SPECIAL FEATURE: THE YEAR IN REVIEW

CHINA ECONOMIC REVIEW

DECEMBER 2012 VOL. 23, NO. 12 www.chinaeconomicreview.com

- China's coming wave of bad debt
- Minxin Pei on Beijing's transition

For richer or poorer

How will China's new leaders take on income inequality?

ISSN 1350-6390
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FOCUS: EXECUTIVE LIFE

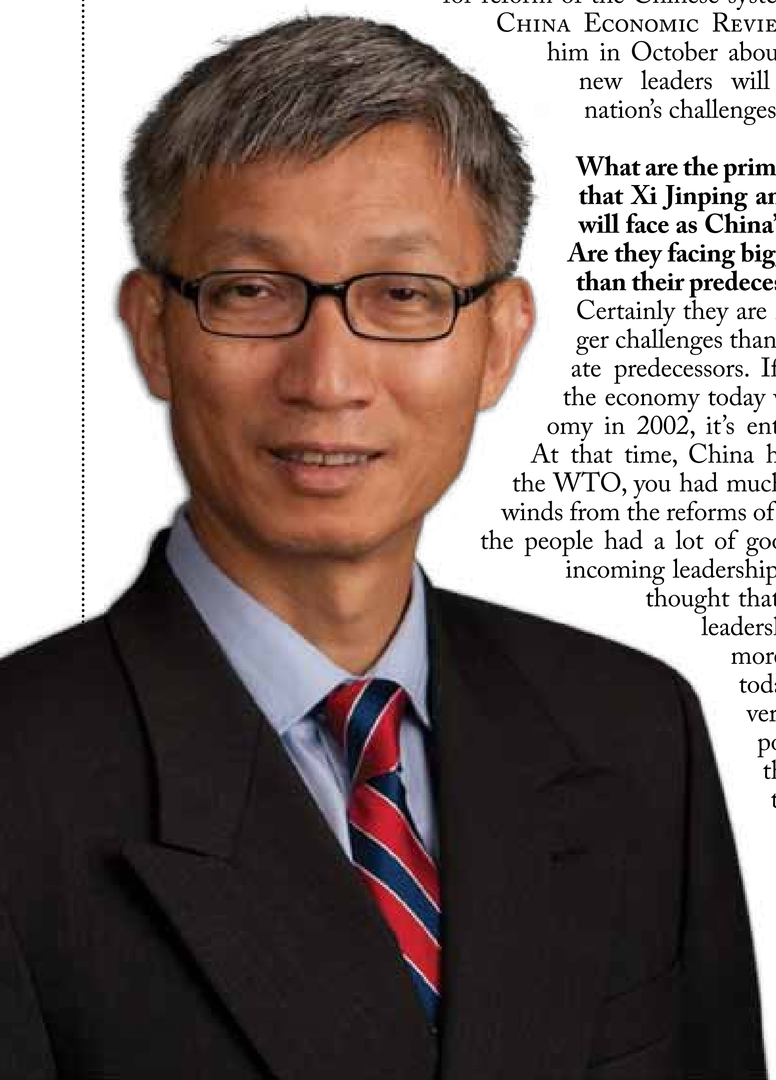
View to the top

Much of what passes for analysis on China's leadership transition is merely speculation, says China scholar Minxin Pei

Reporters and analysts today know far more about China's leadership transition than they ever have before. Sadly, however, all this knowledge adds up to almost nothing. As party general secretary, does Xi Jinping plan to strengthen rule of law? How does Premier Li Keqiang plan to guide the nation toward consumption? No one can say for sure.

Some observers have chosen to delve into the histories of top leaders to answer these questions, while others make predictions based on the factional affiliation of the new leadership. Unfortunately, China's government is too complicated to reduce to such simple formulas, said Minxin Pei, the director of the Keck Center for International Strategic Studies at Claremont McKenna College and the author of several books on China's economic and political system. Because the environment at the top of China's political system is not suited to bold decisions, much of what passes as analysis on China is merely speculation, argues Pei.

Pei is a well-known iconoclast who has argued for reform of the Chinese system for decades. China Economic Review spoke with him in October about how China's new leaders will confront the nation's challenges.



IN FOCUS: Despite the rise in media coverage of China's leadership transition, observers still know little, Pei argues

What are the primary challenges that Xi Jinping and Li Keqiang will face as China's new leaders? Are they facing bigger challenges than their predecessors?

Certainly they are inheriting bigger challenges than their immediate predecessors. If you compare the economy today with the economy in 2002, it's entirely different. At that time, China had just joined the WTO, you had much stronger tailwinds from the reforms of the 1990s, and the people had a lot of good will toward incoming leadership in 2002. They thought that the incoming leadership would do more for them. But today, you have a very disappointed population. In the last 10 years, the leaders did more talking than work. And when you look at the economy, the structural conditions are very different. Exports can no longer drive the economy, unlike in 2010 when export growth was more than 20%. Now, if China can maintain 10% export growth that would be very good. The economy is far less balanced today.

'I'll admit the China field has not produced simple analytical tools for practitioners to use. But that's because of a very good reason – they don't exist'

It sounds like you'd agree that the pace of economic liberalization slowed under Hu and Wen. Why do you think that happened?

