Temporary Difficulties or the Start of the 'End Game'

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Editor's Introduction

In this article, economist and Asian Studies specialist Mikhail Karpov tackles the dichotomy in the most recent grand Chinese policy plans *vis-à-vis* their enactment. He argues that Liconomics—Chinese economic and particularly financial deregulation policy objectives under Li Keqiang's premiership—has produced underwhelming results after looking quite promising when announced. Furthermore, he argues that the concurrent policies enacted by Xi Jinping, such as the anti-corruption campaign, could threaten Party cohesion at the highest levels. In response to David Shambaugh's piece stating that 'the Endgame has begun…' the answer is not obvious still. However, the need to push for efficiency gains seems increasingly obvious.

The author begins with the 18th Party Congress, full of positive ambition, but lackluster in the follow through. A striking comment in a latter section states that: 'it is no exaggeration to say that the so-called "liquidity crisis" in China in spring and early summer of 2013 signified the defeat of Liconomics.' And this moment is pivotal to the issues addressed in this paper. The consequences of a number of policy solutions aimed at solving the way in which the financial system relies on consistent bailouts and the economy on repeated stimuli are difficult predicaments. The author presents a compelling story which facilitates our understanding in respect of the pains the Chinese leadership faces given the 'technical' and 'political' obstacles pertaining to the challenges facing China's financial system and the broader economy.

Chinese politicians have regularly promoted structural reform to allay fears of continuing state enterprise inefficiency and thus to publicly show commitment to the implementation of economic policies designed to improve China's chances of maintaining relatively strong economic growth. However, financial deregulation and a reliance on markets is one end of a see-saw with rescue packages and state led and directed investment on the other side. There is also the worrying issue of large scale layoffs and redeployment, in an economy still with significant state ownership and, therefore, state industry employment levels. This carries obvious political and social stability risks, an aspect of the Party's mandate since time immemorial. Concurrently, the Party's reputation and arguably its legitimacy relies on strong economic results being delivered through the state's implementation of policy, whether that be by way of intervention or stand-offishness. China continues to face this 'Catch 22' economically and politically in an era beyond marshalling the masses to get mere food on the table. Echoing the counterbalance of Chun Yi vs. Deng Xiaoping in the 80s and 90s and Li Peng vs. Zhu Rongji in the Jiang Zemin era of the 90s, conservative stalwarts and the reform-minded seem feudally at odds with one another.

In this incisive analysis, Karpov is of the view that trust needs to be rebuilt between Party, People and institutions for the financial system to find its feet. The battle between socialist ideology and marketisation continues to rub together like two plates under the earth. While he does not rule out that the 'endgame' has begun for the CPC, he does not find convincing evidence that it has really started. However, what is clear is that the Party has a very hard task in keeping control of the balance of the economy using unfamiliar methods like marketisation and that the relationships between the financial authorities, the banks and the business and consumer sectors teeter frequently as the CPC continues to cross its Niagara Falls on a tightrope with no harness.

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Temporary Difficulties or the Start of the 'Endgame'?

The Chinese Economy Between Financial Deregulation and a New Stimulus Package

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Abstract

Between April and June 2013, the Chinese economy experienced an acute liquidity crisis, when the People's Bank of China (PBOC) sharply limited recapitalisation volume for the commercial banks, telling the banks that they must make better use of their incremental funding and revitalize stock options. This led to a sudden credit crunch and shortfall in the cash market, with Shanghai interbank overnight lending rates (SHIBOR) rising from 3% to 30% on 20 June 2013 and repo rates exceeding 25%. There is sufficient reason to suggest that the events of the spring and summer of 2013 significantly contributed to the development of negative trends in the Chinese economy. The origins of the liquidity crisis in spring 2013 looked like a kind of technical default, caused involuntarily by the good reformist intentions of the new leadership. In the Chinese systemic setting, the reformers' attempts to improve financial discipline and clamp down on 'shadow banking', by way of strictly disconnecting the state 'commercial' banks from the state budget on the eve of the interest rate deregulation announcement, meant that the Chinese party-state would *de facto* refuse to comply with its obligations as the lender of last resort (at least, partly).

