AKE Special Report

AKE INTERNATIONAL

China's 19th National Congress and the Economy

Overview

The 19th National Congress was as pivotal political event that saw Xi Jinping consolidate his position within the Communist Party. However, the six-day meeting also had major implications for the future of China's economy. This report will explore how the Congress revealed that:

- There will be progress in the liberalisation of some areas of China's market, but regression in others;
- State-owned enterprises will undergo reforms, but will remain central to China's economy over the next five years;
- China will become far cautious over what it is willing to invest in overseas, even as the Belt and Road Initiative expands;
- The government will continue to crack down on major polluters as it looks to reduce China's environmental degradation.

Introduction: The 19th National Party Congress

While the Communist Party's quinquennial National Congress is the biggest event in the Chinese political calendar, the 19th National Congress in October 2017, often referred to in Mandarin literally as the '19th Big', was particularly important. While there was no change of President – Xi Jinping's first term began at the 18th National Congress in 2012 and he was always expected to carry on for a second five-year term – the 19th National Congress cemented Xi's position as China's most powerful leader since at least Deng Xiaoping, the man largely held responsible for kick-starting China's economic transformation – if not since Mao Zedong himself.

Much has been written on how the 19th National Congress has cemented Xi's power within the Chinese Communist Party and how it sets the stage for him to ignore the customary two five-year term limit to stay in power beyond 2022. This makes sense, as the Congress is primarily a political event and is the best indicator of China's future political direction.

The Congress and China's economy

However, the matter of what the 19th National Congress had to say about the future of China's economy receive relatively little attention. This report aims to redress this imbalance by examining what was said at the Congress in relation to four key areas for China's economy:

- Market liberalisation
- Reform of the state-owned enterprises
- Overseas investment
- Environmental protections

The 19th National Party Congress does have the same economic significant as the Third Plenum meetings, with the next scheduled for autumn 2018. However, the 19th National Party Congress does provide major clues as to China's future economic direction. While Xi Jinping consolidated his political strength in his first five years, it is likely that the next five years will see him turn to enacting his economic vision for the country. This report looks at what this vision will entail.

About us

AKE has over 20 years of experience working with the insurance sector, providing clients with unrivalled political and economic risk consultancy. Our experienced team of analysts provides tailored analysis and strategic forecasting, allowing our clients to better assess risks in challenging environments.

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Market Liberalisation

Overview:

- *Despite decades of liberalisation, foreign companies continue to face discrimination in China.*
- *While accounting standards and the rule of law will improve, access to China's market will remain patchy.*
- *Liberalisation is unlikely to be linear - while some areas may open, there may be reversals elsewhere.*

The Challenge

Measures to encourage foreign investment initiated in 1978 with China's 'Reform and Opening Up' program catalysed the most rapid economic transformation in history. In the 1990s, the once-hermetic nation became the largest emerging market recipient of foreign direct investment in the world. Yet progress towards market liberalisation has not been linear, particularly in the Xi-Li era, with a number of foreign companies operating in China reporting a deterioration in the business environment due to growing discrimination against foreign enterprises. Forced technological transfers – companies having to surrender intellectual or technical knowhow to enter the Chinese market – remains a gripe.

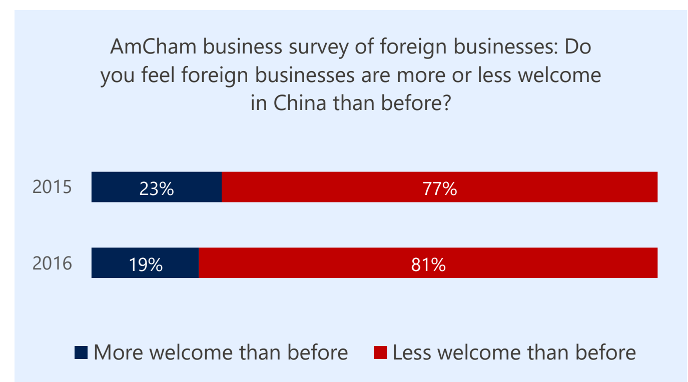
Many economists argue that China must liberalise its markets if it is to avoid a destabilising slowdown in growth, and the Communist Party itself has repeatedly stated market liberalisation is a key aim. With the Trump administration and the EU increasingly threatening to block Chinese M&As if their companies do not receive the same opportunities in China, market liberalisation will continue be a pressing issue in the years ahead.