Not just slowed, I think there was a reversal. When you look at the expansion of the state-owned enterprises during the last 10 years, that was clearly a reversal of reform. Frankly I think the Jiang-Zhu administration genuinely was interested in certain important reforms, so they did a lot from 1993 to 2002. But when you look at 2002 to today, I really cannot think of anything.

Can you offer any insight into whether Xi and Li will be more aggressive than their predecessors in implementing a reform agenda?

It's hard to see at this moment. First of all, they have not said anything publicly, really. They're in a very tricky position. If they say they're going to do a lot more reforms, that implies their predecessors have not done a lot of reform. That kind of criticism they don't want to make in public. And second, these are relatively cautious people. When you

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look at their records in Zhejiang, Fujian, Henan and Liaoning provinces, we don't have any evidence to show they are going to be aggressive. The third reason is, when you look at the balance of power at the very top, the Politburo Standing Committee (PSC) is a carefully constructed group with representatives from different factions. Making bold decisions in this environment can be difficult. So right now, you do not know. It would be premature to bet one way or another.

Many observers are attempting to look at the factional balance in the PSC to determine what policies they might lean toward. How do the backgrounds of Xi and Li differ from Hu and Wen?
I would say in the previous administration the lines are probably more sharply drawn, because you can see who the people are that owed their official careers to President Jiang Zemin. This time, it's harder. We know probably two or three people who are Hu's men, but the rest we don't know. Factional lines do not necessarily determine whether one faction supports reform and another faction supports the status quo. It's far more complicated. A lot of that depends on the emphasis the top leader, the general secretary, puts on a certain policy. If he displays an attitude which essentially means you're either with me, or you're not with me, then his other colleagues probably will think twice about opposing him. Third, the consensus under which top decisions are made is important. If there's a real crisis, however you define that, then factional lines are much more fluid. That's why I'm very

'Today, no one in his right mind at the top wants to tell people what he wants to do, because that way he makes enemies'

cautious about using factional line-up to predict how the leadership will act in terms of policy.

Do you think that's a tendency of the Western media, to interpret those factions along the lines of political parties, because that's a framework they understand?
Yes, I think Western media or some observers have an oversimplified framework for understanding or analyzing decision-making at the top. They oversimplify in terms of the number of factions. They think there are two groups, the princelings and the Communist Youth Leaguers – it really doesn't tell you much. Let's look at the princelings. Bo Xilai is a princeling, Xi Jinping is a princeling. They're very different. One is very cautious, and one – what should I say – is very entrepreneurial [laughs]. One is a neo-Maoist, one is clearly not. That's why I'm very adverse to attaching a label to one person and then trying to use the label to extrapolate what that person is going to do as a policy maker.

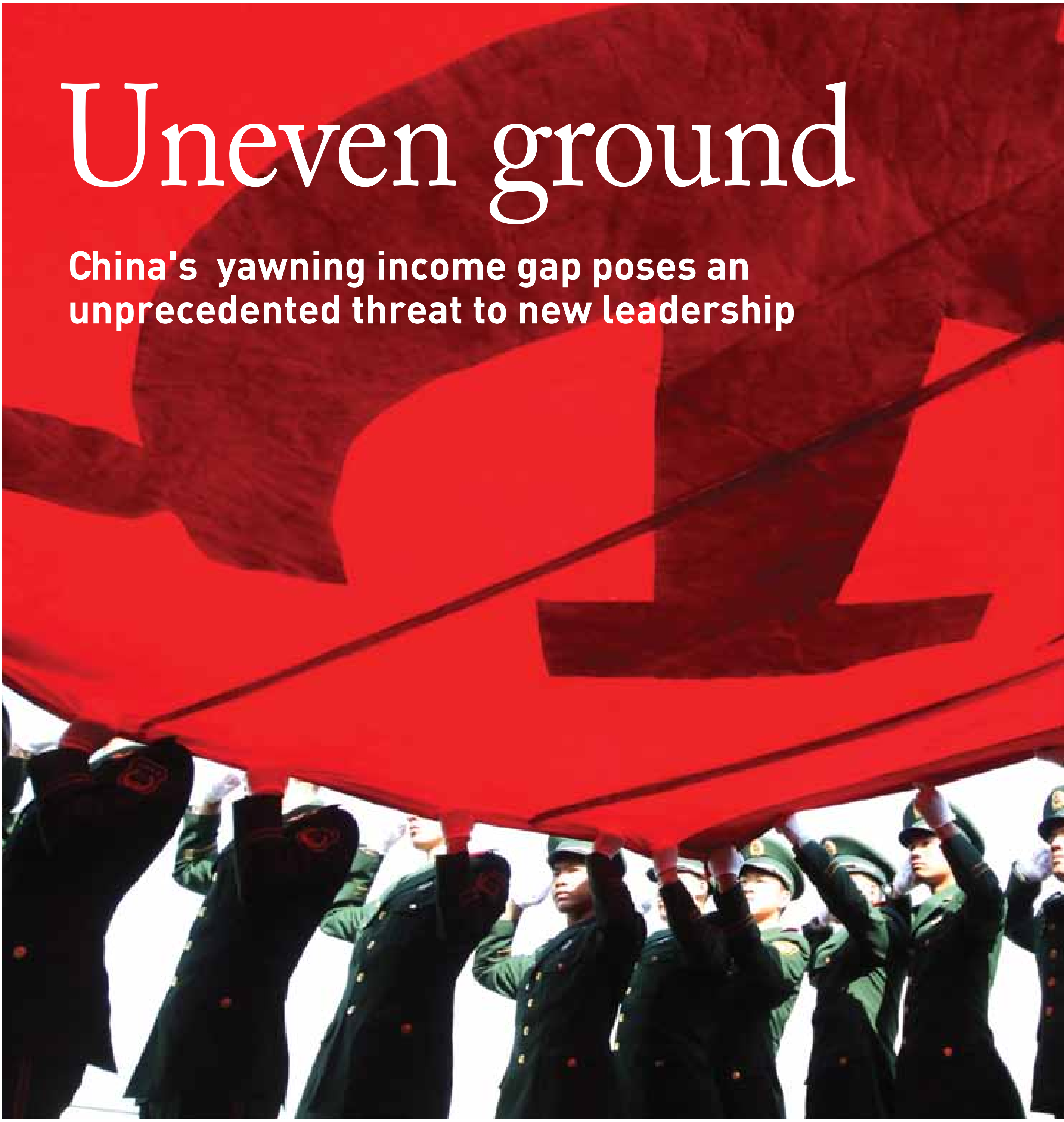
Is there a better framework for analyzing policy decisions at the top?
No framework. Today decision making at the top really depends on individuals. A much better framework would just be to know who they are. Know the circumstances under which decisions are made, and know the urgency with which certain decisions have to be made. If you look at history, if you do not know the person himself, it is extremely hard to predict what that person would do beforehand. Zhu Rongji is an exception rather than the rule: He was not afraid to tell someone what he wanted to do. Today, no one in his right mind at the top wants to tell people what he wants to do, because that way he makes enemies. So I'll admit the China field has not produced simple analytical tools for practitioners to use. But that's because of a very good reason – they don't exist. Such tools have simply been impossible to produce. Politics in China, in terms of decision-making at the top, is really complex.

