

*November 11, 2013*

## **Let's Party Like it's 1978**

A twice yearly meeting of the Chinese government officials, formally known as the third plenary session of the 18<sup>th</sup> Communist Party of China Central Committee, started on Saturday and will end tomorrow.

Officials have indicated that this plenary session could be a springboard for major reforms. In fact, Chinese General Secretary Xi Jinping has indicated that this session could be as consequential as the plenary session in 1978 which introduced policies that set in motion the Chinese growth engine. The 1978 meeting was a significant turning point for both the country and the Communist Party itself.

This week, we are going to take a closer look at the changes from the plenary session 35 years ago, the circumstances leading up to the session and how China changed following the meeting. In understanding the changes associated with the 1978 meeting, we can better assess the statement that this week's meeting could be just as significant.

### **Chinese Politics**

The Chinese Communist Party (the CPC) is elected for a five-year term and will hold a number of plenums during its term, which is when major policy changes are introduced. The third plenary sessions usually focus on economic policy. The first two plenums usually focus on personnel issues as the new leaders move their own allies into necessary political positions.

Aside from the 1978 plenum, other third plenums have also been noteworthy. The third plenum in 1993 endorsed the socialist market economy, which was the foundation needed for setting up the Chinese economy as we know it, with state-owned enterprises and the financial system that supports them.

### **Of Cats and Mice**

The third plenary session of the 11<sup>th</sup> CPC Central Committee took place in 1978 in Beijing. This meeting radically changed the Chinese government view on the relevance of communist ideology and the fundamental forces of economics, setting in place the path of Chinese development. Although Mao died two years prior to the plenary meeting, his legacy and ideology still remained at the core of Chinese policy. Mao's death left Hua Guofeng in charge, known as the "chief whateverist," meaning whatever Chairman Mao said Hua would agree with and implement.

However, Hua was not a strong leader himself and the pro-reform movement used this chance to step into the limelight. This meeting replaced Hua with Deng Xiaoping, a reformer. One cannot talk about China's break from Maoism to the market economy without mentioning Deng. He was a supporter of communism and served in the army under Mao. However, Mao viewed him as too progressive and purged him twice from the Communist Party. Deng was persecuted, imprisoned and sent to labor camps on two separate occasions. But he persevered; partially shielded by the relations he had forged in the army, Deng was "rehabilitated" back into politics and returned to lead China to the market economy.

Social unrest escalated leading up to the 1978 plenum. Maoist policies had led to an inefficient economic system, with the main emphasis on following communist ideologies, especially the great class struggle, with little regard toward the fundamentals of economics. Although China was unified under the great Maoist philosophy, the country was extremely poor. There were calls for change. Although the Gang of Four, a radical communist group led by Mao's widow, continued to carry out Cultural Revolution principles, they were arrested in 1976, after which support for Maoism waned.

When Deng came to power, the country was in a paralyzed state as Maoist ideology was driving the economy. Deng liked the Communist Party political control, but wanted to see the country grow. Above all, he was a nationalist and a pragmatist. He supported any initiative that allowed China to become wealthier as long as the CPC's control of the government was not threatened. In a speech in support of more market liberalization Deng said, "It doesn't matter whether a cat is white or black so long as it catches mice." This pragmatic approach was in sharp contrast with Mao's ideological fanaticism and set in motion the economics above politics approach.

### **Socialism Does Not Mean Shared Poverty**

Deng's view was that socialism could be married to market economy. China was to remain socialist, but could still take advantage of the benefits of a market economy. As Deng put it, "I have two choices: I can distribute poverty or I can distribute wealth." Deng chose to distribute wealth. In the years following the meeting, many reforms were introduced, starting with the agricultural land contracting system. The "four modernizations" were considered the party's main focus, which were

modernization of industry, agriculture, national defense and science/technology.

The third plenary session opened the door to change, but the change was gradual. The session did not expose a grand plan of market economy, in fact it did not introduce any immediate reforms, but rather it was a shift in political paradigm that allowed change to happen in the following years. The reality is that the third plenum was an ideological turning point but did not spell out concrete actions. Most of the reforms were implemented over many years, partially due to the slow process of Chinese politics.

The party's new slogan was, "to make China a new, powerful socialist country before the end of this century." In this, the Communist Party has succeeded. In 1978, China was desperately poor, with per capita income at \$200. Today it stands at \$6,000. This political ideology change allowed China to double its per capita income between 1978 and 1987 and double again between 1987 and 1996. To put it into perspective, it took the U.S. fifty years to double its per capita income and Britain sixty years.

Deng integrated capitalist-minded participants in the political process. Under Mao, anyone who was deemed to have a connection to the former landlord class was not only prohibited from joining the party, but also had general employment limitations set on them. Removal of these limitations allowed reform-minded participants to help shape China.

Additionally, power was split up between the premier and the party chief to avoid a Mao-like personality cult. The party was responsible for developing policy, while the state implemented it.