Background

Although Xi called for a better balance between the planned economy and the free market in 2013's landmark Third Plenary Session, various restrictions have hindered progress and generated frustration among foreign businesses and would-be investors. Foreign businesses must comply with often arcane and arbitrarily enforced local regulations and there is a widely held perception that they do not enjoy the same level of political protection afforded to local companies. The World Bank's 2017 Ease of Doing Business report ranked China 78th out of 190 countries. Similarly, a 2017 American Chamber of Commerce report found that eight in ten companies believe China is becoming more hostility towards foreign businesses, and 60 per cent remain unconvinced that the government is even interested in a more open market.

What was said at Congress

In his keynote three-and-a-half-hour speech at the 19th Party Congress, Xi reiterated his dedication to supporting foreign companies in China, while simultaneously strengthening state owned enterprises (SOEs). He also delivered a clearer outline regarding China's much-touted 'open door' policy. This included a vow to 'improve rules and practices, in order to strengthen a unified market and fair competition' as well as 'support development of private firms and improve the vitality of all types of market entities'. However, Xi also reaffirmed his focus on SOEs and called on China 'deepen reform of state-owned enterprises, develop a mixed-ownership economy and create globally competitive world-class firms'.



Source: AmCham China 2017 Business Climate Survey

The Outlook

Now Xi has consolidated his grip on the Chinese Communist Party and moved his favoured people into key posts, his second term will focus on the various market liberalisation reforms put forward during his first term.

However, progress is likely to be piecemeal and often contradictory. For example, the government will increasingly explore 'mixed-ownership models' in state-owned enterprises, inviting foreign investors to purchase shares, while at the same time cementing the Party's ultimate control over SOE decision-making. While the government promised to raise the cap on foreign-ownership in joint-venture firms in the futures, securities and funds markets, it has also increased capital controls, preventing companies from moving money out of the country.

Foreign companies should expect this pattern of conflicting signs to continue over the next five years. While some previously frustrating restrictions will relax, other policies will spring up to prevent a truly mixed market.

Reform of state-owned enterprises

Overview:

- *State-owned enterprises tend to be wasteful compared to the private sector, but they are also major employers.*
- *The Communist Party must balance reforms and closures without causing social instability.*
- *The years ahead will likely see a consolidation among state entities, but they will retain their central place in the economy.*

The Challenge

China's state-owned enterprises (SOEs) remain a central feature of China's economy despite decades of liberalisation and more recent efforts to steer the economy away from an overdependence on heavy industry, which SOEs dominate. China has roughly 150,000 SOEs, accounting for around 17 per cent of urban employment. Yet SOEs tend to perform less efficiently than China's private sector. While SOEs hold around 40 per cent of China's industrial assets, their return on assets is just 3 per cent, compared to 10 per cent for private firms. They also often survive on government loans, and account for around 60 per cent of China's corporate debt.

SOEs tend to dominate coal, steel and other heavily polluting sectors that exacerbate the country's already grave environmental challenges. As the Communist Party looks to manage a likely economic slowdown, it must reduce SOEs' drain on China's resources without causing major unemployment and unrest.

Background

A legacy of China's 'iron rice bowl era', SOEs allow the Communist Party to maintain control over key areas of industry. They played a major role in supporting the country's infrastructure drive that helped shield China from the 2008 Global Financial Crisis. Yet the robust response to the crisis also brought problems, as many SOEs used inefficiently while racking up huge debts, with state banks often reluctant to allow bankruptcies among the worst offenders.