You're based in the US. There has been an unprecedented level of coverage of the Chinese political transition, but you might agree that some of it is clunky. What are the big misconceptions?
The interest is laudable because the leadership change is indeed a very important development. But analysts in the US or in the West operate under the same conditions as everyone else, [with] very little real information. Speculation is taught as analysis. Also, I think the main problem is that they overlook the bigger political picture in which the transition is taking place. So most analysts focus on who's up or who's down, they attach labels to individuals who don't deserve them – oh, this person is a reformer, unfortunately he's not going to make PSC. That kind of talk I personally find kind of laughable, because if you look at a person's background, it's impossible to say that person is a reformer or not a reformer. You might say that person has a different set of ideas, but whether he can actually put his political capital on the line, it's a huge question mark. I also say that they completely overlook the Chinese society at this moment. I've been writing that the Chinese government probably becomes less and less relevant in terms of determining China's future. You look at whether the government is going to reform or not. Of course, the new leadership has a say, but let's not forget that the Chinese people have a say. So the lack of attention to China's social change and the new political environment is something I find deeply disappointing.

In your recent piece in *Foreign Policy* you argued that people in the US wrongly think that China will continue to rise. Your argument centered on China's declining fortunes. Is there anything China can do to reverse those fortunes?
Oh, yes, by reform, by adopting aggressive reform and making up for lost ground, because China has lost a decade. I think this is the consensus today among thinking people of China: That China has lost a decade of opportunity. Had China done more reform, it would not be in this very difficult social, political and economic environment that it faces today. Reform is hard, but if you do not reform, life will be even harder. ◆

Uneven ground

China's yawning income gap poses an unprecedented threat to new leadership



LOSING STEAM, P36
A timeline of China's economic reforms shows a slowdown in the last decade

URGE TO PURGE, P38
Beijing battles high-profile corruption cases that threaten to undermine its authority

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It may come as a surprise that, amid China's meteoric rise, its leaders are contemplating cautionary tales of fallen empires. But inside Beijing's political circles this fall, left-leaning academics and politicians increasingly pointed to the break-up of the Soviet Union as an example of the destabilizing influences of unbridled capitalism. More reform-minded Chinese officials considered the demise of France's last monarchs; Wang Qishan, one of the seven newly appointed members of the Communist Party's Politburo Standing Committee, recommended to his colleagues Alexis de Toqueville's "Ancien Regime and the French Revolution," which discusses how leaders can avoid violent revolution by carrying out peaceful and incremental reform.

As the country's fifth generation of leaders comes into power, the perception is growing that China could soon experience a crisis that will threaten its very foundations. Xi Jinping and Li Keqiang, who officially ascended to the top posts in the Communist Party in November, are inheriting a country with far more social tension than when their predecessors, Hu Jintao and Wen Jiabao, took over 10 years ago.

