before because of travel, trade and cultural exchanges, it would be rash to assume that the Party will command unswerving support under all or any circumstances.

Increasingly uncertain prospects

There is little doubt that China will continue to introduce economic and governance reforms in its attempts to bolster efficiency and achieve an orderly rebalancing of the Chinese economy. Equally, there is little doubt that these reforms will not seriously 'marketise' the economy (other than to serve the iron triangle better), effect a meaningful transfer in structure from the public to the private sector, or introduce rule of law based on an independent legal system and neutral contract enforcement. The question then arises as to what the implications of this juxtaposition might be for the economy over the next several years?

For the time being, the government is likely to struggle to sustain economic growth at the new target of 'about 7%' while the economy is rebalancing or after. The downturn in investment growth, especially of real estate and construction, is a secular phenomenon. The government will have to acknowledge this sooner or later because it must also address the challenge of unwinding the economy's reliance on credit creation and debt accumulation, sooner or later. That will doubtless affect economic growth.

Little political appetite to manage debt

The major problem is that in spite of the rhetoric about managing debt, there is little political appetite at the moment to do so. Credit growth has slowed down from over 30% a few years ago to about 14.5%, but so has the growth rate of money GDP, from 15% to about 7.5-8%. So there will be no let-up in the increase in the ratio of debt to GDP, which is on course to double again by around 2020 or just after, having done so already since 2004. Debt has to be paid for via losses and write-offs, losses have to be assigned and recognised in the balance sheets of private and public enterprises, and the state. Reform, as such, cannot resolve this, only proper de-leveraging can.

Reform, though, is in some ways exacerbating the problem of indebtedness. While financial, fiscal and capital account liberalisation policies are all in principle desirable, they tend to stimulate the demand for and supply of credit, which is precisely what the authorities are supposed to be trying to tame. Deleveraging, meanwhile, is still at a very early stage and it will probably entail several quarters of declining transactions volumes in real estate, defaults, falls in the investment rate, and declining credit to GDP. These trends, though, would add to deflationary pressures, put employment creation at risk, and pose a significant political and economic challenge to the government.

In the longer-term…

In the longer-term, economic reforms have to go much further now that China's potential to derive growth from the deployment of physical labour, or from limitless capital accumulation is diminishing quickly. A different sort of economic growth is required for China to grow its per capita GDP strongly as well as its nominal GDP. This would be based much less on the dominance of state institutions, and more on innovation, higher educational attainment standards, stronger productivity, and entrepreneurship. This is all the more relevant because China's working age population share of the population is declining, and rising wage costs and digital technologies are encouraging foreign companies to go home or to cheaper manufacturing nations in Asia, such as Vietnam, Cambodia, Bangladesh, and now perhaps Modi's India.

The growth and development model has to change

China's leaders are well aware that the growth and development model has to change. The anti-corruption campaign is essential to securing the reforms that would lead to that change. But, as argued, the campaign has weaknesses and shortcomings. Reforms, especially to create robust and inclusive institutions that would really put China on course to become a high income country are most likely incompatible with the central philosophy of Party, which is to rule unchallenged. A purified Party is no substitute for political reforms in which the Party has no interest.

We can understand the resulting insecurity that seems to pervade the behaviour of the leadership, which has manifested itself in fear, distrust, and a major crackdown on opponents, critics, liberals, and most recently, Western values and influences. The government has forbidden universities from teaching or discussing universal values, press freedom, civil society, civil rights, historical errors of the Party, capitalism and an independent judiciary — collectively known as the 'seven don'ts'. Ironically, allowing these don'ts would go much further in purging the country of corruption than an extra-legal campaign of going after tigers and flies that by comparison, seems quite limited.