In the 2013 Third Plenary Session of the 18th Central Committee, the Communist Party called for greater competition between SOE and private companies, as well as a consolidation of existing SOEs. So far only the latter aim has been pursued within the energy sector, while mega-mergers are planned in the steel, coal, chemicals, and telecommunications sectors, among others.

What was said at Congress

Xi called for a 'deepening' of SOE reform during the 19th Party Congress, but implied that his government envisages a continued domination of SOEs in key industrial sectors. Xi pledged to push for more efficiency in the public sector through major mergers among SOEs. There were also calls for capacity cuts in sectors experiencing severe oversupply, such as steel and aluminium.

As part of a broader corporate ownership reform agenda, the Party Congress also called for greater experimentation with 'mixed-ownership models', through which shares in SOEs will be made available to private investors. The new ownership structures are also expected to help reduce SOE reliance on loans from China's state banks.

The Outlook

The government is likely to take piecemeal steps towards SOE reform in the next five years as it explores ways to make them more efficient without causing major instability. The 2014 Pilot Program for increasing 'mixed ownership' deals will likely be pushed with greater energy in Xi's second term, with the number of key SOEs controlled by the State-owned Assets Supervision and Administration Commission (SASAC) likely to be reduced from 101 down to 80 by the end of 2018.

However, while consolidation is to be expected, it is unlikely that SOEs will lose their central place in the economy, particularly in heavy industries such as energy, steel and coal.

Moreover, any major reforms of the public sector will remain both politically and socially unviable, as mass lay-offs would likely lead to widespread public discontent and substantial anti-government protests. The Communist Party, valuing stability above all, will seek to avoid any sudden and sweeping reforms of the country's SOEs.

Overseas Investment

Overview:

- *Xi Jinping's Belt and Road Initiative self-consciously marks China's growing clout on the international stage.*
- *Despite grand claims that US$900bln will be spent as part of the initiative, the government is becoming more concerned about low returns on such projects.*
- *The state will remain heavily involved in Chinese overseas investment, generating concerns abroad.*

The Challenge

Overseas investment has become a major hallmark of the Xi-Li era as China's growing economic clout gives the country a self-confidence not seen since its first humiliations at the hands of expansionary Western powers over 150 years ago. The Belt and Road Initiative is President Xi Jinping's signature project, with over US$900bln of investment pledged across Eurasia and the southern sea routes. The investment has several goals: the promotion of Chinese influence abroad through infrastructure enhancements; the domestic imperative to relieving excess capacity in heavy industry, real estate and infrastructure, and the development of the poorer western provinces and rustbelt.

However, with such grand plans comes considerable waste, with many companies jumping on the Belt and Road bandwagon in the hopes of favourable loans from state banks for projects of questionable utility. Ensuring Beijing's largesse is channelled into viable projects will be key to making the Belt and Road Initiative a success.

Background

While the Belt and Road Initiative has grown in international prominence over the course of 2017, the same year Chinese investment abroad actually fell precipitously. Non-financial outbound investment dropped 41.9 per cent from January to September year-on-year. The Chinese leadership, facing what it perceives as unpalatable levels of risk and excessive capital outflows, has tightened control over the volume and nature of outward-bound investment. In January 2017 it banned SOEs from investing in certain industries such as real estate and iron ore mining, in August 2017 it ended overseas investment into what it has called 'irrational' acquisitions, and during the summer of 2017 it cracked down on five major private conglomerates.

A notable problem with the Belt and Road so far has been its lack of clear mission. In some regards its key aim is to expand China's influence abroad, the government seems to lack clear calculation of just how much capital it is willing prepared to on potentially unsound investments in pursuit of this aim.