The failure of Liconomics has seemed to show that the fifth generation of the Communist Party of China (CPC) are incapable of implementing financial deregulation. This has come at a time during which China has accumulated a huge amount of domestic debt. The Chinese economy hangs between a new attempt to liberalise national finance and a new monetary stimulus package being provided. On the plus side, the investment-led growth model has imbued China with large currency reserves and China retains the advantage of a comparatively low price of labour. The fundamental task for the Beijing authorities after the 'technical default' of 2013 is to rebuild trust and assert themselves as the real and not just the apparent, financial regulator and lender of last resort. However, the most important question that remains is this: is the Chinese political and economic setting able to conduct systemic reform or has the 'endgame' indeed begun? Today, perhaps more than ever, a convincing answer to this question is not obvious.

> Predicting the demise of authoritarian regimes is a risky business…
> Several seasoned sinologists have risked their professional reputations by asserting that the collapse of CPC rule was inevitable. Others were more cautious…
>
> But times change in China, and also must our analysis. The endgame of Chinese communist rule has now begun…
>
> David Shambaugh (2015)

> Yet China is not normal. It is caught in a dangerous no-man's-land between the market and state control.
>
> Economist (2016)

Background: The 18th Party Congress

Almost four years have passed since the 18th Congress of the CPC. Great hopes for Chinese systemic breakthrough given by the fifth generation of the country's leaders have been slowly evaporating. The reform blueprint of Xi Jinping and Li Keqiang whose objective amounted to solving structural problems accumulated during the 'maintaining stability' decade under Hu Jintao has quite obviously stalled in China's 'new normality' as one of latest maxims frames it. This 'new normality' manifests in a decreasing gross domestic product (GDP) growth rate, decreasing domestic consumption, inhibition of financial liberalisation, sluggishness in the real estate and stock markets, and violent anti-corruption campaigns—'fighting the tigers'—involving the elimination of whole clusters of the political class and seemingly undermining intra-elite stability.

Contrary to these outcomes, the 18th Party Congress and words echoed after it seemed to make it clear that the leaders of the fifth generation had adequately assessed not only the need to transition China towards a new consumption-driven economic growth model, but also that a logic and consistency was going to be required. The transition would need to pass through two main gateways: financial liberalisation, to include the deregulation of interest rates in addition to vastly enhancing capital account convertibility; and overcoming the resistance of lobbying groups interested in the state of 'eternal transition' of the Chinese economy and society. Consensus among the Chinese expert community with regard to these gateways looked to be shared by the country's new political leaders, a unity arguably seen for the first time since the 1980s. In particular, broad and open discussions in Chinese business media and analytical circles during 2013 echoed Premier Li's statements and vice versa.

Some important initiatives certainly came to pass. Beijing's new leaders officially promulgated the Shanghai Free Trade Zone (FTZ) with the vision of *yuan* capital account convertibility, to be extended later to other parts of the national economy. Some other regions of the Chinese south and southeast began eagerly lobbying the establishment for similar zones. The lower limit of the credit interest rate 'corridor' ceased to exist. Obvious reluctance of the new Premier to provide the economy with new money stimulus made the leadership's new approaches to structural reform and financial discipline appear worthy of praise. Investment mechanisms went through further decentralisation. Even the fifth generation's determination to 'fight corruption' at the start gave rise to expectations that those groups of political and economic elites who 'maintain stability' for the sake of their own vested interests would be punished or marginalised.

However, almost from the start of the Chinese ‘new deal’ in early 2013, there were symbolic events which at first were bewildering and, with new facts coming to the surface, gave way to a slow build up of disappointment. Despite the highly articulated importance of the Shanghai FTZ—the brainchild, they say, of the Premier Li Keqiang—he never attended its inauguration ceremony. This gave rise to speculation about growing opposition to the plans for financial deregulation. Mechanisms for interaction with the rest of the economy remained unclear in respect of the FTZ. It began looking more and more like a new ‘offshore territory’ as opposed to a pilot project for later systemic integration with the country. Structural reform in Chinese industry aimed at decreasing excess capacity. Although this was addressed, the results were underwhelming.

Contrary to much talk and high expectations, interest rate deregulation never quite happened either. New evidence also shows that the Beijing monetary authorities did not so much abstain from new financial stimulus as simply trim it down, distributing money pointwise according to what is not considered the finest Chinese tradition—behind-the-scenes bargaining. Moreover, rumours have surfaced that Li Keqiang may resign as Premier at the next party Congress or even earlier on health grounds (Zhong, 2016, p. 126).

