



China's Real Leadership Question

Economic Development and Social Challenges Ultimately Will Determine Who Runs the Country over the Coming Decades

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Introduction and summary

Top Chinese Communist Party leaders met this month in Beidaihe, the beachside retreat on the Yellow Sea where they gather every summer to hash out critical political and economic decisions in comfort and seclusion, far from the prying eyes in Beijing.¹ These summer meetings are always important but this year is particularly critical. This summer they must forge a consensus to settle years of heated negotiations over who will take the helm when the current leaders retire later this fall.

The big question seemingly is who will take the remaining spots on the Politburo Standing Committee, the group of seven to nine top leaders who will guide the party and the country for the next 10 years. The top two positions are already locked in. Current People's Government Vice President and Politburo Standing Committee member Xi Jinping will become Party General Secretary and current State Council Vice Premier and Politburo Standing Committee member Li Keqiang will become the next Premier.² The remaining positions are still being hashed out and will most likely have been the focus of intense debate in Beidaihe.

These internal personnel negotiations get more contentious with every leadership transition, because each time marks 10 more years removed from the Communist Party strongman eras of Mao Zedong and Deng Xiaoping. Today there are no aging revolutionary leaders left to serve as tiebreakers when internal party factions butt heads. And this 2012 transition is the most contentious yet because none of the next generation of leaders were approved or anointed in any way by the last of those strongmen, Deng Xiaoping.³ That leaves a relatively open field for the various factions to fill the top seats in the standing committee—and plenty of room for internal political infighting.

Look no further than the scandal and intrigue involving Bo Xilai, the red princeling previously considered a strong contender for one of those top leadership posts. He and his wife now stand accused of so many wrongdoings it is hard to keep them straight. His fall from grace earlier this year is still sending shockwaves through the halls of power in Beijing and across China.

For Pekingologists—those China experts around the globe who try to discern what’s going on in Zhongnanhai, the Chinese Communist Party’s small enclave near the Forbidden City in downtown Beijing—watching Bo Xilai fall and the Chinese leadership scramble to explain it all has been absolutely fascinating. This particular scandal provides a rare glimpse into the political negotiations that usually occur behind closed doors among a tiny circle of senior communist cadres who lead various political factions within the party.

But we should not get too excited about this particular incident. The Bo Xilai saga has certainly been interesting, but at the end of the day not much has changed in Beijing. The current standing committee will manage to come to a consensus on their successors and those successors will most likely continue plodding down the same economic and social policy paths that China has followed for the past 10 years under the leadership of Party Secretary Hu Jintao and Premier Wen Jiabao.

And therein lies the reason why the final composition of the next Politburo Standing Committee doesn’t really matter as much as how these new leaders will actually deal with some of the biggest challenges facing China since the initial economic reforms initiated by Deng Xiaoping in the late 1970s. In the coming decade this new leadership team must attempt to transition the Chinese economy from an export-led juggernaut to one dominated by domestic consumption and the types of investments that improve the everyday lives of the Chinese people, who, despite living under an authoritarian regime, are finding myriad ways to express their deep frustration with the direction their nation is headed.

Several decades ago, facing even more daunting challenges in the wake of Mao’s utter destruction of the Chinese economy, Deng rolled out a bold set of reforms that propelled China through its first big transition period from closed to open markets, lifting tens of millions of Chinese out of poverty and carrying the coastal provinces of the nation into the ranks of East Asia’s and Southeast Asia’s so-called tiger and dragon economies. But Deng could do this confident his authoritarian grip on China was secure and that the primacy of the Chinese Communist Party would remain unquestioned. He proved those two points in June 1989 by crushing the first open opposition to the party in Tiananmen Square and in other cities around the nation.

In contrast, the new leaders who will take the helm in late fall of this year will have to navigate a new economic and social transition from much more precarious starting points. The transition from export- and investment-led growth to domestic consumption-led growth based on technology innovation, and from lifting

tens of millions out of abject poverty to satisfying a more demanding middle class will be even harder for the party to execute. The reason: It will require the kind of deft governing skills that authoritarian regimes are generally not good at using. To further complicate matters, based on their performances thus far, it appears there is not a single bold leader in this new group who can push the necessarily ambitious economic and social reforms while also preserving the Chinese Communist Party's absolute grip on power.

The new standing committee will include an interesting group of cadres, but none of them appears to be another Deng Xiaoping—a visionary reformer and steely-eyed dictator who could enact sweeping change while maintaining the communist party's absolute grip on power.

That means this new crop of Chinese Communist Party leaders may not be able to repeat Deng's successes amid what promises to be a very rocky next 10 years in China. And as interesting as 2012 has been for Pekingologists, China's current leaders and their incoming replacements are already dealing with something far more important: figuring how to adapt China's political, social, and economic systems to power through the next development phase and avoid falling into economic stagnation and political turmoil. To do so, they must answer two questions correctly:

- What combination of economic growth and social improvements will they have to deliver to maintain popular support over the next 10 years?
- What changes will the Chinese Communist Party have to make in order to meet those goals, and how can they do so while also maintaining their grip on power?

