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Grand Steerage as the New Paradigm for State-Economy Relations

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By the time Xi Jinping assumed power in 2012, it was evident that the Chinese economic system was developing in new and unprecedented directions. One sign of change was that industrial policy objectives, originally modest, were bundled into the much grander "Innovation-driven Development Strategy", first mentioned at the 18th Party Congress in that year.

In 2017, I proposed "Grand Steerage" as a label to describe the Chinese government's use of massive resources to drive a market-based economy towards a visionary outcome (Naughton 2020). The term incorporates two fundamental features of China's contemporary economy. First, increasingly ambitious Chinese leaders have embraced a model in which government shapes China's development trajectory towards hi-tech manufacturing and the incorporation of information technology into every aspect of the Chinese economy and society. Second, in order to steer the economy, Chinese leaders predominantly use indirect, market-conforming instruments such as investment funds, subsidies and tax breaks to achieve their ambitious goals.

"Planning" is not the right word for this, since it suggests outdated instruments and a focus on short-run coordination, while China's economy is now predominantly market-based, and thus fundamentally different from the old "planned" economy in its institutions and information flows. "Steerage", on the other hand, unmodified, fails to capture the magnitude of planners' ambition. The provisional term "grand steerage" thus captures key features of the Chinese economy and politics, the salience of which has only increased over the last five years.

Chinese leaders have steadily intensified their drive to shape the economy, in part under the pressure of increased tension with the U.S. Most recently, though, Xi Jinping has pushed the idea of steerage to its limits, throwing off some of the constraints that policymakers had previously accepted as necessary to preserve the dynamism and gains of the market economy. In the process, Xi has imposed significant costs on the economy. This has already invited policy push-back, and while Xi has created new uncertainties about China's policy direction, he may also have inadvertently revealed some of the internal logic of the grand steerage model. Despite the new uncertainties, I will argue that the most likely outcome is some form of backtracking that leads to a reassertion of the grand steerage model.

Where Did "Grand Steerage" Come From?

Grand steerage emerged at the end of the 2000s, in the wake of the Global Financial Crisis, as Chinese planners doubled down on previously tentative industrial policies. The steadily increasing priority given to policies like "Strategic Emerging Industries" and "Made in China 2025" naturally derived from the bottom-to-top priority given to economic growth in the Chinese system since the 1980s. But with annual Chinese GDP growth falling below 10 per cent in 2011, Chinese policymakers had a choice essentially between two options: rebalancing or increasing government intervention.

Rebalancing would have aimed to increase the share of consumption and domestic demand in the economy, allowing growth to slow but leading to more diverse and higher quality output. Instead, Chinese policymakers chose to reduce the rate of growth of consumer demand and keep the investment rate high (above 40 per cent of GDP ever since 2009) and step up government intervention, driving investment into infrastructure, housing and high-tech industry. Although the subsequent GDP growth slow-down was irreversible—given the exhaustion of one-time structural growth factors—policymakers were propping up growth as much as they could.

The government used this massive, sustained and unprecedented investment effort to steer the economy in the direction of their vision, and effectively abandoned the idea that China's middle-income economy would be shaped primarily by consumers' wishes.

Chinese policymakers were already firmly on this path when the U.S.–China "trade war" began in 2018. Increased threat perceptions, especially the potential for technology embargoes and sanctions, strongly increased the perceived need for a high degree of technological—and even economic—self-reliance. In 2020, Chinese policymakers floated a programme of "dual circulation" (explained in more detail in the chapter by Sarah Tong in this volume), which essentially declared that Chinese policymakers would pro-actively manage an expected decline in export demand by selective supply-side policies that would reduce import dependence. The strategy also provides a means to reduce the dependence on foreign technology and rely more on "indigenous innovation". The accompanying extension of the concept of "economic security" to cover full supply chains has meant that government techno-industrial policies are now reaching into previously untouched corners of the economy.

The impetus behind grand steerage is thus in a broad sense a continuation of China's traditional growth orientation, but with an even greater emphasis on national security considerations, causing important tensions and trade-offs. Chinese leaders are diverting substantial resources into defence preparedness, civil-military fusion and priority implementation of social control systems based on surveillance and artificial intelligence (see also the chapters by Joel Whutnow, John Lee and Tai Ming Cheung in this volume).

Over-investment in infrastructure and in immature technologies is a feature of the model, leading to significantly lower returns on investments. Over a longer term these investments will still contribute something to growth, and smarter cities and intelligent factories will contribute to future productivity. Yet, from a purely economic standpoint, a more effective growth strategy would include liberalising and developing labour-intensive services and increasing the range of employment opportunities. This would increase the output of hundreds of millions of less-educated workers, under-employed and stuck in the informal sector, who are neglected under the current policy settings.