The fifth generation’s anti-corruption zeal exceeded all reasonable expectations with members of CPC Polititburo, People’s Liberation Army (PLA) high command as well as regional party-state bosses falling victim to the uncompromising fight against the ‘tigers and flies’. The situation with human rights in China considerably worsened. From a certain viewpoint, the whole campaign began looking less like clamping down on ‘counter reform’ and ‘corrupt’ factions as ruthless annihilation of any threat to Xi Jinping’s reign, be it conservative or liberal. Such a campaign has the potential to undermine the moral authority of the CPC and decades-long general intra-elite consensus.

Interestingly, even the tune of some seasoned and cautious foreign China watchers have begun to alter significantly. Perhaps the most vivid example is the article by David Shambaugh published in March 2015 in the Wall Street Journal. Shambaugh, who has previously tended to subscribe to the notion of ‘authoritarian resilience’ of the Beijing regime, quite suddenly proclaimed the start of the ‘endgame of Chinese communist rule’ (Shambaugh, 2015). Some experts, however, preferred to explain this change in perception with a rationale that appears more technical, if having the scent of a conspiracy theory. Supposedly, a prominent US sinologist with good connections in Beijing simply transmitted the anxiety of some parts of the Chinese political class over potentially devastating systemic consequences of Xi Jinping’s ‘crusade’ against corruption (Denisov, 2015).

However, even if such an interpretation were partly true, it is neither sufficient to explain unusually tough statements in the text[1] written by a scholar who might otherwise be considered to be very careful. Nor can it negate the general impression left by the stalled reforms which have arisen from the analysis of the developments in China since the 18th CPC Congress.

The Rise and Fall of Liconomics

On 27 June, 2013 three experts from Barclay Capital, namely Huang Yiping, Chang Jian and Loey Chew coined the new title for the Chinese economy after the 18th CCP Congress, derived from the family name of Chinese Premier Li Keqiang—*Liconomics*. The new deal was described by the experts as comprising of three pillars: no financial stimulus to generate GDP growth; deleveraging of economic regulation; and structural reforms, the foremost of these being financial liberalisation (S.R. | Hong Kong, 2013). This was the epitome of the reform blueprint deduced from the documents of the 18th CCP Congress and subsequent speeches of Li Keqiang at different meetings with party and state officials.

[1] i.e. Shambaugh’s assertion that ‘The endgame of Chinese communist rule has now begun’

With regard to no more stimulus, the explanation was that the previous package of four trillion *yuan* injected into the national economy under the auspices of former Premier Wen Jiabao in 2009 led to an increase in domestic indebtedness of 100%, with overall internal debt rising to 250% of GDP in 2013 (Anderlini, 2014).

It especially worsened the regional debt situation, which was to blame for an overheated real estate market as well as excessive production in industry and infrastructure. In metallurgy, for example, the level of excessive capacities was 271 million tonnes—'far in excess of total capacity in any other country' (National Australia Bank, 2014, p. 2). Therefore, there was no macroeconomic space for further monetary stimulus. The emphasis—according to the argument—should move from growth figures to the quality and efficiency of growth. The prescribed 'new normality' of annual growth rate was around 7% (Ba, 2015, p. 99).

With regard to deleveraging, the argument was that total social loans, state corporate bonds and equity financing in China were up to 190% of GDP. This number needed considerable reduction in order to attain the goal of more structurally balanced growth.

As to financial liberalisation, by 2012-2013 there was a consensus in the Chinese expert community that this structural reform is indeed imperative to proceed from the current costly investment-led growth model to desired consumption-led growth with – supposedly – higher efficiency. The phrase about 'letting the market forces play a decisive role in distribution of resources in national economy', presented in the 18th CCP Congress summary report, found its way gospel-like into all kinds of experts' texts and important party documents shortly before the Congress and after it.

Some China watchers also supposed that the rejection of further monetary stimulus might strengthen financial discipline as a preparatory step towards deregulation of interest rates and the capital account (Kumar, 2013).

A number of Chinese and foreign economists claimed that 'new normality' would not necessarily be painful for the country's economy (Quah, 2015). Indeed, with the given Chinese economic structure and macro misbalances, 7% of annual growth would now be much healthier than, for example, 10% of growth even ten years ago. Besides, China's domestic demand obviously falls short of its supply. China still spends less than it earns. Therefore, lack of monetary stimulus should not automatically damage the prospects of domestic consumption and GDP growth. However—and I emphasise—concerning one crucially important condition, namely, *if and only if Beijing authorities perform financial deregulation successfully, this alone would enable supply to meet domestic demand structurally and solve the problems of excessive production capacities, foreign trade surplus and currency devaluation. In the given structural context, financial deregulation indeed was the key to overall success of Liconomics.* This core reform, however, failed conspicuously.

