THE OUTLOOK

China's One-Two Punch Threatens to Hit Economic Growth

Anticorruption Drive Could Disrupt Plans for Wider Overhauls

ByBOB DAVIS

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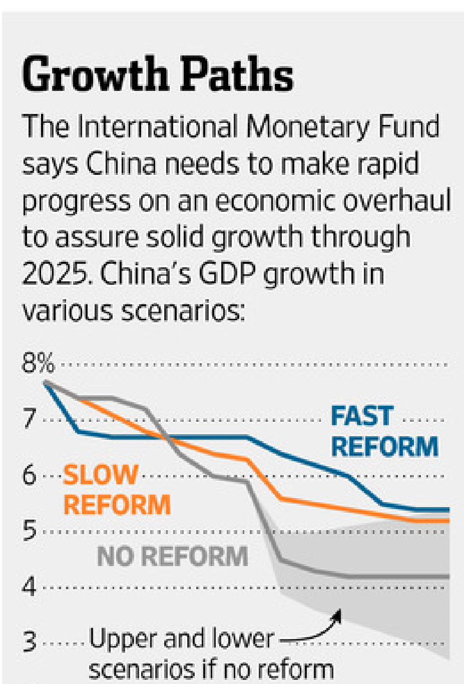
The strength of China's long-term economic growth depends on whether it can accomplish two feats at the same time: purging corrupt officials while taking sweeping steps to restructure the economy.

The risk? That the purge blunts the overhaul and the economy falters over time.

A downturn in China would be a blow to the global economy, which counts on the Asian giant to suck in imports and provide opportunities for investment. That's why the U.S., Europe and others in Asia are watching events in China so closely.

China's anticorruption drive began in late 2012 as a way to cleanse the ruling Communist Party and convince ordinary Chinese that the system isn't rigged against them. Investigators are targeting some of China's most powerful officials and disciplining tens of thousands of lower-echelon officials who party investigators contend got used to padding their salaries.

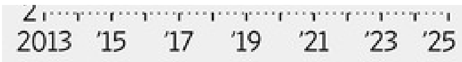


The worry now is that the headline-grabbing campaign could disrupt plans, which were launched in the same year, to open the financial sector, reduce the role of bureaucrats, give rural residents more rights and limit the power of big state-owned firms, among other changes.

A slowing of the economic overhaul would weaken growth prospects during the next decade, rather than strengthening them as Communist Party chief Xi Jinping intends.

One big problem: Mr. Xi must rely on bureaucrats across the country to enact the economic shifts, many of whom are being targeted in the corruption probe and fear what's coming next.

"Since publicly opposing reform is risky, officials will choose to drag their feet," says Minxin Pei, a China specialist at Claremont McKenna College in California. He likens it to



Source: International Monetary Fund
The Wall Street Journal

pilots following air-traffic rules to the letterand slowing the system to a crawl.

Chinese officials describe the anticorruption push and economic overhaul as a one-two punch.

First, frighten execs at state-owned firms and the bureaucrats who protect them. Then sock them with economic changes to clip their power. They will be too afraid to resist.

"If you don't get rid of privileged groups, economic reform can't be carried out," says Huang Jing, a political analyst at the National University of Singapore.

The first punch is landing hard. At least 50 executives at China's big state-owned companies have been fired under the campaign and are being investigated for corruption, according to China's top anticorruption agency.

There is little evidence, though, that the purge is accelerating the economic overhaul; in fact, just the opposite. Chinese Premier Li Keqiang named a laundry list of changes that were moving ahead during a recent speech in Tianjin, including reducing the red tape required to launch a new business.

But economists in China say many significant measures are frozen. In July 2013, the U.S. and China agreed to negotiate a new kind of investment treaty to permit foreign investment without any approval from Beijing, except for sectors that China ruled out of bounds—a so-called negative list. But China and the U.S. aren't scheduled to even start talking about the specifics of the negative list until next year.

In other cases, the process has gone backward. China pledged to reduce excess capacity in the steel industry by letting unprofitable firms go belly up. But during the past two years, China's steel-producing capacity has grown by 200 million tons—more than twice what all the mills in the U.S. produce in a year.

Already the economy is flagging because of a real-estate-market downturn. The anticorruption campaign will subtract another 0.6 to 1.5 percentage points from gross-domestic-product growth this year because of reduced investment and luxury-goods sales, Bank of America estimates.

Cornell University economist Eswar Prasad, a former senior official in the International Monetary Fund's China division, says that if GDP growth falls below 7%, from the current pace of 7.5%, support for the economic overhaul would start to evaporate as officials worry about rising unemployment.

The easiest way for China to boost growth, economists say, would be to return to its old playbook by boosting investment in capital-intensive industries, even if they are plagued by overcapacity, and ordering state banks to start lending more.

China's leaders are trying to finesse the problem by directing stimulus to where they deem it most necessary, Mr. Prasad says, the opposite of giving markets a bigger role. "They seem to view this approach as the lesser of two evils," he says.

It is hard to know when China will make a more sweeping economic overhaul its top priority. The official running the anticorruption drive says it is a three-stage process, and so far, the campaign is in its first stage.

"Currently the [leadership's] objective is on politics and governance," says Tsinghua University economist Li Daokui, a former adviser to the Chinese central bank. "Economic reform, to some extent, isn't in first gear."

That's a growing problem, warns the IMF. The longer China waits to push bigger economic-policy changes, the bigger the long-term cost in growth.

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