

Focal Point

China's Party Congress to address key challenges

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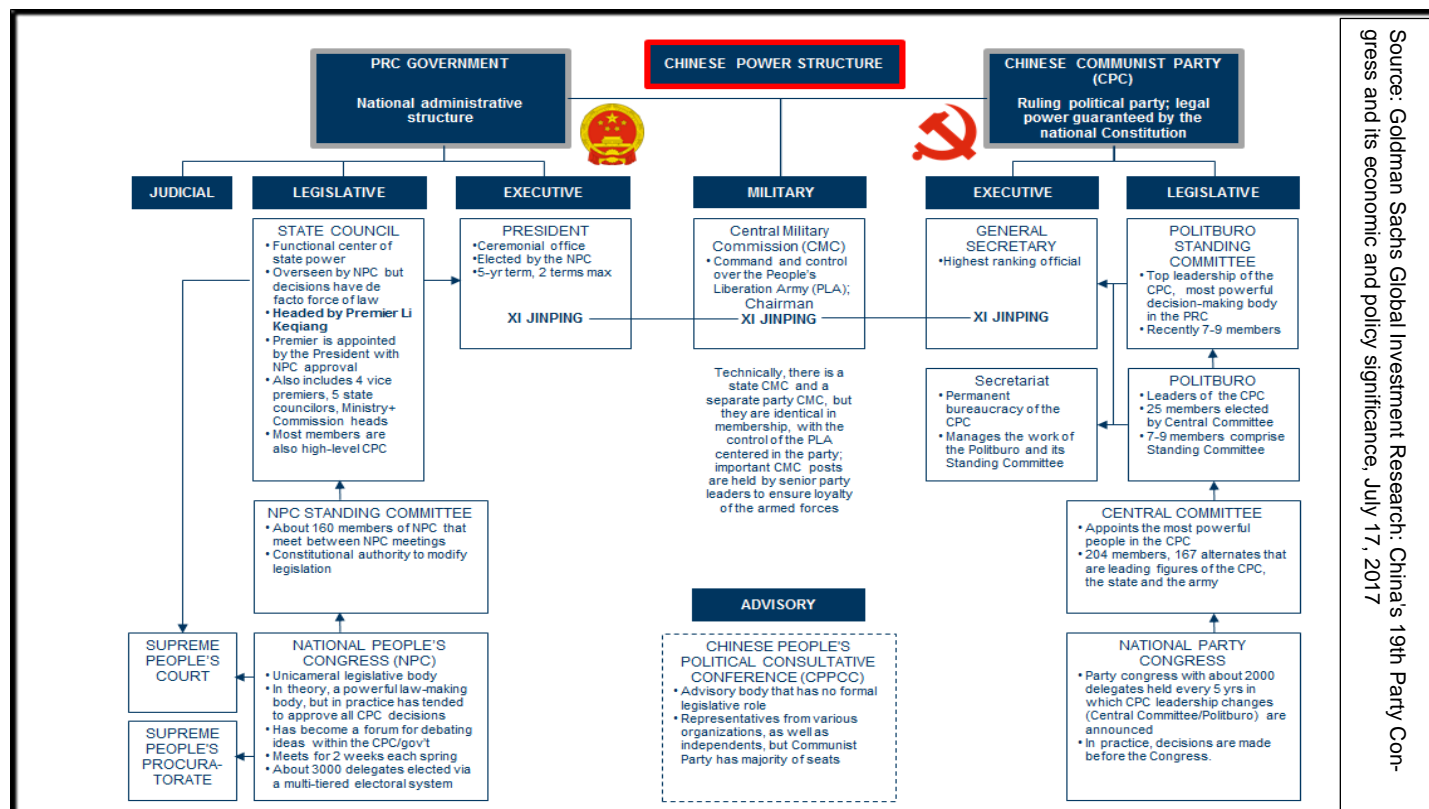
- China's most important political event this year, the 19th Communist Party Congress, will start on October 18. It will conclude with a major leadership reshuffle in the Standing Committee of the Politburo, the party's top decision-making body.
- President Xi Jinping will present the "Political Report" to the Congress, setting the policy priorities for the next five years.
- Among the most relevant economic topics to be dealt with is the trade-off between the already high credit-to-GDP ratio and the need to achieve sufficiently fast growth.
- We expect China to deal with this dilemma by raising the efficiency of State-owned-Enterprises (SoEs), increasing financial market supervision but also by fostering the transition from an investment- to a more consumption-based economy.
- In our view, this should allow China to continue with a managed slowing of growth.
- Although the dilemma cannot be solved immediately, the fact that China is willing to address the problems amid growth to slow only in a controlled fashion, should overall prove reassuring for markets.