The first ordeal came as early as in spring 2013—even before the term 'Liconomics' was coined—and took the shape of the so-called 'liquidity crisis'. The Beijing government made valiant attempts to crack down on interbank financing channels and shadow banking. According to the China Banking Regulatory Commission (CBRC), in mid-2013 total capital turnover in shadow banking was about thirty three trillion *yuan* (more than five trillion US dollars), which accounted for 80% of the country's GDP in 2012 (Wang, 2014). Quite a few state-owned enterprises, obtaining money from state banks through credit channels, instead of investing in production, make loans to other state-owned and non-state enterprises. The profits gained from this shadow lending would offer at least one and half times more than that of standard production activities. Besides, in April 2013 alone the money supply index M2 rose 16% (Quah, 2015). Therefore, the People's Bank of China (PBOC) decided to act and sharply limited the commercial banks' recapitalisation volume. Instead, it told the banks to make better use of their incremental funding and revitalise stock options. All this lead to the sudden credit crunch and shortfall in the cash market, with the Shanghai interbank overnight lending rates (SHIBOR) rising from 3% to 30% on 20 June 2013 and repo rates exceeding 25% (ibid.).

What happened would appear to be nonsensical in a normal market economy. The country suddenly runs into an acute credit crunch and falls short in cash, while its money supply index M2 to GDP approaches one of the World's highest at 200%. The core problem, however, was certainly not the physical lack of money, but huge and multi-layered domestic indebtedness. This indebtedness, amassed over all periods of 'reform and openness' and especially in the period after 2009—the four trillion *yuan* stimulus injection with little or no return—'requires ever-increasing amounts of liquidity, and that's becoming harder and harder to perpetuate'. It would be very difficult and even dangerous to bail the system out, either by deploying foreign reserves or by lowering the required reserves ratio. Following the first route would simply kill Chinese exports by strengthening the *yuan*. The alternative route would be detrimental for the medium and small banks, which tend to make riskier loans and whose non-performing loans ratio has already been climbing (Guilford, 2013).

In fact, it is Chinese shadow banking which—in the case of uninterrupted liquidity injections from the official state banking system—helps greatly to guarantee the latent character of debt claims between the state-owned and non-state economic actors, and between them and the state. For example, some Chinese state owned enterprises, having obtained credit from state banks, relend this money to their heavily indebted state and non-state allied firms at far higher interest rates (Guo, 2011). Such state owned enterprises are, therefore, performing the role of shadow banking institutions.

The Beijing political and monetary authorities have faced an almost unsolvable dilemma. Financial deregulation with freeing interest rates and the capital account would inevitably activate debt claims on the ground, amounting on average to 200-250% of GDP. This could structurally undermine the existing banking system, investment and currency evaluation mechanisms, and rent-creation and rent-seeking practices, with unpredictable consequences for growth rates and socio-political stability. On the other hand, evidently, there was no more macroeconomic space for monetary stimulus.

It is no exaggeration to say that the so-called 'liquidity crisis' in China in spring and early summer of 2013 signified the defeat of Liconomics. Faced with the problem of domestic debt, the vehicle ground to a halt with its head gasket blown.

Rejecting monetary stimulus without financial deregulation meant in practice artificially decreasing both GDP growth and consumption rates. It is exactly what we are witnessing now. Instead of strengthening financial discipline as a preparatory measure for coming liberalisation—which in fact never arrived—such a policy would inevitably put extra strain on all political, social and economic actors, decreasing their share of profit and rent or simply depriving them of it, amassing disappointment, resentment, stress and opposition. We dare to argue that harsh 'anti-corruption' campaigns in China recently—among other things—may aim at keeping this opposition in a systemically acceptable framework, while paradoxically undermining the system from other angle: producing the impression of hopelessness and making capital and wealthy active people flee the country. According to estimations of some market players, in 2014 total non-FDI[2] capital outflow from China amounted to 320 billion US dollars (Lo, 2015). The previous record was in 2012—165 billion US dollars (Street, 2015).

