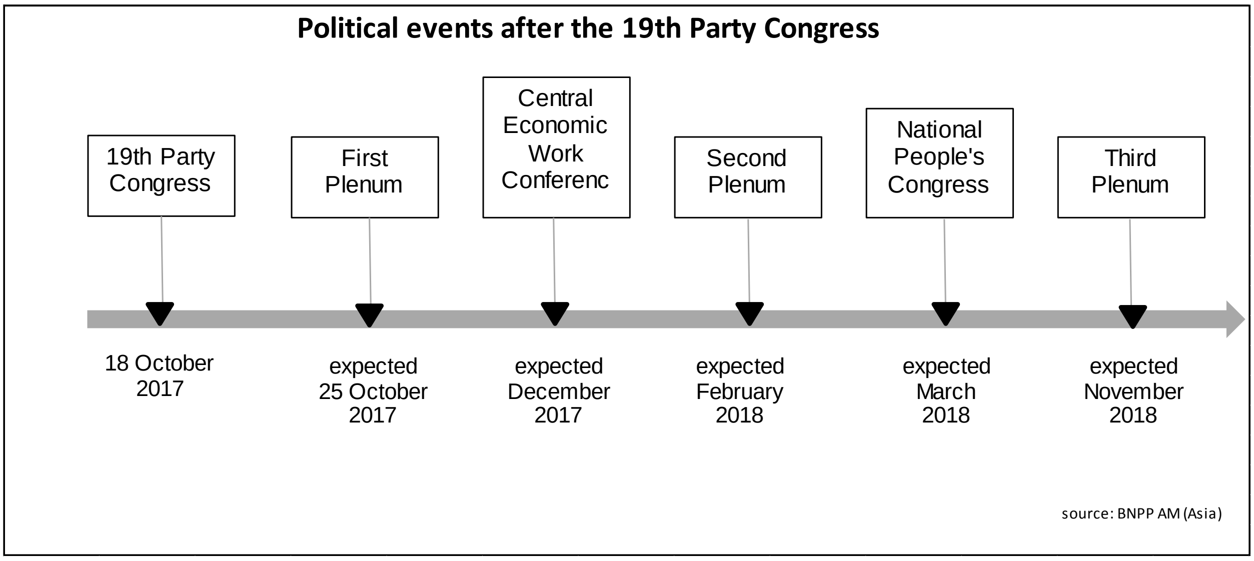
LIFE AFTER CHINA'S 19TH PARTY CONGRESS

Life is not a problem to be solved, but a reality to be experienced.

Soren Kierkegaard

The 19th Chinese Communist Party Congress (which started yesterday) is all about ratifying the government's personnel changes, NOT policy changes. It is expected to conclude on 24th October with the election of the 350-member Central Committee, which will elect the 25-members Politburo at the First Plenum (see chart). The most important change is the members of the new Standing Committee of the Politburo, who will be elected by the Politburo also at the First Plenum.



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According to the Party's conventional practice, details of economic reforms and policies will be announced at the Third Plenum of each five-year Party Congress (see chart). Any policy changes that may come prior to the Third Plenum, such as FX reform (possible CNY-USD trading band-widening), expansion of the renminbi offshore market and increasing access by foreigners to the onshore market, will be the results of the decisions made before, not at, the Congress.

Post-Congress, one big question for investors is whether the deleveraging effort will continue and how will it affect economic rebalancing in the coming years?

Indeed, China's high debt burden is an area where reform is most urgently needed but progress has been the slowest. The rapid growing debt level is mainly due to misallocation of capital to benefit the state-owned enterprises (SOEs) at the expense of the private sector. This credit rationing has pushed the private sector to turn to shadow banking for funding which has, in turn, encouraged banks to engage in risky off-balance businesses and regulatory arbitrage to serve this demand for funds by the private sector. Meanwhile, a substantial amount of credit has been stuck with the inefficient SOEs, who have also been using new credit to rollover their old debt.

As I have argued, deleveraging efforts and structural reforms are expected to continue and even intensify in the coming years under a more reform-minded Standing Committee of the Politburo[1]. A key part of the economic rebalancing effort is likely to be increasing financial support for the new economy (which includes the service sector, high-tech manufacturing and household consumption) while deleveraging the SOEs and the heavy industries that they dominate.

I expect the focus of deleveraging to gradually shift in the coming years from local-government debt and shadow banking to SOE debt (which should then start reducing the debt-to-GDP ratio). Debt-equity swap will play an increasing role in lowering SOE debts in the process. A key solution to resolving China's debt problem should be privatisation of SOE assets alongside deep state-sector reform. But this will touch the nerves of China's political system and will need much longer time to deliver.

Another imbalance Beijing will need to address urgently after the Party Congress is China's property market, which has been torn between excess demand/tight supply in the major cities and excess inventory/weak demand in the small cities. Reallocation of capital will likely involve directing funds to shanty town redevelopment to help release suppressed upgrading demand by the millions of households in the small cites, while a tight policy bias for the major cities will remain to curb their bubbly market conditions.

One of the goals of economic rebalancing is to upgrade China's manufacturing capability and grow high value-added industries through technological innovation and automation, as summarised by the "Made in China 2025" initiative announced by Beijing in 2013 and being implemented since 2015. The boom in the new economy is seen in the rapid growth of China's e-commerce market and rising R&D expenditure by Beijing. The internet-based new economy is not just displacing parts of the old economy but also reshaping the whole economy from retail, energy supply, catering and travel to healthcare, transport, education and finance and investment.

The biggest challenge to these rebalancing efforts ties back to the reallocation of capital and deleveraging. But the implementation of more structural reforms and deeper economic rebalancing should also present investment opportunities in the emerging sectors and the new economy.

[1] See "*Chi Time: A Strategic Assessment of China's Upcoming 19th Party Congress and Its Implications*", 19 July 2017.

Do not expect big economic policy shifts post-Congress, despite my expectation of stronger reform momentum (relative to the past five years that is). This is because the board policy framework has been put in place since President Xi Jinping came to power and the policy-mix implemented has been successful in striking a balance between sustaining growth, keeping financial stability and addressing the debt burden. There is no impetus for any major change in course at least in the first year of his second term.

The following policy/reform framework is expected to continue in the medium-term:

- Continuation of a strong role by the state in directing marketisation of the economy, with limited privatisation of state-owned assets.
- Gradual reduction of excess capacity in heavy industries under the name of “supply-side reform” and continuation of the promotion of the new economy.
- Selective tightening of financial regulation and monetary policy that aim at forcing debt-reduction in certain segments in the financial sector without hurting liquidity flows to the real economy.

Another big question is how important the growth target is. It is very important, in my view. President Xi’s growth target is not narrowly defined as X% a year but as achieving the goal of doubling China’s per capita real GDP by 2020. This goal was set by the previous administration in 2010 and is taken seriously by the Communist Party as a major key performance indicator (or KPI in business language) of Mr. Xi’s ability.

Given the growth achievement between 2010 and 2016, China’s economy will have to grow by an average of 6.3% a year between 2017 and 2020 to achieve that KPI. So keeping growth above the 6% growth floor will remain the top policy priority. Any downside risk to growth undershooting 6% would likely be met by strong policy easing response.

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