The answers to these questions will ultimately decide how long the Chinese Communist Party can stay in power and whether China's rise can continue over the coming decades. This report takes these two questions as its core mission, attempting to provide a framework for considering them rather than trying definitively to answer them, which of course would be impossible. It is difficult to predict exactly how China's new leaders will behave once they take over this fall. But framing the problems facing China is a perfectly fine way to define the challenges the new leadership must tackle, which in turn informs how the Chinese leadership may react to these problems for the good or ill of the party and the Chinese people.

This report explores these two questions first through the prism of the ongoing Bo Xilai case to explain why the corruption scandals and political intrigues currently making headlines do not pose new or insurmountable problems for the party. The

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report then explores the two challenges that could potentially be insurmountable: overcoming the vested interests resisting central government attempts to rebalance the economy and improving quality of life for China's growing middle class without sacrificing single-party rule.

In the pages that follow, this report will detail those anticipated challenges and how China's new leaders may deal with them. But, briefly, here is a synopsis of the analysis:

The Bo Xilai scandal has led many to question how much longer the Chinese Communist Party can maintain its grip on power, but corruption scandals and factional infighting are old problems with familiar solutions. The real threats facing the party today are the new problems that do not yet have clear solutions, two of the biggest being economic rebalancing and figuring out how to satisfy China's growing middle class.

Rebalancing the economy will require political capital that this group may not have

For the past three decades, the Chinese Communist Party has maintained its grip on power by promising to keep the economy growing and to keep improving living standards. The first stage of growth (from lower to middle income) was enormously successful. The next stage (from middle to upper income) will be harder to traverse, and that makes it harder for the party to keep delivering on their promises to the Chinese people.

The only way Beijing can keep the economy growing and avoid falling into the so-called middle-income trap—falling into a period of economic stagnation, as happened in Malaysia, the Philippines, and Thailand—is to shift from export- and investment-led growth (which is producing diminishing returns) toward a new growth model based on domestic consumption and technology innovation. To do that, Beijing must reduce government support for state-owned enterprises and traditional industries such as coal and steel and increase the support given to private enterprises and the industries of the future such as clean energy and next-generation information technology.

Beijing must also stop channeling credit through state banks and local government officials, who make investment decisions based on cronyism. Instead, Chinese leaders need to rely more on commercial banks, which have incentives to lend

to the best companies and technologies regardless of their political connections. Expanding the profit incentives and reducing the political incentives driving credit allocation is the only way that Beijing can ensure that the technologies China produces will actually be competitive on the global market.

The problem is, all those reforms require Beijing to transfer money and policy support from the politically powerful—local government officials, state-owned enterprises, and traditional industries—to the politically weak, private enterprises and infant industries. That is hard to do in any country. It may get even harder to do in China once the new leadership takes the stage this fall because this new group appears to be more divided and politically weaker than its predecessors.

Beijing faces massive challenges meeting its economic promises to the Chinese people, and China's growing middle class is demanding even more

For many Chinese people, the first stage of economic growth provided bigger homes, better access to new consumer goods, and the freedom from worrying about having enough to eat. Now they want more—particularly China's growing middle class. They want quality-of-life improvements such as a cleaner environment, higher food-safety standards, and protection from local government abuse, but those things could be hard for the Chinese Communist Party to deliver.

The United States can deliver those things because we have a strong democracy, independent courts, and a free press. In China, local governments are their own little kingdoms. They control the courts and the press, and they don't have to worry about elections. As a result they are often more interested in making money than improving the quality of life for local citizens—and there is not much those citizens can do about it. Local officials expropriate their citizens' land and homes without paying for them and then let developers move in to build factories that pollute the environment.

In previous decades, many people felt that the opportunity to work in those factories made the other problems worthwhile. That balancing is now shifting. Many Chinese people are no longer willing to put up with problems such as excessive environmental pollution, and they are flooding the streets in mass protests that give Beijing nightmares.

It will be extremely difficult for Beijing to address environmental pollution and other quality-of-life problems without becoming open to major political reform, and they do not want to do that quite yet. Until then, the best they can do is to make small improvements and hope that will be enough to prevent major social unrest. Whether that works will depend largely on whether Beijing can keep the economy growing. As long as the economy is booming, most Chinese citizens can put up with at least some political frustrations. If growth slows too much, however, Chinese Communist Party rule will begin to look like a bad deal on multiple fronts.

The United States will have to learn to deal with a China that is increasingly divided and uncertain about its future

For the United States, China's neighbors in Asia, and the world at large, how China's new leaders carry their country through perhaps wrenching social and economic changes in the coming years will help determine their own economic growth prospects.

Whether the Chinese leaders succeed or fail will also impact how China deals with the world around it and whether China will play a positive or negative role in global peace and cooperation. Understanding how this all plays out in China could not be more important for policymakers around the globe. We attempt to set the stage in this report.

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