Rising inequality has sparked much of that dissatisfaction. The coming of capitalism to China has raised living standards across the board, but it has benefited some people far more than others. One-tenth of China's population now generates 56% of the country's annual income and holds 84% of its wealth, a drastic change in a society where nearly everyone was equally poor 30 years ago.

Much of that wealth has flowed to well-connected officials and state-owned enterprises (SOEs), while households and private businesses struggle with rising costs and limited opportunities. Many economists agree that China's investment-driven, state-heavy economic system is crowding out private businesses, which tend to be more efficient and deliver benefits to a broader group of people.

This trend is reducing China's economic potential and, in some cases, driving a wedge between the government and the people.

"In general in the US, people accept that people who win in the marketplace won because they had better products or a better idea or worked harder, but in China that idea is much less certain," said Nicholas Borst, a research associate and China program manager at The Peterson Institute for International Economics, a think tank. "I think people quite rightly attribute a lot of business success [in China] to connections and political favors and sometimes even corruption. Because there's less of a sense of fairness about economic outcomes, inequality tends to be much more sensitive."

Indeed, income inequality presents perhaps the biggest challenge to its legitimacy that the Communist Party has ever faced. The issue is front and center as China's new leaders take office, and it will require great economic insight and political skill to resolve.

"If we don't push forward with structural reform to mitigate social conflict, not only will the economy go wrong in the future, so will social stability," said Liu Shengjun, deputy director of the Lujiazui Institute of International Finance at the China Europe International Business School (CEIBS). "In the coming 10 years, the new leadership will face the fact that … social conflicts are on the verge of explosion and many factors that have driven China's growth are disappearing."

The downside of development

China's rapid development has ushered in glaring inequalities. The country is home to one of the world's fastest growing markets for luxury products as well as a population of 150 million people earning less than US$1 a day.

But while the country is unequal by global standards, it is by no means the world's most imbalanced society. Although income inequality is difficult to quantify due to the vast amount of money moving under the table in China, the World Bank estimated China's Gini coefficient, a commonly used measure of the inequality of wealth, at 0.425 in 2005. That makes China slightly less equal than the US, which scored 0.408 in 2000 (a higher score indicates more inequality in family incomes), but more equal than countries like South Africa (0.631) and Colombia (0.559).

But this disparity in China has still become an unprecedented source of tension, partly for historic reasons. While Americans have lived with income inequality for generations, for Chinese it is a new phenomenon. "Some people say [China's Gini coefficient] is lower than the US, some say it's higher," said Wei Yao, chief China economist at Societe >>

>> Generale. "But I think the trend is that China's income inequality deteriorated at a much faster rate than a lot of major economies in the world."

One of the most glaring disparities is between China's coastal cities, where economic reforms first occurred, and the underdeveloped interior. Average incomes in China's cities are more than three times the level in the countryside. This is partly because China's household registration, or *hukou*, system prevents rural residents from freely moving to urban areas, with the goal of avoiding a population rush that would overwhelm urban infrastructure capacity and social services.

Another major imbalance is that between the public sector, meaning both government and state-owned enterprises, and the sphere of consumers and private businesses.

Both the Chinese people and private companies pay relatively high taxes for few benefits. The effective tax rate for private companies is easily three times that of SOEs; individuals face a higher tax burden than in many wealthy countries, but also receive fewer social services, including education, health care and social security, as a percent of GDP than other major economies, according to a report by Societe Generale. Local government tax revenue has been growing at more than twice the speed of GDP and four times as fast as rural residents' income for years, said Li Jian, associate professor of macroeconomics at Shanghai University of Finance and Economics.

Few Chinese appear to understand the broader link between growing income inequality and the state monopolizing resources

The state sector also benefits from a steady flow of cheap loans. Most Chinese have no choice but to put their savings in the state-owned banking system, for which they receive minimal returns (the interest rate for depositors was often less than the inflation rate in the past 10 years, meaning Chinese were actually losing money on their investments). Many of these funds are eventually funneled to SOEs, which are fast-tracked for approval.

Virtually 90% of all bank loans are made to state-owned enterprises, which produce only 50% of GDP – meaning only 10% of all official bank loans are supporting roughly half the economy, said Robert Theleen, managing director of investment firm ChinaVest and the 2013 chair of the American Chamber of Commerce in Shanghai.

