

A Non-Technical Summary of “China’s Political Business Cycle”

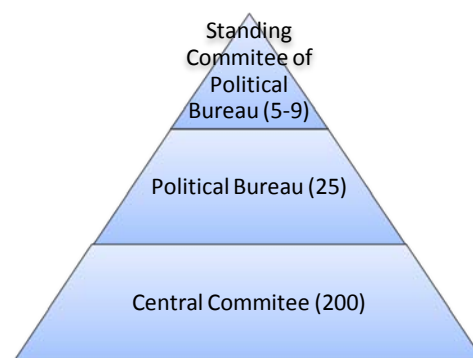
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China has been very important for the current global economic recovery and macroeconomic events in China are likely to play an even larger role in the future. Despite this and the fact that China's institutions are different from those of a Western democracy, there is little empirical and theoretical work of the determinants of Chinese business cycles. This paper primarily aims at partly filling this gap. Moreover, by studying the mechanism of the business cycle, I clearly define the China Model of governance and growth.

I begin by presenting several facts that motivate the study.

First, the replacement of political leaders at all levels has become a regular feature of the political system after the death of Mao Zedong in 1976. Starting in 1977, there is a Central Communist Party Congress every five years at which the Central Committee Members are changed regularly. The Congress is held either in later autumn or early winter in the Congress year. The hierarchy of the Party at the central level is shown in Figure 1. There are around 200 members in the Central Committee, above which is the Political Bureau of the Central Committee, consisting of around 25 Central Committee Members. Above the Political Bureau, there is a Standing Committee of the Political Bureau, consisting of 5-9 Political Bureau Members. Keep in mind that the top Chinese provincial leader is called Provincial Party Secretary and most Provincial Party Secretaries from the thirty-one provinces of mainland China are Central Committee Members. The Secretaries from a small number (less than five) of politically or economically influential provinces, e.g. Beijing and Shanghai, are Political Bureau Members, but are outside the Standing Committee.

Figure 1: The Hierarchy of the Party



Second, the growth of gross capital formation corresponds well with the timing of the Central Party Congress. In Figure 2, we plot the time series of gross capital formation growth, with the vertical dashed lines indicating the Central Party Congress Years. Since China's economic growth is very capital intensive, this is a key element in the understanding of China's business cycle. The figure shows that there is strong evidence political business cycle in China---gross capital formation growth increases dramatically in the year after a Central Party Congress and drops sharply before the next. This pattern

repeats except in 1997-2000 when the Chinese economy was hit by the Asian Financial Crisis. Figure 3 plots the average growth rates around the Congress year which is denoted by $Y(0)$.