However, this situation is unsustainable without any stimulus whatsoever. Therefore, the main problem which Beijing authorities have been addressing since the 2013 'liquidity crisis' has not been whether to supply economic actors with money but how much money to supply. Chinese economic

[2] Foreign direct investment

media became engaged in discussion about whether introducing ‘some stimulus’ contradicts ‘further reforms’ or—just the opposite—creates favourable macroeconomic conditions for them and does not signify an injection of a bigger package in the near future. As Gordon Chen puts it, ‘…the PBOC is not taking away the punch bowl. It is refusing to give a bigger and bigger punch bowl’ (Chen, 2014). At the same time, China watchers here and there started to give examples of pointwise money injections throughout the Chinese economy. The Economist Magazine ironically remarked in November 2014, ‘The taciturn tendency [of the PBOC] has long bemused people trying to understand the direction of China’s monetary policy’ (Economist, 2014). Since June 2014 the PBOC has injected 1.8 trillion *yuan* (294 billion US dollars) to prop up the slowing economy through a mix of targeted liquidity facilities. The PBOC deliberately chooses convoluted means to loosen monetary conditions —in essence, providing cheaper medium-term money to some banks, not others. Elsewhere central banks cut interest rates close to zero before turning to unconventional policies. Instead of letting the market allocate resources [i.e. quite contrary to the gospel that has been repeated endlessly in party documents and experts’ advisory texts—M.K.], the Chinese central bank is choosing which banks should be beneficiaries of easing and how they should direct their lending. The Chinese central bank decides, for example, how much money should go into the construction of public houses. The PBOC’s policy is to have short-term money rates in decline, while official bank lending rates rise.

Such policies undoubtedly helped, but not that much. On 1 March, 2015 the PBOC decided to cut financial institutions’ RMB benchmark lending and deposit interest rate overall by 0.25%, the one year lending rate to 5.35% (from 5.6%) and the one year deposit rate to 2.5% (from 2.75%). However, in the same month China’s factory activity continued to shrink, with the new factory orders sub-index falling to an 11 month low of 49.3 and the unemployment sub-index contracting for the seventeenth straight month, hitting its lowest since the global financial crisis. According to some estimations, GDP growth was well below 7% (Wong, 2015). HSBC analytics remarked, ‘It really does show that the [Chinese] government has not done enough yet in terms of stimulus. Yes, they have cut interest rates, they have injected liquidity; but the economy is still really suffering and so this means three things: more stimulus, more stimulus and more stimulus’ (ibid.).

Taciturn and pointwise money injections accompanied by an uncompromising ‘anti-corruption’ drive has successfully managed to keep post-Liconomics China in an acceptable shape but have turned out to be only tactical and temporary solutions. The country’s economy seems to be hanging between a new package of financial deregulation and a new package of monetary stimulus.

Why the ‘Beginning of an Endgame’?

I do think that in the context of the study of China in the world today, David Shambaugh’s pronouncement about the start of the CPC endgame is indeed remarkable, but it does require further clarification. As for me, I have always felt closer to those China watchers who view the ‘authoritarian resilience’ of Beijing regime as limited and to whom eventual collapse of the Chinese party-state system seems rather plausible.

Let us examine the defeat of Liconomics once again, but from a broader systemic and historical perspective. The second largest economy in the world that earns more than it spends with money supply index M2 approaching 200% to GDP is suffering from a liquidity crunch and a lack of monetary doping. At the same time, its central government has not successfully implemented interest rate and capital account deregulation due to the tremendous amount of internal debt, gradually amassed during consecutive years of the economic growth ‘success story’. Such deregulation threatens financial sustainability, GDP dynamics and ultimately systemic political stability. Therefore, to deregulate seems not only technically difficult but also politically troublesome, since there are powerful elite groups with strong interests in opposition to free financial market. Instead of using standard mechanisms, the country's central bank turns to behind-the-scenes pointwise money injections and administratively decides for investors where this money should go. This situation is somewhat contrary to the functioning of a normal market economy, albeit authoritarian and monopolised by the state.

