



Chi Time

FOR PROFESSIONAL INVESTORS – 30 October 2017

PARTY CONGRESS OPENS A NEW ERA FOR CHINA

In politics stupidity is not a handicap

Napoleon Bonaparte

China's 19th Communist Party Congress concluded on 24 October, the new members of the Standing Committee of the Politburo (SCP) were announced on 25 October at the First Plenum. They were almost exactly the same as I expected in my July report¹, with six out of the seven members correctly predicted (Chart 1 and 2). We have now six reformers in the SCP (Chart 2), adding to my conviction in July that structural reforms, including efforts to cut debt, will progress faster and deeper.

The reform party has begun

Crucially, President Xi Jinping's "core" leader position² was affirmed by the Party Congress with his political ideology – "Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era" – being written in the Party's charter. This has put his status on par with Mao Zedong and Deng Xiaoping, the only other two leaders who enjoyed similar distinctive recognition. It also suggests that Mr. Xi had garnered enough Party support to carry out the structural reform mandate to achieve his "China Dream".

Mr. Xi indeed used the Party Congress to set the stage for extending his power in the years to come as he broke the Party's convention by not naming a successor. He does not have to remain as the President after 2022 (the constitution bars him from doing so) to retain control. He could arrange an extended tenure in his positions as the General Secretary and chairman of the army, which would allow him to exert power behind the scene. Note that Deng Xiaoping did not retire from all his positions until he was 85 years old; Jiang Zemin served as the General Secretary for 13 years and as the army chairman for 14 years.

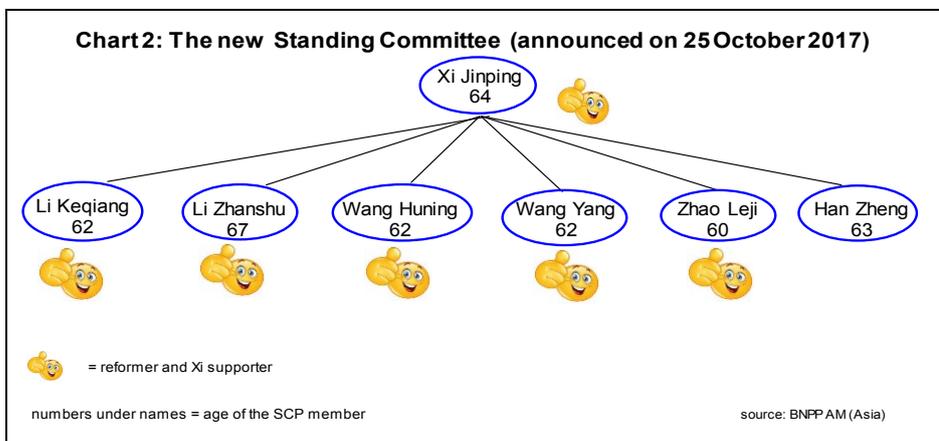
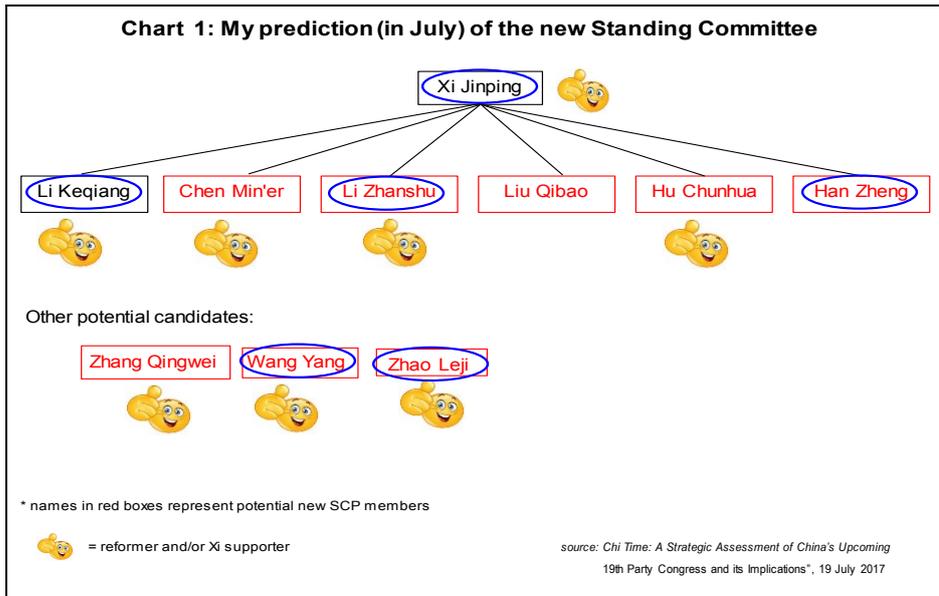
¹ See "Chi Time: A Strategic Assessment of China's Upcoming 19th Party Congress and its Implications", 19 July 2017.