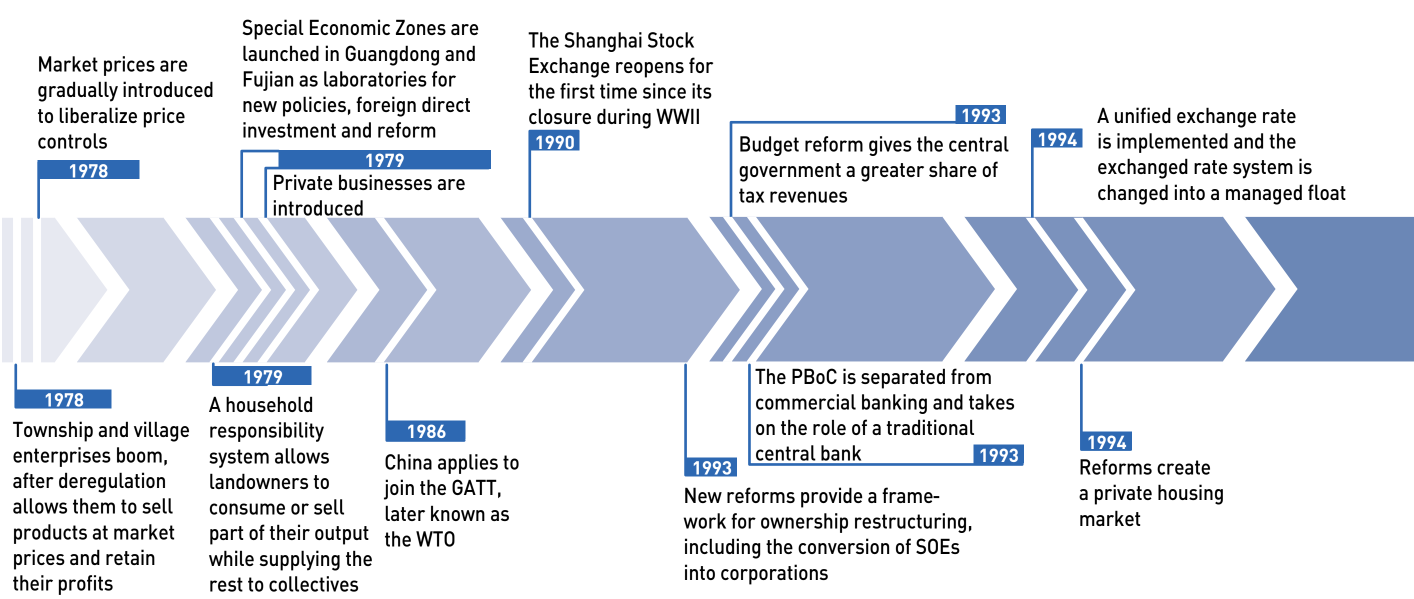
State companies also benefit from government subsidies, lucrative government contracts, artificially cheap resource prices and barriers to entry for non-state competitors. Stimulus measures aimed at stemming the economic slowdown have left even more assets in the hands of Chinese SOEs – even though small and medium companies generate roughly 80% of the country's jobs.

The generous funding given to SOEs is too often squandered. Fixed investment by SOEs often costs 20-30% more than that of private companies and takes roughly 50% longer to complete, according to independent economist Andy Xie. If capital markets were reformed to allow private and public companies to compete on even footing for funding, China's economy would be more efficient and distribute economic benefits to a wider range of people – not just the wealthy and well connected.

Many Chinese recognize that SOEs are offering tougher competition to private enterprises than in years past; "*guojin mintui*," meaning "the state advances and the private sector retreats," has become an economic catchphrase in recent years. However, few Chinese appear to understand the broader link between growing income inequality and the state monopolizing resources.

In a 2012 poll by the Pew Research Center, while 45% of Chinese respondents agreed with the statement "most people can succeed if they work hard," one in three disagreed – indicating that Chinese see not just income, but also

TIMELINE: The slowing pace of reform



BLOOD AND SWEAT MONEY: A migrant worker in Foshan protests for unpaid wages from Guangdong Fourth Construction Engineering Corporation

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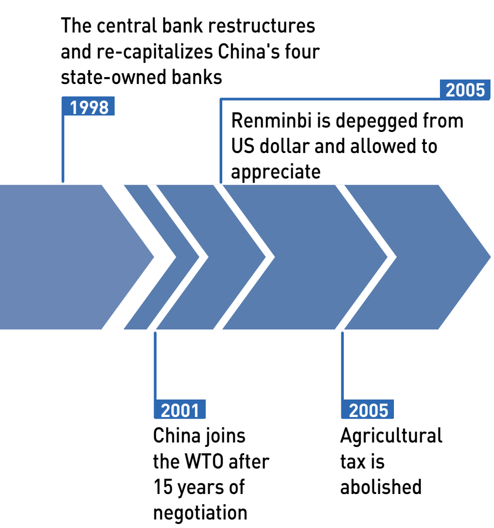
opportunity as unequal. However, those who said that hard work is no guarantee of success – in other words, those who felt powerless to advance their situation – also professed less faith in the free market and a greater desire for the state to play an active role in the economy.

So long as the understanding of how a freer market could narrow income inequality is limited, so will be political pressure for change. As a result, Chinese leaders may be tempted to focus on superficial measures to help the poor, rather than truly reforming the way income is distributed.



Where to begin?

Many economists argue that China's state-owned sector has begun crowding out economic activity, and that the investment- and manufacturing-heavy SOE model has largely run its course. Channeling more of the country's wealth toward average consumers and small businesses could provide China with a strong, sustainable source of growth for decades to come, economists from the World Bank and China's Development and Reform Commission concluded in a report released earlier this year.

But reforming the distribution of wealth will be difficult, said Li Shi, an economist and executive dean of the China Institute of Income Distribution at Beijing Normal University. Making such a shift would require a slew of complex social and financial reforms involving the financial system, employment, household registration and social security that many Chinese do not understand and some fervently oppose. "It will take systematic and comprehensive changes to solve the problem. Incremental reforms will hardly be effective," Li said.