What was said at Congress

The key takeaway from the Congress regarding overseas investment was the enshrinement of the Belt and Road Initiative in the updated party constitution, reflecting a greater, party-wide emphasis on increasing foreign infrastructural investment in the service of state foreign policy. The current high level of loans to developing countries, about US$80bln annually which have been labelled as part of the initiative, is likely to increase while the number of countries included in the initiative is likely to expand.

The Party Congress report also called for increased support in the growth of private businesses, although always with state control. The likelihood is that private efforts will be channelled into high technology, manufacturing and modern services.

Source: AEI

The Outlook

Chinese investment abroad is likely to be defined paradoxically by strong state control. However, government ministries have also released memoranda pledging to support private manufacturers and investors to expand abroad, reflecting the Party's enhanced confidence and stable base of power coming out of the Congress.

Overseas investment by both SOEs and private companies is likely to increase, especially in infrastructure and connectivity projects. The government is likely to be more particular about projects that it finances, realising that news of failed projects is more harmful for its image abroad than successes are positive.

The Environment

Overview:

- *Environmental degradation is becoming a key source of popular content.*
- *The Xi-Li government appears to be taking the challenge seriously, with enforcement of environmental regulations improving in Xi's first term.*
- *The next five years will see the government further invest in environmentally-friendly technologies while punishing major polluters.*

The Challenge

China's environmental degradation has become a key source of public discontent. Communist Party leaders are greatly concerned that high levels of pollution could unite the country's working and middle classes against the state, threatening political stability. Many major cities including Beijing are frequently engulfed in a smog which both harms public health and causes the world's second-largest economy embarrassment abroad.

President Xi Jinping has declared a 'war on pollution' to tackle the issue, with much greater enforcement of environment standards a major component of the government's strategy. In response to concerns that stringent environmental policies may contribute to an economic slowdown, the Ministry of Environmental Protection (MEP) has emphasised their long-term benefits to the economy, stating that environmental protection and economic development go hand-in-hand.

Background

While directives on environmental protection had little impact under former President Hu Jintao, they have been better enforced after Xi assumed office in 2013. The 'war on pollution' was ramped up ahead of the 19th Party Congress and industries in the smog-affected north of the country are already feeling its effects. China is gradually weaning itself off coal consumption and the government has cancelled plans for more than 100 new coal-fired power plants.

In 2016, the MEP was given the authority to conduct investigations unannounced and hold polluters accountable for their actions. In early October 2017, a new regional pollution alert system ranging from the cleanest 'green zones' and the most polluted 'red zones' was rolled to highlight regions where relevant projects will no longer be approved by authorities.

What was said at Congress

In his extensive report to the Congress, XI revealed his plan for building a modern socialist country by 2035 which involves the development of several key concepts, including that of an 'Ecological Civilisation' and a 'Beautiful China'.

In vowing to take a tough stance against polluting activities, Xi has set concrete goals for safeguarding against environmental degradation during economic development. One such goal is to fully comply with the China's own air quality standards – an average PM2.5 reading of 35 micrograms per cubic meter by 2035. More generally, the Congress also reiterated the government's support for the 'green' industries of the future, with investment and support for electric vehicles as key a component of the initiative.

The Outlook

The emphasis on environmental protection at the 19th Party Congress will likely result in concrete changes in the way China approaches economic development. The new policies will increase pressure on government agencies and local MEP departments to meet the country's new environment-linked objectives at the expense of GDP targets.

However, Congress is that companies that are prepared contribute to building a clean, green and sustainable China are set to benefit. Companies that are unable to shift from high-carbon to low-carbon technologies and do not offer solutions for pollution control and waste disposal will suffer.

Disruptions to existing manufacturing plants will become increasingly frequent while the fear of inspections could generate an unpredictable operating environment for foreign manufacturers. Relocation will no longer be an effective solution for companies struggling to comply with regulatory hurdles as China's environmental targets are likely to become increasingly widespread, encompassing provinces as well as municipalities.