It should not be a surprise, however. In 2002, the observer of 'The Economist Intelligence Unit' and the author of 'The China Dream', Joe Studwell, coined an apt phrase: 'The biggest myth about China in 1990s was that country ceased to be socialist' (Studwell, 2002). Almost 15 years passed since then but not much has changed. People's Republic of China still is a Marxist-Leninist party-state, forcedly implementing market reforms within the systemic space initially designed for egalitarian command industrialisation with *no market whatsoever*. In such systems – unlike in truly authoritarian statist and monopolistic capitalisms like ROC on Taiwan or South Korea in the 1950-80s – the fundamental task of 'transition to market' is not to liberalise already existing market institutions but to build them from scratch after decades of devastating repression and successful annihilation of exactly these same institutions. Political science usually defines those Marxist-Leninist party-states, which introduce market reforms, as post-totalitarian, not authoritarian. Historic experience tells us that there is no direct evolutionary line of development from post-totalitarianism to authoritarianism.

True, authoritarian capitalism monopolistically controls the market. However, a Marxist-Leninist party-state exterminates it. Therefore, implementation of market reform in state socialist systems from the standpoints of institutional setting and constellation of actors is genetically different from economic (financial) liberalisation in authoritarian capitalism.

The empirical history of such attempts in the former USSR and East-Central European communist countries is not encouraging. All of them went through systemic collapse, even those that used to be 'paragons' of European 'market socialism' with decades of 'transition' experience, like Hungary and former Socialist Federative Yugoslavia (Csanádi, 2008). It is further important to mention the problems that eventually buried them economically and unfolded in the most acute form exactly when they began trying to introduce elements of market economy into the sphere of macroeconomic regulation, pricing and national finance. Indebtedness was a major factor. An obvious pattern was that the more 'market' there was in an East European socialist country, the bigger was her open domestic and foreign debt, and the higher was her open inflation. The main reason seems to be that despite some market-oriented changes in property structure, economic regulation and pricing, none of the Eastern European 'socialist markets' were capable of tightening their economic actors' budget constraints (Kornai, 1992). The systemic solution to the problem of a soft budget constraint is financial deregulation. However, amassed open and hidden indebtedness from the softly constrained budgets, as well as conservative opposition within the party-state, made financial deregulation technically and politically impossible under communist party rule. Fundamental market reforms in the sphere of national finance in all of these countries remained imperative for the first non-communist governments at the turn of the 1990s.

'Market socialism with Chinese characteristics' not only survived a turbulent and bloody 1989, but also demonstrated the 'miracle of growth' in the subsequent couple of decades. Still, the case of 'transition to market' in PRC—with all its undeniable singularities—fits so far quite well into the dynamic empirical pattern of socialist market reforms, a persistent soft budget constraint, amassed domestic indebtedness and impasse of financial deregulation. Hence, the universal quest for liquidity, a nearly fantastic amount of money supply to GDP and no less impressive debt accumulation.

On the other hand, China's macroeconomic regulation is still very much anti-market in nature, since the 'socialist plan mechanisms' persist, at least, in systemically vital fields of finance and investment. These mechanisms may be decentralised, but are still of pivotal importance. For the CPC to relinquish them totally would mean causing a macroeconomic storm and losing its political power monopoly (Fan & Zhang, 2005).

Such a state of affairs indeed may produce the impression of a vicious cycle. Bargaining 'over best conditions' in a politically monopolised systemic setting reproduces economic units' soft budget constraint, which contributes to the accumulation of domestic debt that, in turn, fundamentally complicates macro regulation and financial liberalisation, every time forcing the party-state to refer to administrative methods of macroeconomic management. The latter reproduces the politically monopolised systemic setting.

After the 18th CPC Congress, the Chinese economy went through such a complete cycle in less than three years. Since this cycle is not only economic, but also a political stalemate relating to the very nature of the Chinese party-state structure and its political power monopoly, it may give some ground to perception that the endgame of CPC rule has begun.

An Involuntary 'Default' Caused by Good Intentions

If we are to believe Chinese official statistical data, GDP growth rate started to decrease slightly with 9,3% in 2011 after an impressive 10,14% in 2010. Annual rate in 2012 was somewhat close to 8%, with the last quarter of the year showing the best results, perhaps, due to the convocation of the 18th Congress of CCP in November (Statista, 2016). It seems that real trouble – sharp fall in growth rate, stock market turmoil and the acceleration of capital outflow - started sometime after the second half of 2013 – just after liquidity crisis and the failure of Liconomics. There is sufficient reason to suggest that the events of spring and summer of 2013 significantly contributed to the development of negative trends in Chinese economy.