Observers disagree on where the incoming government should begin. One popular initiative is building out the social safety net, meaning providing greater funds to subsidize health care, housing, pensions and education. Chinese have among the world's highest savings rate, in part because of their need to shoulder these costs independently. A stronger safety net would allow many Chinese to spend a greater proportion of their income on consumption, driving economic growth.

The government has taken big steps toward building out these social services. In just the past few years, China eliminated fees and taxes imposed on farmers and extended a limited pension scheme to all rural residents. It abolished tuition fees at all government schools for children below the age of 16 and encouraged massive investment in affordable housing. And it expanded the health insurance system until 95% of all Chinese have some kind of coverage, up from just 15% in 2000. Other initiatives under discussion include relaxing the *hukou* system to allow greater urban-rural migration, requiring SOEs to put some profits toward the social welfare system and giving rural residents ownership of their land.

These highly visible measures are popular among average Chinese, said Borst of the Peterson Institute. But while improving the social safety net is a necessary initiative, it will go only partway toward fixing income inequality.

These reforms address the umbrella of what economists call the secondary >>

Urge to purge: Can China take the painful steps to quash corruption?

The political exposes that emerged in China this year were fit for tabloid dramas. The now-infamous downfall of former Chongqing Party Secretary Bo Xilai left the global press spinning tales of murder-mystery intrigue. In March, the government moved quickly to cover up the story of Central Secretary of the Communist Party Ling Jihua's son crashing a Ferrari in Beijing while allegedly playing sex games with two scantily clad women.

In July, Bloomberg's site was pushed outside the Great Firewall after the news agency published a story estimating the total private wealth of incoming president Xi Jinping's family at close to US$1 billion. Then in October, *The New York Times* published an expose that linked the family of outgoing Premier Wen Jiabao with US$2.7 billion in private wealth.

These were just the highest profile cases; thousands more officials were prosecuted for corruption this year. Among them was Yang Dacai, head of the Shaanxi provincial Work Safety Administration. Authorities launched an investigation that stripped Yang of his official duties after photos caught him smiling and wearing an expensive watch at a fiery accident site.

Given the growing perception of income inequality in China, highly publicized incidents of official wealth and corruption threaten to undermine the government's authority. "If you're a socialist government who claims to be working towards creating a socialist market economy, and you still have a communist party in charge, for [income inequality] to be going in the wrong direction is very difficult for them to reconcile," said Nicholas Borst, a research associate and China program manager at the Peterson Institute for International Economics, a think tank in Washington, DC.

Party officials are aware of the risk that high-level embezzlement poses. "If the anti-corruption campaign fails, the party, even the country, may perish," outgoing president Hu Jintao said during his work report to the 18th Party Congress in November. But while the stakes are extremely high, government officials have thus far been unwilling to take the necessary but painful steps toward stamping out official corruption.

Let the sun shine in

Most Chinese will say that corruption is endemic to China. However, there is some evidence that Chinese corruption may not actually be that extreme from a global perspective.

While the level of corruption is extremely hard to measure, experts typically estimate China to be more corrupt than about 75% of countries around the world. China is "in with a lot of other countries of similar economic circumstances, countries that are developing rapidly. So China is not extraordinarily corrupt, according to experts," said Andrew Wedeman, the author of "Double Paradox: Rapid Growth and Rising Corruption in China."

And in contrast to popular thinking, the level of corruption has probably not surged in the past decade. The number of corruption-related prosecutions has been fairly constant, with 35,000 officials indicted every year on related charges, Wedeman said. "The data suggests that corruption surged in the 1980s and 1990s but has leveled off over the past decade."

Even so, corruption remains a huge political problem in China. Because of the state's central role in the economy, those with government connections have more opportunities to accrue wealth, both legitimate and otherwise. The wealthiest Chinese often are among the most politically connected, and vice versa – even more so than the highly income-stratified US.

According to a study by Bloomberg, the wealthiest 70 members of the National People's Congress have a combined wealth of about US$90 billion, compared to a combined wealth of US$7.5 billion for the 535 members of the US Congress, the president, his cabinet and the US Supreme Court. "Members of China's National People's Congress have become so wealthy that their meetings may best take place in a bank vault," former media executive James McGregor writes in his book, "Ancient Wisdom, No Followers."

Off with his pants

Government measures to fight corruption in China often take the form of campaign-style crackdowns featuring flying banners and officials carted out in handcuffs. These short-term, high-profile campaigns are aimed at assuring the people that the government is doing something about corruption; however, they are not very effective at reducing it, Wedeman said.

The better way to police corruption is the simple work of following assets and bank accounts, he said. "Anti-corruption officials spend an awful lot of time doing what is basically auditing."

China has proposed several initiatives to audit officials more strictly, but perhaps unsurprisingly, they have met with significant political opposition. "Ahead of the 18th Party Congress, many old party members called for party representatives to make their incomes public. But that call was muffled immediately," said Zhang Lifan, a political historian and blogger.

The existing asset declaration system "is basically toothless," said Li Shi, an economist and executive dean of the China Institution of Income Distribution at Beijing Normal University. "What we need is to have government officials' assets disclosed and verified so people can monitor them and report false claims."