After two quarters of surprisingly stable growth, market worries of a hard landing in China have calmed down over the course of the year. However, underlying problems did not vanish. On the external side, a US-China trade conflict remains a possible scenario. On the domestic side, the high credit dependency of China's growth has been a major point of concern, recently prompting S&P to downgrade China's credit rating. Against this background, China's Communist Party (CCP) will convene for its 19th National Congress – an event held only every five years – from October 18 on in Beijing. The Party Congress will likely be attended by around 2,250 party members and conclude with the election of the Central Committee (205 members), which will then elect the Politburo (25 members) and the Standing Committee of the Politburo (PSC, 7-9 members). The latter is the party's top decision-making body. Moreover, the Members of the PSC typically not only hold important roles within the party but also top government positions (see graph next page), underlining the CCP's political supremacy. Current members of the PSC include President Xi Jinping and PM Li Keqiang, but also encompass the First Vice PM, Chairmen of other legal bodies, the party secretary, and the head of the Commission for Discipline Inspection, leading the recent year's anticorruption campaign. According to unwritten rules, the cut-off age for senior leaders to start a new term is 67 (known as "seven up, eight down"). According to this "soft" rule, all members of the PSC other than President Xi and PM Li would have to retire. An exemption is being discussed for the head of the discipline commission, in order to continue his work. However, with four or five new members of the currently

seven member strong committee, China will witness a major leadership reshuffle with a new generation of senior policy makers being promoted. In addition, China's next president in 2022 may well be among the newly elected members, as a president typically serves two periods (2x5 years), and Xi Jinping has reached his mid-term election. Thus, the October Party Congress will shape China's policies much longer than the official five-year term suggests.

President Xi's Political Report

President Xi, also being the CCP's General Secretary, will open the Congress with a lengthy speech on the state of the party and nation – the Political Report. It contains past achievements, but more importantly the top leadership's priorities for the next five years. It is expected that Xi will try to stamp the report with own concepts, like the "Four Comprehensives" (Comprehensively build a moderately prosperous society, deepen reform, govern the nation according to law, strictly govern the Party), the Chinese Dream ("dare to dream, work assiduously to fulfill the dreams and contribute to the revitalization of the nation") or on international power relations. As the report will have been internally drafted by a wide range of influential groups, the ability of Xi to bring forward his own topics is also seen as an indicator for Xi's consolidation of powers. In this regard, Xi is considered well advanced, supporting expectations of a strong leadership in his second term. However, from an economic point of view Xi has to deal with important structural reforms to render growth more efficient again and less dependent on credit:



Growth: Fundamentally, the party is largely bound by previously set targets, especially to double 2010 real GDP by 2020. Back in 2010, the target looked “easily” feasible. However, given receding growth rates over the last years, annual GDP needs to expand by 6.3% on average until 2020 to fulfill this goal, which is much more of a challenge. Against this background, the IMF recently (IMF Article IV Consultations: China, August 2017) revised up its outlook from 6% to 6.4% for the next two years, judging fiscal policy to stay sufficiently expansionary and to not strongly prioritize debt consolidation.

Debt-to-GDP ratio: Accordingly, the IMF sees the debt-to-GDP to continue to rise. While general government debt as a share of GDP is expected to increase only limitedly from likely 37.5% in 2017 to 42.2% in 2022, the IMF’s broader, “augmented” debt measure including local government financing vehicles (LGFV) and other off-budget activities could increase further by about 23 pp to 91.5% in 2022. Accordingly, the IMF estimates the augmented annual borrowing around 12% of GDP. By contrast, China denies having more legal obligations towards LGFVs, after sorting their liabilities out at several audits (see FP: China’s structural debt problem is still aggravating, Oct. 2016). Nevertheless, after the Great Financial Crisis (GFC), China responded to every downturn of the business cycle with fiscal stimulus measures, including also higher investment spending of SoEs. Market worries shifted accordingly to public corporate debt. Nominal credit to the non-financial sector jumped up since the GFC by almost 100 pp, over the last five years by about 68 pp. It reached 234% of GDP by the end of 2016. 30 pp of the latter increase was due to SoEs (IMF data). In fact, credit intensity has risen significantly over the last years, i.e. ever more credit was needed to result in the same improvement of output. On the real level, the identical issue was present in a slowing productivity growth. Finally, from a GDP perspective, the problems arise due to China’s high share of capital forma-

tion (44.2% of GDP in 2016) which is backed up by even slightly higher gross national savings (45.9%), additionally supporting the current account surplus. These related issues are at the heart of China’s rising debt problem, given the adherence to quantitative growth targets.

Is China’s debt crisis unavoidable?

