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SGH20 Insights

China leadership reshuffle - a "Beautiful China"

Key insights

- Ahead of the 19th China CPC Party Congress meeting there was a strong emphasis on maintaining stability.
- Now that Xi Jinping has consolidated his powerbase, the question is will he pursue a more reformist economic agenda.
- We believe the concerns of an aggressive reformist program are overplayed, and the priority is to strengthen China's Communist Party rule with a focus on political stability and order, and avoid the political pitfalls that brought down the Soviet Union, even if this means growth slows (as we expect).
- Consistent with the change in the party propaganda headlines from the "China Dream" to "Beautiful China" this is likely to see more of an emphasis on the quality of growth and not just the quantity. It is also more likely to see China maintain strong control over State-Owned Enterprises and, supply side reforms continuing to be selective and targeted at industry consolidation, deleveraging, anti-corruption and pollution measures.
- China's large debt build up continues to be the biggest risk to the economy. Since 2016 a number of reforms have been introduced aimed at restructuring the banking sector and curbing excesses. Important to this has been the authority's ability to control its currency and stabilise the capital account over the last year. This remains critical to the ongoing financial restructuring of the economy.
- From a portfolio positioning perspective we maintain a constructive view on Chinese growth, particularly on the "New China" theme around the emerging consumer, and on rebalancing the economy away from investment. In the near term, we see a cyclical slowdown with ongoing property tightening and, the winter crackdown on polluting industries likely to weigh on bulk commodity prices.

The Chinese Communist Party leadership reshuffle is an important political process in China, spanning three key events over six months, being:

1. **The Party Congress meeting** held in October (over the last week). This is more about politics than economics, with the focus on the re-election of the party leadership and make-up of the all important and powerful seven member Politburo Standing Committee.
2. **The Central Economic Working Conference** in December is where Party leaders discuss economic policies for the next year and, the key issue of the GDP growth target is set.
3. **The National People's Congress** in March 2018; which focuses on the appointment of the key Central Government cabinet and ministry officials and, outlines the Government's working plan for 2018 including details on its economic policies.

The Party Congress meeting has confirmed the party leadership, and ended with 'Xi Jinping thought' added to the CPC constitution enshrining his name and ideology in the party constitution and, confirming his power is now almost unassailable. This could potentially see him hold leadership well beyond this current term.

Xi Jinping during his party speech:

- Refrained from providing a quantified growth target (unlike his predecessor), whilst conceding it is 'quality' that matters, presumably referencing the cutting of excess capacity and cleaning-up of pollution.
- Reasserted that the anti-corruption and anti-graft drive was not finished.
- Acknowledged the need to strengthen financial regulation and defend against systemic risk.
- Commented that 'Housing is for living in, not speculation'.
- Outlined eight areas prioritised for reform including deepening of supply-side structural reforms.

Away from the main stage China's environment minister made it clear that the recent seasonal phenomenon around capacity shutdowns during Chinese Winter will remain a policy, and continue into 1Q18. *"This campaign started in September and will last until March next year but it will not be a one-off. We will continue it in the following years as a long-term project. This campaign is not just a temporary measure."*

Now that Xi Jinping has consolidated his powerbase and ensconced his leadership position, and name in the party constitution, the question is will he pursue a more reformist economic agenda? A populist view is he will.

Whilst time will tell, our observation is the overriding goal is to strengthen China Communist Party rule with a focus on political stability and order, to avoid the political pitfalls that brought down the Soviet Union. Consistent with the change in the party propaganda headlines from the "China Dream" to "Beautiful China" this is likely to see anti-corruption and pollution measures remain high priorities. It is also more likely to see China maintain strong control over State-Owned Enterprises and continue to promote policy and investment in green technology (including batteries and Solar PV) and robotics and artificial intelligence.

The risk is that with a more consolidated power base it increases the prospects of structural reforms. The potential result could be more sustainable, but slower, economic growth and greater focus on financial discipline (which is our working assumption).

It is important to recognise this would be consistent with the Party's official growth target, set at the 18th Party Congress in 2012, of doubling the nation's real GDP growth between 2010 and 2020. For the six years to 2016, real GDP has annualised 7.2%. This means it only needs to grow 6.4% p.a between 2017 and 2020 to meet the target.

Even more relevant to maintaining social stability, the Government is also well on the way to meeting its other key target: to double disposable income between 2010 and 2020 for both urban and rural consumers. Urban and rural disposable income per capita has increased by an annualised 7.3% and 9% respectively over the past six years. This means both have only to grow 7.0% and 4.5% between 2017 and 2020 to meet the target.

An aggressive and persistent reform agenda runs the risk of potentially eroding confidence and compounding social pain and stability.

If reform is targeted and selective, as has been the case with recent supply-side measures, then the broader health of the economy and social stability is more likely to be maintained. We expect supply-side reforms to focus on industry consolidation, deleveraging and the creation of national champions. As we have seen with recent capacity cuts in coal and steel, this may not necessarily be negative for commodity prices (and resource stocks).

China's large debt build up continues to be arguably the biggest risk to the economy. In absolute size it is the largest debt build up ever (from 154% of debt-to-GDP in 2008 to over 260% today). Since 2016 a number of reforms have been introduced aimed at restructuring the banking sector and curbing excesses. The fact that debt is mostly domestic (as opposed to foreign borrowings) means that the Chinese Government has fairly good, though by no means guaranteed, control over the pace and progress of addressing the debt overhang. The bigger risk is the distribution and concentration risk, and ultimately losses, within the Chinese banking system. It is also important to recognise that the authority's' ability to gain control of its currency and stabilise its capital account over the last year has been critical in undertaking the restructuring initiatives to date. This remains critical to the financial restructuring of the economy.

In summary, we think the concerns of an aggressive reformist agenda now that Xi Jinping has consolidated power are overplayed. A more important consideration is the party's priority of cementing their power, coupled with the long term stability of the economy, even if this means growth slows (as we expect). The Economic Work Conference in mid-December and National Peoples Congress in March will be important to watch to see how this plays out as well as providing broader details around China's policy for the years ahead.

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