That initiative picked up speed this fall, when Wen Jiabao answered *The New York Times* article on his family wealth with both a denial of the report and a call to speed up the release of China's much-delayed "Sunshine Law" to disclose official assets.

Increasing transparency may be the best way to restore trust among an increasingly jaded public. "If one person has to pull off their pants, it's better that everyone does it at the same time," said Zhang. "Only when leaders and officials expose their wealth, can the social inequality issue be dealt with successfully."

But Chinese officials may not really be ready to bare it all. After all, the country already has an effective force for increasing transparency: the media, if it were allowed to operate independently. For the government to simultaneously call for stronger sunshine laws and do their best to block the media from accurate political reporting seems disingenuous at best.

There are legitimate concerns, of course. Media disclosures of official wealth might cause a public uproar. But in this increasingly high-tech society, it seems likely that the truth will leak out one way or another. Chinese leaders must evaluate whether official disclosures or surprise media exposes ultimately present the bigger risk. ◆

'Income inequality is the same thing as asset allocation inequality or capital inequality. They go hand in hand' -BOB THELEEN, CHINAVEST

distribution of wealth – measures like taxation, social security and transfer payments that reshuffle income after it has been generated. Economic studies suggest that reforms to secondary distribution methods are less effective at reducing income inequality than structural reforms that influence the primary distribution of income.

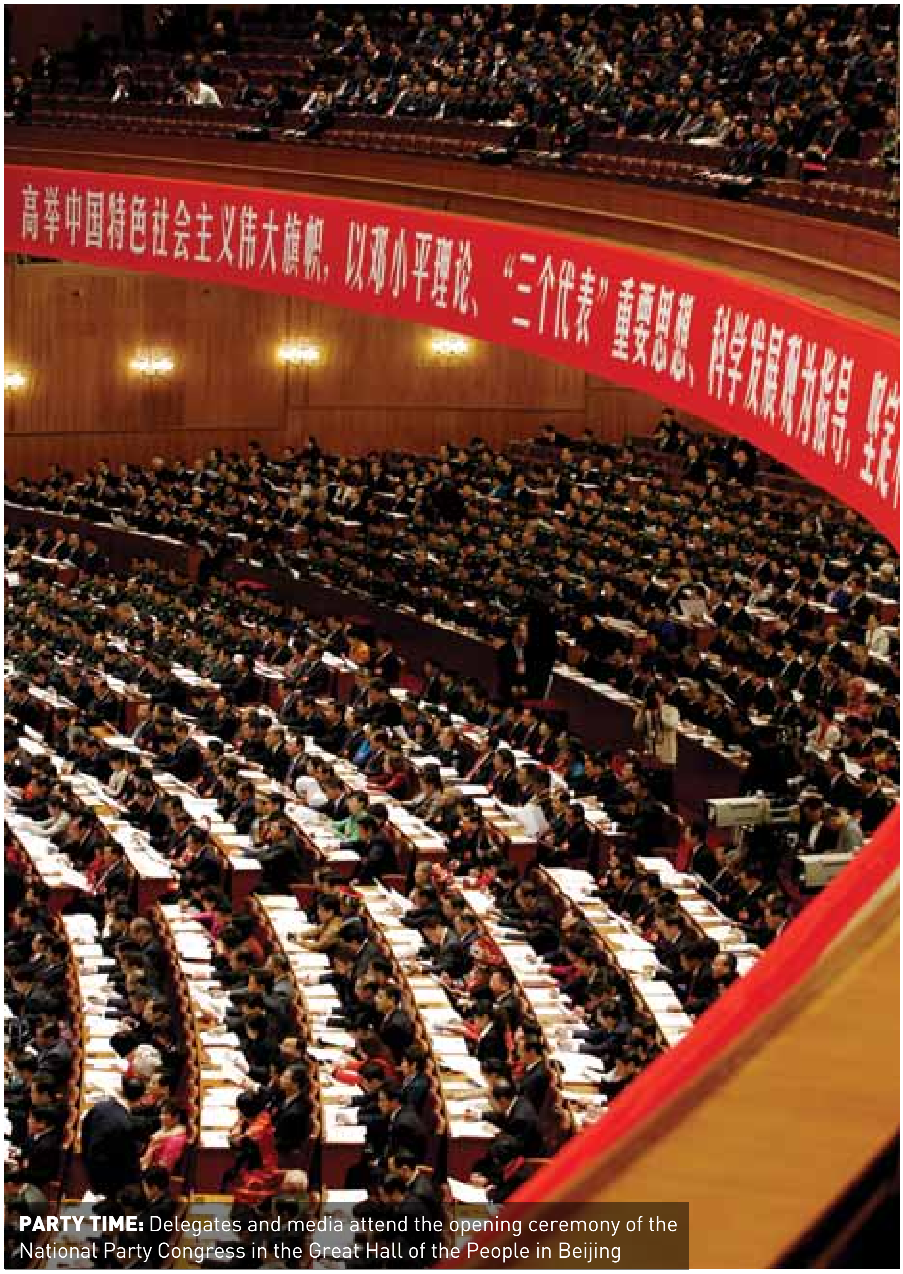
Chief among these measures would be increasing economic efficiency by opening up state-dominated sectors to private competition. Also effective would be removing government subsidies of resources, including electricity and water, which tend to benefit resource-intensive manufacturing industries, many of which are state-owned. "China has been sort of overweighted on industrial firms, industrial growth over the past decade, partly because of these price controls and subsidies. So removing those would be a very gradual but effective way of boosting household incomes," said Borst of the Peterson Institute.