From a growth perspective, China is overdoing its high-tech push. However, there is no inherent contradiction between the economic and the technological goals: it is easy to imagine a superior policy mix that would consist of further liberalisation and a more even-handed and supportive policy for labour-intensive sectors, but still include affirmative policies for the substantial high-tech investment that would doubtlessly come from China's entrepreneurs and engineers. Yet the enormous strategic ambition of Chinese leaders has made it clear that national security and national greatness are the ultimate objective, and technological primacy trumps simple economic growth as the essential contributor to this goal.

Instruments and Policy Restraint

The instruments that characterise grand steerage have always implied a degree of restraint by policymakers, especially top leaders. Acknowledging the indispensable role of a well-functioning market in maintaining efficiency, China's leaders have effectively committed themselves to mainly using market-compatible instruments. Policymakers do not simply issue commands, as they did in the old system. Instead, grand steerage is implemented primarily through instruments that guide resources through the market economy.

The most distinctive instruments are "Government Guidance Funds" (GGFs). The purpose of these funds is to expand government influence by channelling resources into favoured sectors, yet the institutional setup of such funds is intentionally patterned on that of venture capital funds. There is a managing partner (usually a government or financial agency), which is responsible for specific investments and day-to-day operations, while limited partners provide funds and meet periodically to approve the funds' strategic orientation. This division of labour fosters professionalisation and enables high-powered incentives that reward successful investments. GGFs proliferated rapidly from 2014, and by mid-year 2020 had reached a total authorised funding scale of RMB 11.27 trillion, which equalled no less than 11 per cent of China's GDP that year (about USD 1.6 trillion).

Government industrial guidance funds are one of the largest funding instruments, but other instruments taken together are even larger. A pioneering attempt to estimate the aggregate size of annual industrial policy support in China, using conservative assumptions and methodologies, yields a figure of 1.73 per cent of GDP in 2019, far higher than any other country (DiPippo, Mazzocco and Kennedy 2022). Tax breaks and rebates for depreciation and R&D are significant. Policymakers have learned that they can exploit the stock market to raise money, laying out investment themes that will attract funds looking to bandwagon on state priorities. All of these are dwarfed by the flood of credit that comes from state-owned banks, guided by the general priorities and favoured projects of the leadership. Notionally, we can think of a gigantic development budget that flows through multiple channels without any unified accounting or perhaps even a clear knowledge of just how big the aggregate flows are.

This is hardly a seamless operation: as befits a "grand" policy project, it forswears tight coordination and sometimes spurns small-scale efforts. Policymakers are well aware that future technological paths are uncertain and they have been careful to lay out their visions in broad terms, such as "contending for global innovation leadership by 2050".

China's technology thinkers frequently cite the Silicon Valley maxim that a venture capitalist will invest in ten start-ups, knowing that nine will fail, but that the one successful game-changing start-up will pay for those nine. Planners accept that they will have an even lower success rate than the savviest Silicon Valley venture capitalist, but they will do well enough, and besides the government has plenty of money.

Similarly, Chinese industrial policy has seemed entirely comfortable getting behind successful private companies *after* they had proven the success of their business concepts in market competition. Many new sectors were regulated lightly—or not at all—in their early stages, allowing maximum scope for entrepreneurship. Only later, as winners emerged, were those firms retrospectively anointed "national champions", and brought under somewhat tighter political scrutiny. This pattern seemed to fit very well such firms as Huawei, the electronics hardware giant; Alibaba, the internet platform; and Didi the ride-hailing monopoly.

The Disruptions of 2021

These patterns were profoundly disrupted by the policy initiatives of Xi Jinping in the summer of 2021. It is not that the drive and impetus behind Grand Steerage had faded—quite the contrary, the high-tech securitisation of everything continued unabated. But Xi Jinping abruptly discarded much of the restraint that had marked Grand Steerage up until that point. High-tech growth and technological self-sufficiency were maintained as priority objectives, but a host of new objectives was introduced that had little to do with growing national power or technological self-reliance. Objectives that, for a period, achieved rhetorical parity included: common prosperity; an easier life for families and stabilisation of the plummeting birth rate; data privacy for Chinese individuals combined with data security for the nation; heightened control of unhealthy internet activities; and carbon neutrality. These may all be worthy objectives, but they are challenging to implement and, more crucially, to balance one against the other. Under "Grand Steerage" the overall principle was fundamentally simple: if investments contributed to China's technological strengthening and development, they should be supported to the maximum possible. Abruptly, in the summer of 2021, it seemed that this was not enough. Rather, Xi Jinping was apparently assembling a broader and more populist programme to bring to the Twentieth Party Congress, in order to insure his coronation for an unprecedented third term as General Secretary. Additionally, it cannot have escaped Xi's notice that many of these measures had the side-effect of tightening political and ideological control.

