PGIM FIXED INCOME

Perspectives

October 2017

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China: The Next Five Years

With China's 19th Communist Party Congress kicking off on October 18, investors are turning their attention to the outlook for the next five years. In this short note, we seek to provide some markers for events over the coming six months that should be helpful in assessing the future course of policies. In doing so, we also provide our views on what has happened in the first five years of President Xi's term—highlighting what we consider to be some misperceptions among market participants and investors—and set out our base case expectations for economic policy going forward.

The Timeline and Markers Over the Next Six Months

On October 18, the much-anticipated 19th Party Congress of the Chinese Communist Party will commence, likely lasting about a week. The Congress will formally kick off Xi Jinping's second five-year term as General Secretary and begin a series of comprehensive changes in leadership and potential policy over the next six months leading up to the National People's Congress (NPC) that is likely to commence in March 2018.

First, the 19th Party Congress will focus on personnel issues. While the Congress will formally receive and discuss a report by President Xi on the progress achieved over the prior five years—as well as an outline of policies for the coming period—the main agenda item will be the selection of new party leaders, i.e., the Central Committee (some 200+ members), the Politburo (some 25 members), and, most importantly, the Standing Committee of the Politburo. The key points of this selection process include:

- The size of the new Standing Committee, which was reduced from nine to seven members at the 18th congress. A further reduction could hint at continued centralization of policy making, while an increase may indicate a return to the consensual style prior to Xi's leadership, which would arguably reflect a weakening of his position.

- Potential for further, formal elevation of Xi Jinping. Having already assumed "core" status in October 2016, there could be additional elevation with one step consisting of conferring Chairmanship to Xi Jinping (a position that was abolished after Mao in favor of collective leadership). Another step could elevate "Xi Jinping Thought" into the Party Constitution (Mao has been the only sitting leader to receive the recognition).

- Selection of the obvious successors in the Standing Committee. Existing retirement rules will result in the retirement of five of the seven standing committee members, with only Xi Jinping and Prime Minister Li Keqiang eligible to serve one more term. The elevation of someone young enough to still serve in 2022 (i.e. a "sixth-generation leader") would, therefore, give strong indications regarding Xi's succession, while the absence of such a selection would further feed expectations of Xi Jinping extending his leadership beyond 2022.

- Adherence to retirement rules. Notably, this would imply the retirement of the governor of the People's Bank of China (PBoC), who has already been permitted to serve longer, as well as those of five current standing committee members, including Vice PM Wang Qishan who has been heading the anti-corruption campaign. While some investors have expressed hope that Wang would stay on—pointing out that the rules are informal—adherence to these rules should provide some reassurance to investors that stability remains important. Otherwise, a wholesale change of the political model developed since Deng Xiaoping could be in the offing. Moreover, with a human capital base as strong as China's, personalities are likely not as important as adherence to rules.

Second, the Central Economic Work Conference is set to take place in December 2017. A key development at this stage could include the potential for further loosening of the economic growth target, which is currently set "around 6.5%."

Third, the NPC, which will be held in early March 2018. While party leadership will have been determined in October's Party Congress, the NPC will determine the shape and composition of the new government. One key decision for investors to follow concerns the Prime Minister. Following the economic and financial wobbles in 2015-16, observers speculated whether PM Li Keqiang would remain in his position for another term. With the subsequent stabilization of the economy and financial conditions, these rumors have subsided, but a new PM would indicate a significant strengthening of Xi Jinping's position.

When evaluating the potential series of changes, our expectation is that Xi Jinping will succeed in further strengthening his position, but will do so while adhering to long-established rules. We further expect that he will use this strengthened position to push ahead with economic reforms.

The Economic Policy and Reform Outlook

Before turning our attention to future economic policy and reform, it is useful to have a better understanding of developments— particularly the reforms undertaken—during the first five years of President Xi's term. There is a common refrain among investors that reforms have disappointed since 2012. However, a more nuanced reading is probably warranted. Major political reforms were set in motion, especially in the governance of the communist party and the military. On the economic front, expectations following the third plenum in 2013 were arguably set too high. Even so, reforms emerged, but our earlier worry about improper sequencing materialized; financial liberalization, especially the opening of the capital account, were pursued before tackling excess capacity and distorted incentives in the state-owned enterprise (SOE) sector. This approach quickly ushered in major vulnerabilities—evidenced by the burgeoning shadow banking system, stock market volatility, and large scale capital outflows in 2015-16—which then triggered corrective measures and tighter controls. This resulted in the current situation where important buffers have been eroded and debt growth has

continued, as highlighted by S&P's recent credit rating downgrade. We think that this recent experience will result in an impending shift in policy priorities.

For the next five-year term, we expect that the sequencing lesson has not been lost, such that financial liberalization and especially capital account opening will likely occur at a much more measured pace. Given the uncomfortable debt position—recently aggravated by steeply rising household debt—we expect policy makers to continue to lower the economy's dependence on fast-paced debt accumulation. SOE reforms are unlikely to follow the orthodox, divestiture-centered path in Western countries, but rather, to be geared toward *dirigiste* industrial policy and the creation of national champions. While this approach should help consolidation and coordination, it is unlikely to improve the distorted resource allocation toward SOEs (to the detriment of the private sector) and, therefore, is unlikely to significantly improve efficiencies across the economy.

This policy mix—more orthodox macroeconomic policies aimed at stability and industrial policy aimed at strengthening SOEs—is not conducive to higher growth, and the "safe-growth speed limit" will arguably continue to trend lower. Thus, an important question is whether the authorities will accept this reality in the form of a lower growth target. While many investors point to the arithmetic necessity of 6.5% growth to achieve the standing five-year target of doubling of the 2010 GDP by 2020 in order to build a "moderately prosperous society," we are less concerned.

Many emerging economies have previously found a need to update their GDP measurement as the economy develops, typically resulting in significant increases in GDP levels post-revision. China would likely be able to replicate this pattern if it revised its national accounts methodology, in effect becoming able to meet the 2020 level target without 6.5% average growth. However, maintaining high growth targets, especially if coupled with further financial liberalization and capital account opening, could once again risk financial and economic stability.

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2017-4631