Figure 2: Political Business Cycle

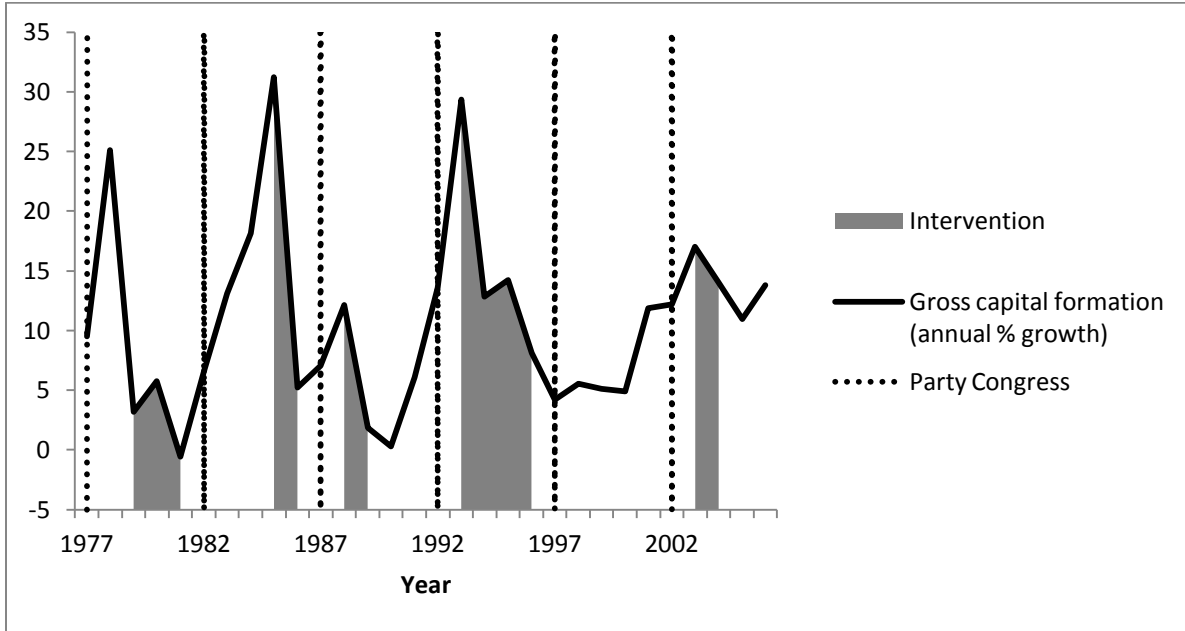
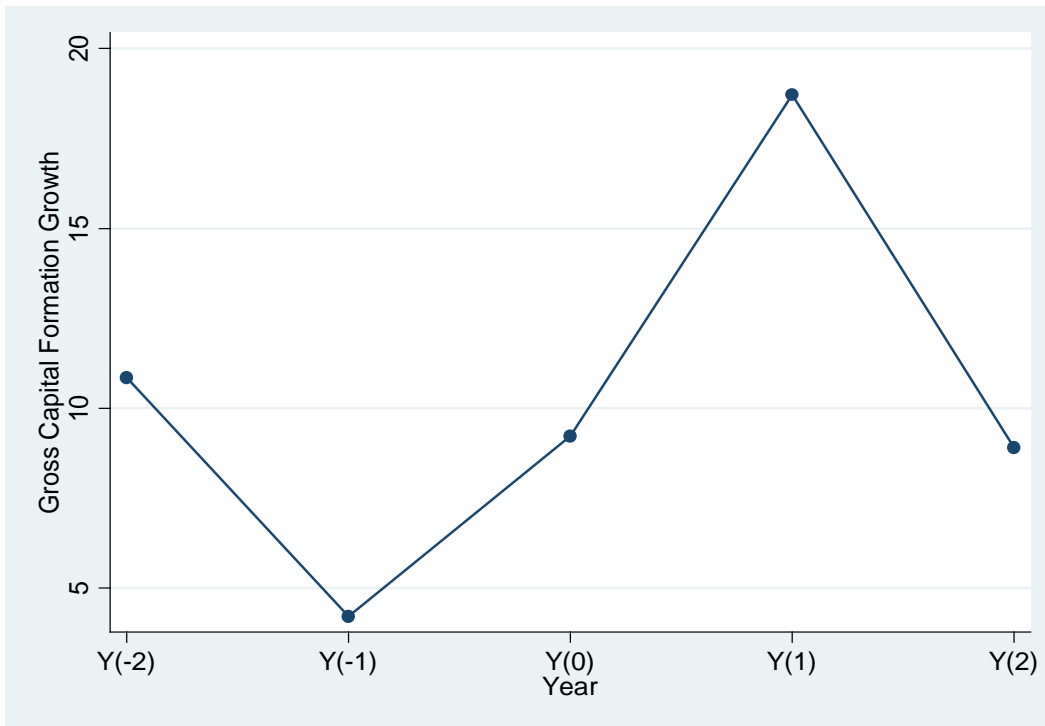


Figure 3: Average Growth around the Congress



Third, gross capital formation growth correlates well with the growth of several other variables such as net domestic credit growth, M2 growth and especially inflation.

I continue by arguing the fundamental cause of China's business cycle is to be found in two particular features of China's institutions:

- 1) Economic decentralization. During the Mao period, the Chinese economy is a central-planned economy in which the central government makes all the decisions. In the post-Mao reform era, the central government has decentralized the economic power and delegated it to the provincial governments¹.
- 2) Political centralization. The Provincial Party Secretaries, who are the Communist Party Central Committee Members, are evaluated retrospectively based on their economic performance. Specifically, provincial leaders with a better economic growth performance during the term have a higher probability of moving up in the hierarchy, which is associated with more privilege and a better future career chance.