The sudden proliferation of priority objectives in mid-2021 was not accompanied by consideration of appropriate policy instruments. This was most obvious with respect to "Common Prosperity" (see the chapter by Bert Hofman in this volume). All over the world, the first and most effective means to reduce income inequality is to make taxes, and especially income taxes, systematically progressive: yet China introduced a common prosperity programme in 2021 without proposing serious tax reforms.

Instead, China threw together some ad hoc measures, such as insisting that profitable corporations, including previous "national champions" like Alibaba, make generous "voluntary" contributions to a range of charities, many of which were non-profits with close links to government agencies. These actions provoked a serious crisis of confidence within China's private business class: Why was China picking fights with its own most successful high-technology firms, which had so recently been national champions? China's leaders shattered the simple coherence of the visionary outcomes that had animated grand steerage previously and at the same time discarded the restraint embodied in the choice of instruments and the inclusiveness of the programme. Does this mean that "Grand Steerage" is over?

The Future of Grand Steerage

In fact, in the course of the first half of 2022, the Chinese economy went through substantial economic turbulence, much of it related, directly or indirectly, to the abrupt summer 2021 policy shifts mentioned above. Capital has again been flowing out of China; the RMB has depreciated; and youth unemployment has spiked to an unprecedent 18 per cent in cities. To be sure, these effects are partly due to the damaging "zero COVID policy" lockdowns in Shanghai and other cities. But they are also partly down to the increased intervention by top officials and crisis of confidence among business leaders.

Chinese policymakers have noticed. From mid-March 2022 through the end of May (when this was written), policymakers, including key economic adviser Liu He and Premier Li Keqiang, have been trying to walk back the most damaging initiatives from the summer of 2021. They have promised a new regime of stable and predictable regulatory policy ("with green lights as well as red lights"); greater financial support to the housing sector, stock market and macroeconomy; and renewed support for overseas listing of Chinese companies. So far, though, these promises have not been credible enough to restore confidence in the orientation and capability of policymakers, badly shaken by recent events.

In fact, these episodes may have inadvertently demonstrated the internal coherence and logic of grand steerage. The grand steerage model worked reasonably effectively in China because the commitment to market-based instruments limited both the costs for the government and the damage the initiative could do to the economy. To be sure, the overall cost of the full "development budget" is still huge. This is not surprising, since China has an enormous economy with a powerful government able to mobilise vast resources to achieve priority objectives. But the commitment to market instruments kept the *excess* costs to a minimum and prevented planners from driving the economy into bottomless pits of failed investments. The system is far from fully transparent, but there is a surprising amount of economic information available, at least to insiders, financial institutions and policymakers. Companies and projects in China go bankrupt when they are not able to meet their targets and funders tire of losing money. Financial accounting reveals costs and cost overruns.

In 2021, Xi Jinping showed himself willing to override the information about investments and initiatives available to policymakers, specifically by presiding over a massive destruction of stock market value. Having already demonstrated that he did not put economic growth above all other objectives, Xi Jinping displayed even greater ambitions and asserted his right to steer society in more dimensions than ever. Yet the things Xi Jinping was discarding are precisely those fundamental components that make grand steerage work: restraint in the choice of instruments to conform with market forces, and adherence to a broad vision that can be readily communicated to a very diverse set of actors.

Whatever happens at the 20th Party Congress, it is likely that policymakers will learn at least something from their mistakes and patch together a new form of Grand Steerage that will look remarkably like the old one. The market economy is the foundation of the growth China has created, and without economic growth, China has no chance of ascending to "the centre of the global stage", as Xi Jinping demands. Yet, due to missteps in policy, China's growth rate in 2022 will fall short of its growth target and probably will end up below 4 per cent, a rate not consistent with rapid catch up to the US. Eager to prevent further slowdown, policymakers are already looking to restore credibility, provide more stimulus to the economy and repair the damaged "animal spirits" of the business class. Policymakers cannot flip a switch and turn back the clock, but they are likely to grope towards a more satisfactory (and familiar) set of policies. This will require that they recover the focus and self-restraint that contributed to the general coherence of the grand steerage policy orientation in the past.

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