One has to bear in mind that Chinese post-totalitarian Leninist party-state, which deeply penetrates national finance, remains de-facto the lender of last resort for key economic players of all forms of property. Unlike in former authoritarian Taiwan or South Korea, financial means of the state budget, state banking, state corporate sector and non-state sector in the PRC are still lacking clear division. The quintessence of such state of affairs is exactly the 'shadow banking', which – again, unlike the so-called private 'curb financial markets' in Taiwan or South Korea - is indeed 'shadow'. It operates overtly or covertly with state money under the aegis of the state banks, recapitalised from the state budget and amassing big debts due to cronyism and bad financial discipline. For the Chinese big state 'commercial' banks to lend the state money to 'shadow' traders of all sorts is an excellent profit raising opportunity, since lending to manufactures looks grim due to excessive production capacities and the state's attempts to reduce them (Ba, 2015, p. 110). In this context, Chinese 'shadow banking' also becomes an important tool of keeping domestic debt claims – both corporate and institutional – latent.

Against this background, the story about the origins of liquidity crisis in spring 2013 may look like a kind of a technical default, caused involuntarily by the new leadership's good reformist intentions.
This story runs as follows. On the one hand, the tendency for the growth rate to decrease in the highly indebted and overburdened Chinese economy with excess production capacities became tangible after late 2011. On the other hand, in recent years there finally shaped a kind of a consensus (albeit theoretical) among considerable parts of the expert community and political class in Beijing regarding imperative transition from investment-led to consumption-led growth model. The key threshold to be crossed became also more or less clear. 'Let the market play a leading role in resource distribution' – so run not only experts' reports, but also party documents, clearly meaning financial deleveraging.

The new leaders of the fifth generation, coming to power at the 18th Congress of CCP in November 2012, and (Xi Jinping and Li Keqiang in particular) in desperate need of legitimating a reform blueprint after Hu Jintao and Wen Jiabao's 'upholding stability' decade, were associated by too many in China—despite quite appropriate growth rate—with systemic stagnation. Bo Xilai's unfortunate 'coup' seems to be the last drop testifying that something indeed should be done with regard to both disciplining Chinese political class and promoting further economic growth.

In such circumstances, the idea of simultaneous centralisation of political decision-making and implementation of financial deregulation reform blueprint looked like cutting the Gordian knot in paving the way to resuming 'political normality' and setting the engine of the new growth model. All this cannot but recall Deng Xiaoping insisting – despite wide resistance – on radical price reform in spring 1988, sincerely believing that it will strengthen political positions of reformist Premier Zhao Ziyang and help in solving serious macroeconomic imbalances. Deng's resoluteness at that time became one of the key factors aggravating socio-political crisis at the turn of 1988 and 1989, which evolved into a mass protest movement and its subsequent bloody suppression.

This time, in 2013, the course of events also turned out to be much more complicated, than it looked at the beginning. On the one hand, Xi Jinping seems to perceive the realisation of the new reform blueprint as rather a tactical set of steps, legitimizing his own grip on political power monopoly. In other words, if it works, than let it be. If it does not, than use the failure as a pretext for further personal power consolidation. On the other hand, new Premier Li Keqiang and his leading economic advisers, perhaps, seriously misunderstood the very political economy of the Chinese domestic debt accumulation and overestimated the maturity and efficiency of the market institutions in the country's economy.

Well, paving the way to sustainable financial deleveraging indeed implies curtailing unregulated 'shadow money traders'. However, in the Chinese systemic setting, the reformers' attempts to upgrade financial discipline and clamp 'shadow banking' by means of vigorously disconnecting state 'commercial' banks from the state budget on the eve of the announced interest rate deregulation simply meant *Chinese party-state de-facto refusing (at least, partly) to comply with its obligations of the lender of last resort.*

Such combination of factors provoked at least two consequences. First, it caused a kind of 'withdrawal syndrome' in badly indebted and money thirsty Chinese economy. Second, as every default, it fundamentally brought into question abilities and intensions of the Chinese party-state monetary regulators with regard to their obligations as a lender of last resort and, hence, caused a far-reaching crisis of confidence among key economic players. Investors rushed away, shoveling money abroad or starting to play hide-and-seek with the monetary authorities in Beijing.

