

# FINANCIAL TIMES

## Xi should draw up a new social contract for China

By David Pilling - October 31, 2012

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A few weeks ago, Xi Jinping, the man who will shortly become China's next president, disappeared. Perhaps he was getting cold feet. That is not a very likely explanation for [Mr Xi's 13-day vanishing act](#). Far more likely he was ill or fighting a behind-the-scenes battle over the remaining slots on the Politburo's all-powerful standing committee. But he would not be human if he had not paused to contemplate the enormity of the task before him.

Domestically – not to mention internationally where [China's relations with Japan have strained to snapping point](#) – Mr Xi faces extraordinarily complex policy challenges. How he might tackle them and what room for manoeuvre he has within China's system of collective leadership will be the subject of next week's column. Here, let's confine ourselves to examining what kind of China he will inherit.

Economically, the mood has palpably darkened in recent months. [Growth has been slowing](#) for seven straight quarters and, with expected annual growth of 7.5 per cent, the economy is growing at its slowest pace since 1999. That is the official figure. Some observers on the ground, who talk to companies or comb through proxies for gross domestic product, estimate the economy is doing worse than that.

If he chooses, Mr Xi can rev up the stimulus engine once more. By most estimates the combination of state and local debt is no more than 70 per cent of GDP. Restrictions on property and bank lending – designed to tame inflation and cool the economy – can be lifted. Since some of the slowdown has been deliberately engineered, it follows that, if necessary, it can be reversed.

Yet that would be to swallow the poison Beijing has been trying to spit out for a decade. The current government, headed by Hu Jintao, has long recognised the need to rebalance the economy away from investment and towards consumption. Those plans had not been going well even before 2008. After the Lehman shock, they were junked altogether as Beijing mounted what [Goldman Sachs](#) called the biggest stimulus package in economic history.

The inevitable side effects of that stimulus – non-performing loans and potentially deflationary overcapacity – have not yet taken hold. As the economy slows, the bill from the last spending binge will come due. To double down on stimulus would be to take precisely the wrong course. No economy can productively invest more than half its GDP year after year. One economist calculates that half of all China's physical assets have been built in the past six years.

Mao Yushi, one of China's most venerable economists, says that, after three decades of fast growth, the country stands at a crossroads. "Sooner or later there must be a crisis," he says. Mr Mao, who was this year awarded the Cato Institute's Milton Friedman Prize, says many of the investments rushed out after 2008, including the high-speed rail network, will never make a profit. Based on electricity-metre readings, he estimates that almost 30 per cent of China's housing stock is empty. Even if the proportion is half that, it is worrying.

Too many houses is just the start. HSBC says that the [steel industry](#) has record debts, huge losses and rising inventories. Even so, it is continuing to crank up production. As growth slows, unpaid bills to Chinese companies have increased and some local governments have run into financial difficulties. In the financial system, an eruption of wealth management products, sold as a high-yielding alternative to regular deposits, has drawn comparisons with US subprime loans.

Stresses in the economy are bringing more social friction. Capital flight has picked up as people seek a bolt-hole. There is widespread anger at corruption. Allegations in The New York Times about the [wealth of Premier Wen Jiabao's family](#) is but the most spectacular example. Cyberspace is seething with stories of arrogant officials caught wearing expensive watches or lording it over ordinary Chinese. Middle-class anger has risen too. Expectations are outstripping the ability of authorities to deliver the safer environment or justice people seek. Recent [demonstrations in the city of Ningbo](#) against the expansion of a petrochemical plant were the latest in a series of not-in-my-backyard protests. Local governments have been surprisingly quick to yield to popular demands. Even that may not be enough. "You must politicise your request," says an academic at one of China's most prestigious universities. "You must demand power, not just fix a specific grievance," he says, predicting that anger could boil more forcefully on to the streets. If people are as disgruntled as he says, Mr Xi will have to conclude a new social contract that goes beyond trading political monopoly for economic liberty.

It is said that the Chinese Communist party is the world's most competitive political system. "No country prepares its leaders more diligently," says one admiring diplomat. "This is the world's best management school." For China's sake, one must hope Mr Xi really has been its most brilliant student.