### **Agricultural Reform**

Under Mao's Great Leap Forward, rural dwellers were the primary supporters of ideology. Private farms were banned and communal farms established. However, the changes were made with very little regard to the fundamental economic forces and production was instead set by a government five-year plan. The policies were ill-designed and, as a result, tens of millions of people died of starvation as agriculture, manufacturing and trade were all disrupted.

Initial reform was aimed at agriculture. The Great Leap Forward had been a disaster for the countryside and production output was about on par with medieval times. As chance would have it, part of China had a severe drought the same year as the plenum happened. The drought led to mass starvation as the earth was so hard that even tractors could not break it. The only way to plant the crops was through hard manual labor, but the peasants were not willing to do it just to see the collective farms take the crops and distribute them outside the region. To motivate the peasants to work the land, the household responsibility system was introduced under which the workers got to keep part of the crops they grew. The decision was driven by desperation, but the experiment proved successful and had vast positive consequences as it was soon implemented throughout China. Peasants were responsible for the land they tilled and had to deliver a certain quota to the state, but could keep anything they produced above this quota. This meant that the farmers were once again incentivized to become more productive. This started a boom in the countryside, which also increased the availability of agricultural products in cities.

Although property rights were not fully implemented, the communal farms were slowly dismantled and farmers were given

more freedom in managing their crop decisions and were also allowed to sell their products on the market. Farmers, however, did not have rights to their land and therefore could not sell it. Interestingly enough, there are still no clear-cut land property laws in the Chinese countryside.

### **Economic Reform**

Reforms on the economic front were also allowed, and in 1979, a government conference openly discussed the backward nature of manufacturing under Mao. Namely, the more productive a company was the more their quota was increased. Deng called it "whipping the fast ox." Still, the government ruled that the invisible hand of market could not be trusted and that the central committee would make production decisions to achieve the general well-being of society. Chinese leaders wanted to allow economic change, but not so much that it could lead to calls of more political freedoms. A strong party was seen as the most important factor in achieving this balance.

Reforms and progress were slow but steady. In 1984, Deng reassured his government colleagues that they should not be afraid of capitalism and that Western style capitalism would not take over China "like a weed," instead it would be "capitalism with Chinese characteristics." This meant that companies were allowed to keep part of their profits, which came to be known as the "contract responsibility system." Still, these state-owned enterprises (SOEs) remained inefficient in the absence of property rights. Other former communist countries have solved this problem through privatization, but current Chinese leaders have indicated that privatization is off the table.

The new system also gave more power to the local governments, especially in

choosing what to manufacture. Most municipalities chose light manufacturing, as it had low initial capital requirements and involved low skilled labor. When the country moved to heavy industry, however, the capital investment needed became greater and consequently was mostly financed through the banking system, ultimately from household deposits. Deng's reforms forbade the reallocation of profits other than through the central banking system. This constrained banking system allowed the government to invest bank deposits in whatever it wanted to, basically without incurring an interest cost. Thus began the dependency of the SOEs and the banking system. China boosted its trade reach and attracted foreign funds for investment to the Special Economic Zones, where market liberalization was encouraged and foreign investment welcomed. This was in sharp contrast to Mao's self-reliance decades of seclusion, which kept China inward looking.

It wasn't until the 1980s that China decided to follow the path of export-driven growth, after seeing several other countries, especially Japan, rise to prominence following the model. China quickly built industries geared toward exports. Large investments for developing the provincial coastal regions into export hubs would solve several problems. It would provide jobs for the workers leaving the agricultural sector and also provide the country with hard currency through international trade. Still, this was limited to a number of Special Economic Zones, the first of which were set up in 1980.

### **Conclusion**

Promises of another great turning point are quite significant and will likely fall short of expectations, at least in the short term. Although history looks back to 1978 as the

great turning point, no reforms were actually introduced or implemented at the plenum. No grand plan was laid out at the meeting and only general directives were given. The change in ideology allowed for change to happen in the years following, but it took China years to implement these reforms. The slow pace of reforms was partially due to the way Chinese politics work. The CPC standing committee becomes more powerful the longer it is in power as the leaders are able to strategically place their own comrades within the government. Additionally, reforms often attempt to purge people in powerful positions, so change has to be gradual enough not to cause an outwardly visible political conflict.

Thus, announcements of detailed reform strategies are not likely imminent. Instead, the CPC's inclination for economic reform will be indicated by the discussion of the following two topics. All comments are likely to be very general in nature.

1. Financial deregulation could possibly end the financial repression of household savings. This could force the SOEs to borrow at market-determined interest rates and compete for allocation of funds with their private counterparts. It would also boost household spending as deposit rates would exceed inflation.
2. Rural land reform could put rural residents on a more equal footing with city dwellers. The arduous Hukou system of household residency registration is especially hard for newly relocated urban workers. Additionally, clearly defined land property laws would increase farmers' social mobility. The current vague property laws make selling land nearly impossible.

The CPC is not interested in giving up political power. The two changes mentioned above would have an adverse effect on the currently powerful people, the people who have been benefiting from the current policy regime, and therefore General Secretary Xi is likely to keep the pace of

reform slow and the description of the government strategies vague.

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