China’s strong credit rise has sparked worries on markets as well as at the IMF to possibly result in a hard landing. Cross country comparisons show that strong credit booms typically ended in economic crises. However, there is also a list of China-specific potentially mitigating factors:

- China’s debt is overwhelmingly domestically held. On top, the current account surplus and small external debt largely prevent external funding pressures.
- Domestic funding also seems sustainable as the bank loan-to-deposit ratio is around 86%. Total non-financial credit is only 118% of total deposits (compared to more than 350% in the US in 2008 (GFC) and 250% in Japan in the mid-1990s). China’s high savings (low consumption) rate is a major difference internationally.
- Corporate balance sheets have benefitted from rising asset values. The debt-to-asset ratio of the industry sector has fallen from 62% (late 90s) to 56% of late.
- Producer prices, which trended down since 2012, especially in sectors with the highest “debt-at-risk” ratios (mining, steel), turned strongly positive again, improving RoE and the sectors debt servicing capacity
- The government has fiscal space amid a general government debt ratio of less than 40%. The IMF augmented debt already includes parts of the credit that in a case of crisis, the Beijing would have to take on.

In sum, we consider these factors to provide China with time to adjust while not solving the underlying structural problem (and of course not guaranteeing a smooth outcome). What are needed are productivity increasing “sup-



ply-side” reforms. However, given the high investment/savings ratios, this approach alone is not sufficient. In fact China needs to rebalance its economy away from investment to higher consumption, supporting fast growth by tapping savings instead of accumulating further debt.

Structural issues to figure high in Xi’s report

Accordingly, we expect structural reforms to figure high in Xi’s Political Report:

Stability and Growth: The report is likely to emphasize the quality of growth which will probably not imply to drop the quantitative “decade” GDP goal. However, it will imply a shift away from heavy industries to more technological advanced sectors with higher returns as well as less pollution. Over the longer term, de-emphasizing quantitative targets would contribute to limit debt growth.

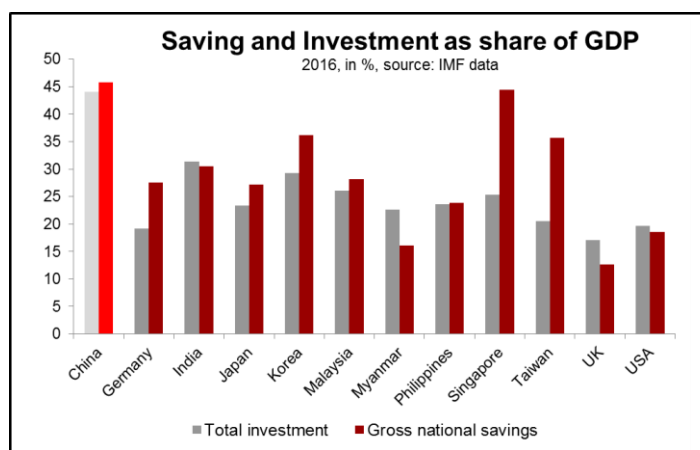
SOE reform: Reforms will include closing so called loss-making “zombie” SoEs and further reducing overcapacities, in part also via sector consolidation. Overcapacity reduction in the coal and steel sectors have already made progress, but the issue pertains also to cement, plated glass, aluminium, chemicals, paper, solar power, ship building and coal-fueled power as well. While the CCP will maintain “leadership” of SoEs (while not running them), bringing private capital in via mixed ownership is intended to raise efficiency and productivity. At the same time, mass lay-offs will likely be avoided and/or socially buffered.

Financial stability: The growing debt-to-GDP ratio was also accompanied by increasingly complex funding structures which also rely in part on short-term funding. At the National Financial Work Conference in mid-July, a new cabinet-level committee to co-ordinate financial supervision has been set up. In a speech before, President Xi already stressed that financial stability is a precondition for a stable economy. The establishment of a high level committee suggests that the move of more regulation and supervision will continue.

Transition to a more consumption-based economy: China’s savings are exceptionally high. Household’s savings are currently at 23% of GDP (IMF data), 15 pp higher than the world average. Apart from demographics and high savings for housing, the break-down of the social safety net during China’s transition to a more market-based economy in the 80-90s, have contributed to this development. China is repairing the social net, but government spending is – according to the IMF – below international standards. Accordingly, improving social security has the highest capacity to reduce precautionary saving and thus contribute to higher consumption.

Conclusions

However, President Xi’s speech is unlikely to present “brand-new” concepts but will probably expand on the 2013 Third Plenum structural reform program and more recent initiatives. Moreover, only the next National People’s Congress (not to be confused with the party congress) in next spring will transform the personal decisions from the party congress to the government level. Thus, we consider an immediate market response as less likely, in line with what happened in the aftermath of the two last congresses. Nevertheless, as it is impossible in the short run to uphold growth and stabilize the debt-to-GDP at the same time, the outlook for a controlled slowing while the party/government recognizing and working on limiting debt should overall be reassuring for markets.



Imprint

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