Li Keqiang's and his advisers' true misunderstanding of Chinese political economy manifested itself in the following. Even if the description of the Chinese 'liquidity crisis' in 2013 as the 'debt crisis' is technically correct, it is still far from the terms of 'normal' debt crisis in capitalist market economy. The key problem is neither the debt itself, even if it is very large, nor the methods of its restructuring. In the half-reformed socialist economy with the ruling party's monopolistic grip on finance and investment, the 'contracting parties' may expect relatively easy debt forgiveness and refinancing. The key challenge is that these 'contracting parties' seem to be incapable of operating adequately without constant inflow of financial doping, thus, in fact, perpetuating the existing model of costly investment-led growth, which in turn creates new socio-economic imbalances. To try to alter the 'parties' modus operandi in the given systemic setting – exactly what Premier Li Keqiang attempted to do in early months of 2013 with all this discourse of 'financial market' and 'credit deregulation' – means erasing the setting's 'bounding property lines', which indeed can lead to unintended systemic consequences. Overall, Xi Jinping turned out to be the ultimate winner of both initiating financial deregulation reform and its subsequent stalemate, being able to significantly strengthen his hold on decision-making. Li

Keqiang, in his turn, lost both battles – for more decision-making influence and for tangible success in reform implementation.

What May Come Next?

The underlying and fundamental task of the Beijing authorities after the 'technical default' of 2013 is to rebuild trust and assert themselves as the real financial regulator and lender of last resort and not simply the apparent one. However, resolution in this task seems to presuppose at least two mutually contradictory policies.

On the one hand, the party-state must toss money into the country's economy in quantities with unclear limits. On the other hand, in order to avoid aggravating debt and problems with excess production capacity, it would be better for the process of tossing money to become a kind of targeted set of actions, eventually improving existing microeconomic structures and macroeconomic conditions.

To try making these two hands shake one another in the given systemic setting is verily a thankless task. The concept of economic 'new normality'—new equilibrium between lower growth rate and overall economic sustainability—put forward by Xi Jinping in May 2014, and more recent pronouncements on 'supply side' reform are, in fact, official wording intended to describe this set of mutually contradicting issues in a politically correct way.

Quite a few Chinese economic experts, including those in the State Commission on Reform and Development, have openly declared, however, that 'new normality' is something which has not been achieved and still remains a target rather than a reflection of the existing state of affairs. 'Supply side' reform of course has nothing to do with the neo-liberal approaches of Margaret Thatcher or Ronald Reagan, but predominantly refers to reduction and restructuring of the excessive production capacities in manufacturing sectors.

Indeed, how much money is sufficient for the investors and the more general population to regain trust in their apparent lender of last resort remains a question with no clear answer. During 2016, the PBOC has reduced the key rate three times, while in January 2016 alone new lending by Chinese banks was 2.5 trillion yuan (385 billion US dollars)—the most ever in a single month. In the first quarter of 2016, overall lending increased up to 5 trillion yuan. The investment rate in the state sector increased 23%. The investment rate in the state budget increased 17%. However, private sector investment rose only around 6%, while the share of foreign capital in investment collapsed almost 26% (Zhang, 2016). Clearly, easing the state credit policy has not yet led to regaining trust.

Chinese experts seem rather unanimous in forecasting further monetary and credit easing, increase in budget spending, unstable stock markets, some growth in real estate markets and onward repression on the fixed income market due to possibly growing abuses in debt securities circulation. There are also serious doubts with regard to tangible success of the state policy aimed at reducing excessive manufacturing capacities in the near future (ibid.).

It is highly likely that this is how the basic things will look like in the medium term. However, the most fundamental question remaining sounds like: is the Chinese political and economic setting able to conduct systemic reform or has the 'endgame' indeed begun? Today, perhaps more than ever, a convincing answer to this question is not obvious.

Interestingly enough, in February 2016, there was an article published in the Economist under the title 'Some Ways in Which Chinese Economy Might Evolve'. Without using the term 'shock therapy', the author, nevertheless, describes exactly this kind of a 'big bang' scenario for the People's Republic. 'It is hard to say precisely, when or why, but deleveraging [in China] at some point is inevitable… Chinese adjustment would require either a really big depreciation, or would be slower and more painful, or a bit of both…' (R.A. | London, 2016). Such depreciation would not necessarily lead to resumption of economic growth, but the households' income will dramatically collapse, making credits more expensive. Forced introduction of harsh limits on capital flow, contradicting the aims and logic of deleveraging, may restart the spiral of the crisis, which led to deleveraging. Such sequence of the economic transition drama anyway sounds much more familiar to Russian or Polish ears than to the ears of the Chinese, which so far seem accustomed to the prideful fanfare of successful gradualism.

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