The institutional setup leads to a conflict of interest between the central government and the Provincial Party Secretaries. On the one hand, the evaluation standard leads the provincial leaders, upon getting power at the Central Party Congress, to stimulate economic growth in the regions under their own governance. The Provincial Party Secretaries' strong incentive to stimulate growth has inflationary consequences when it is constrained by the supply capacity of the economy. On the other hand, the central government bears the cost of inflation. When inflation becomes too high, the central government intervenes by implementing the contractive "Macro Adjustment and Control" (Hong Guan Tiao Kong) program, which involves (1) re-centralizing the authority of investment approval; (2) re-centralizing the authority of credit allocation; and (3) administrative price control. Such interventions, indicated in the shaded area in Figure 2, affect investment and credit on the aggregate level and all local economies are affected simultaneously. During the intervention, there is a dramatic decrease in the growth rate. When inflation comes down to a tolerable level, the authorities are once more decentralized to the local leaders. Therefore, there are two driving forces of the business cycle: the local leaders eager to stimulate growth and the central government's effort to cool down the economy. The nature of China's political business cycle is thus a cycle of policies in the decentralization and centralization cycle.

My theory has three main predictions about the Provincial Party Secretaries' incentive:

- 1) The incentive is positively related to the size of the rent associated with promotion.
- 2) The incentive is negatively related to the cost of stimulus.
- 3) The incentive is weakest when the number of vacant positions in the central government is zero or equal to the number of Provincial Party Secretaries and is strongest at some point in the middle.

I test the predictions of our theory with a panel of Chinese provincial level data from 1983 to 2007. The results are consistent with the three predictions. Regarding the first prediction, I show that the magnitude of the political cycle is decreasing in the age of the Provincial Party Secretary. I also show the magnitude of the cycle of lame ducks, the Provincial Party Secretaries without promotion chance due to the rule on

¹ There are thirty-one provinces in Mainland China. Three regions of China are outside the mainland. They are the Province of Taiwan, the Hongkong SAR and the Macau SAR.

mandatory retirement age, is significantly smaller than that of the leaders with chances for promotion. Regarding the second prediction, I show that the magnitude of the political cycle is positively related to the size of the state-owned sector, which the local leaders can control in a relatively easier way. Regarding the third prediction, I show there to be an inverted-U shaped relationship between the magnitude of the political cycle and the number of vacant positions at the Political Bureau.

My theory is related to the opportunistic political business cycle literature. This strand of literature argues that in a Western democracy, the incumbent politician would stimulate the economy before the election to appear more competent to get re-elected and fight with inflation after the election by tight policies. As I just showed, in China, the local politicians stimulate the economy right after the “election”, note before! The difference to the timing of the democratic political business cycle is due to the Chinese Central government’s inability to commit not to intervene. In plain words, if Provincial Party Secretary A does not stimulate the local economy right after the Congress while all the other Provincial party Secretaries do so, then when the economy becomes overheated and the central government re-centralizes the power, A will have no chance to stimulate and end up with a poor economic performance.

Although the motivation in the paper is to study the mechanism of China's growth fluctuation, I have implicitly explored, at least from the political economist's perspective, the nature of the China Model, which can be summarized as follows:

- 1) Government directed economic growth.
- 2) Decentralization of economic power to the local government.
- 3) Political centralization of local leaders' evaluation and promotion.
- 4) Central government intervention when necessary

Many rules in China have changed since 1976. But the above four points key characteristics never changed and are very unlikely to change in the near future. They can be regarded as China's institutions after 1976. Among the four points, 3 and 4 are essential for the speed and sustainability of growth in the short run, both involving a high degree of centralization. The political cycle is thus likely to be repeated in the future unless there is institutional change.

Year 2012 is a Congress Year. Good luck with China and everyone in 2013!