But the most effective way to narrow income inequality in China would be reforming how capital is allocated, by reducing or eliminating the advantage that state-owned companies have in securing funding. That would allow private businesses to prosper, employing a greater number of people and distributing wealth more evenly through the economy.

"Income inequality is the same thing as asset allocation inequality or capital inequality. They go hand in hand, and it's very important to link the two," said Theleen of ChinaVest. "If income inequality is a problem, part of the solution is access to capital for small businesses."

Those in favor of providing more capital to private businesses argue for a variety of reforms, including liberalizing interest rates, opening the banking sector to private lenders and deepening bond and capital markets.

None of these initiatives will be easy to implement, and some will spark opposition from powerful people and organizations. Officials may also be tempted to disregard the most crucial reforms in favor of those that are easier both for the public to understand and for leaders to accomplish, such as improving the social safety net.



PARTY TIME: Delegates and media attend the opening ceremony of the National Party Congress in the Great Hall of the People in Beijing

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Middle of the road

Chinese leaders have gradually carried out reforms to liberalize the economy over the past three decades, but progress has been uneven. Reforms largely stalled under Hu Jintao and Wen Jiabao during the last decade. Some observers accuse Hu and Wen of merely biding their time while enjoying the benefits of the economic reforms implemented under Jiang Zemin and Zhu Rongji, such as China's acceptance to the WTO. "The current government has done nearly nothing in the past 10 years," said Liu of CEIBS.

Reforms may have slowed in part due to a backlash against the sweeping changes Jiang Zemin and Zhu Rongji carried out in the 1990s, in which 40 million SOE employees were laid off, said Borst of the Peterson Institute.

In addition, the huge challenges Hu and Wen confronted in their second term as the financial crisis reshaped the

LEFT BEHIND: China is still home to more than 150 million people who earn less than US$1 per day

>> global economy undoubtedly waylaid planned reform. "The last five years have been unprecedented … If we want to compare the reforms of the last five years with the previous five years, I think you're comparing apples with oranges," said Bala Ramasamy, an economics professor at CEIBS.

To their credit, Hu and Wen have led China through the financial crisis and are bequeathing to their successors a still-vibrant economy with ultra-low inflation. But even so, the absence of reform in the last decade has left some observers impatient and pessimistic.

There are some signs that China's incoming fifth generation of leaders will adopt a more aggressive agenda. Xi Jinping was known for cultivating private enterprise as party secretary of Zhejiang. Li Keqiang backed the DRC/World Bank "China 2030" report, which set out a series of ambitious reforms to limit the role of SOEs and refigure the economy to benefit consumers and private enterprise.

But those hoping for quick progress seem likely to be frustrated. History and official rhetoric suggest that these men will favor consensus and incremental reform over any dramatic action.

In his November 8 work report to the party congress, former Communist Party Secretary Hu Jintao gave a goal of doubling per capita incomes and GDP by 2020 and emphasized the need to build a "moderately prosperous" society, meaning one in which all people benefit from economic growth. But he also indicated that the government should forge a middle path between a reform agenda and the status quo. "We must not take the old path that is closed and rigid, nor must we take the evil road of changing flags and banners," Hu said.

'Those who will see their interests hurt will surely stand in the way of the reform'
-LIU SHENGJUN, CEIBS

China's governing process has become more consensus-driven with each generation of leaders, and no consensus yet exists on how exactly these reforms should be carried out. "The intention to reform is genuine, and I think the willingness is high. But at the end of the day, it's about how to change the incentives within the party, within the government. So they still have a lot of hurdles to overcome," said Yao of Societe Generale.

One example of this stasis is the blueprint for reforming income distribution. The plan, which has the strong backing of Wen Jiabao, will include measures that address minimum wages, the dividends state firms must pay back to the state, taxes on high-income earners and the salaries of SOE executives.

Chinese media report that it will be released before the end of the year, but Liu of CEIBS cautions against excessive optimism. The blueprint has been on the drawing board since 2004, and the State Council has rejected the plan twice. "Those who will see their interests hurt will surely stand in the way of the reform. Therefore, we should not hold too high hopes for the plan," said Liu.

Others say the measures will die with the Hu and Wen Administration. "My opinion is that new leaders may not want to be tied to what the previous generation was planning," said Zhang Lifan, a historian. "So it will probably take them more than a year to figure out how they are going to address these problems."

But to solve the problem of income inequality, Xi and Li may have to do more than merely forge a consensus. The most influential measures to reform income inequality – those that transform how capital is distributed – will be the most politically difficult to implement. Realistically, there may be no sufficient compromise between this reform agenda and the strong opposition that some SOEs and government ministries present. By trying to walk a middle road, the Chinese government may end up in the same unsustainable place that it started. ◆