² President Xi was designated as the "core leader" by the Party in October 2016.



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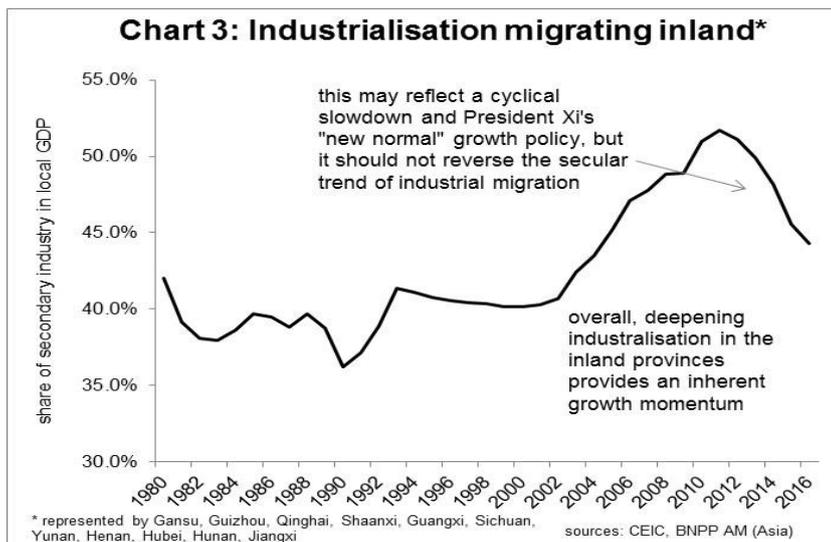


I do not agree with the view that none of the five new faces in the SCP would be young enough to serve as the next president. Mr. Xi's protégé Zhao Leji is only 60 years old. Another Xi supporter Wang Yang is 62. One of them may still be chosen as the next president even though they do not have 10 years of experience in the SCP (which is another Party convention for choosing the country's president). He has already broken some Party conventions, why not break this one also? Exactly how this will play out is uncertain. But it is clear that the Party has endorsed the reversion back to one-man rule by Mr. Xi.

Implications

More reforms and deleveraging efforts will come at the cost of slower growth. But to achieve the goal of doubling per capita real GDP by 2020 from its 2010 level, China's economy will have to grow by an average of 6.3% a year between now and 2020. Any downside risk of undershooting 6.0% growth would likely be met by strong policy easing response.

Growth targets will become less important after 2020, as Mr. Xi's "new normal" growth policy focuses on quality rather than quantity. But the trend of industrialisation migrating inland (Chart 3) to exploit untapped resources should generate momentum to keep GDP growth at around 6.0% for longer than most observers have expected.



SOE, Fiscal and financial reforms, including deleveraging, all rank high on the policy agenda. The policy details will be finalised at the Third Plenum in late 2018. Do not expect big-bang changes. The state will continue to direct marketisation of the system. There will not be much privatisation, as Mr. Xi's reform platform seeks to strengthen "state capital" and increase SOE efficiency through capacity reduction and mixed ownership programmes.

Creative destruction and debt-reduction will intensify under the new SCP. Beijing has already started allowing zombie firms to exit in a manageable way. Systemic risk is expected to remain low under these circumstances, but localised financial risk and bankruptcies at the sector and firm levels should rise.

Why no big-bang changes?

In my view, Mr. Xi's power is still not as strong as most people see it. He failed to install his protégé Chen Min'er (and another reformer Hu Chunhua) and keep Wang Qishan (his die-hard supporter) in the SCP. He kept the size of the SCP at seven instead of reducing it to five, as widely speculated. He also did not name a successor. Together with other anecdotes that are beyond our discussion here, all this might reflect Mr. Xi's inability to negotiate with the elders to get his way.

Risks

Some argued that the lack of an heir-apparent indicated Mr. Xi's strong hold of power by not ceding any of his authority. This may not be the case. In my view, this may reflect strong resistance to ushering in Chen Min'er to the SCP and naming him as Mr. Xi's successor. What happens after his second term in 2022 has not been settled in advance. This is a medium-term political risk.

There is also a key-man risk. With no successor waiting in the wings, Mr. Xi's sudden illness or death would risk systemic upheaval. Meanwhile, he has increased significantly the level of censorship. This could make it more difficult for the country to change course when necessary.

A Goldilocks state

Overall, the outcome of the personnel changes is positive for China's structural reforms, as Mr. Xi's power consolidation has increased the alignment of reform incentives between the core leadership and other officials. But he has also struck a balance by working within many Party conventions and trying to strengthen the Party system. Moving too far towards strongman rule could risk political instability. China may be entering a "Goldilocks" state in maintaining stability and moving reform forward simultaneously.

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