7 November 2017

China's 19th Communist Party Congress – Onward and upward!

The world watched in anticipation as China's 19th Communist Party Congress unfolded in Beijing, concluding on 24 October. President Xi Jinping has consolidated his power[1] – the stage is set for a strong, united and determined government in China for the next five years.

The short-term economic outlook is stable, with credit growth and liquidity sufficient to maintain economic growth. The real economic story for investors to watch is: The "New China" economy continues developing, as the economy shifts from dependence on exports and heavy industry to consumption and services. Manulife Asset Management Senior Asia Strategist Geoff Lewis explains what all this could mean for investors going forward.

China Congress delivers a strong, confident message[2]

China's 19th Communist Party Congress (CPC) ended on 24 October, and sent a clear message to domestic and foreign audiences. The economy remains on track, with a new long-term objective of "becoming a great modern socialist country by the middle of the 21st century", the centenary of Communist rule. Thankfully, no quantitative targets for GDP growth accompanied the new objective. It sends a signal that Beijing is confident that China will continue along the path towards developed economy status.

A long-term vision framework means that Xi's key policies for 2017–2022 can be extrapolated beyond the next five years, ensuring a continuity that will enable China to stick to the desired development path. In the first 15 years to 2035, the aim is to turn the Chinese economy into an innovation leader with:

- A clean environment
- A growing middle class
- Reduced income inequality
- Good public services
- A society that is governed by the rule of law

China is now the world's second largest economy (measured in nominal GDP[3]). Developments there affect us all. The leadership transition is no longer something that concerns just the top ranks of the Chinese Communist Party and dedicated Sinologists. The 19th Communist Party Congress was followed with intense interest by the world media and reported in great detail. One could argue that it is the most important political event of 2017.

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[1] Financial Times, 26 October 2017.
[2] Xinhua News, 24 October, 2017: "Full text of resolution on CPC Central Committee report".
[3] IMF's World Economic Outlook Database, April 2017.

That this Congress would assume international importance seems to have been anticipated by Beijing. President Xi Jinping in his opening speech had a clear message for the world. He said China would play a growing role in world affairs; one more commensurate with her economic clout. China wants to be an active member of the international community and will shoulder her responsibilities. In the economic sphere, the Belt and Road will be China's one of the most important initiatives, a project of stunning ambition and vision that will become a major driver for infrastructure investment in Asia and other markets for many years.

President Xi has clearly consolidated his power and position as China's "core leader"; a title which he assumed in October 2016[4]. The title has only been bestowed on Mao, Deng and Jiang. The decks have been cleared for a strong, united and determined government in China for the next five years. In view of the many structural problems that China still faces, this may be no bad thing from the perspective of managing the economy and implementing potentially painful economic and financial reforms.

China's short-term economic outlook is stable

Post-Congress, we expect to see few major changes to the economic and financial policies that China has been employing with some considerable success in 2017, though the next five years may see greater focus on structural economic reforms and rather less on anti-corruption efforts.

Liquidity remains ample and the renminbi is no longer overvalued, while capital outflows have all but ceased. We are not much concerned over the sharp slowdown in the growth of M2 (broad money supply)[5] resulting from the People Bank of China's (PBoC) financial deleveraging.

Looking under the hood, the growth in bank loans and total credit to the real economy has held up and remains ample to support the current growth in GDP. The deceleration in M2 growth reflects a slowdown in credit to nonbank financial institutions, including the more speculative channels of shadow banking. It is a timely and welcome development that will help ensure financial stability. We have seen some reduction in debt stress at local and national state-owned enterprises (SOEs) due to stronger profit growth; higher raw material and property prices; and margin improvements due to capacity cuts.

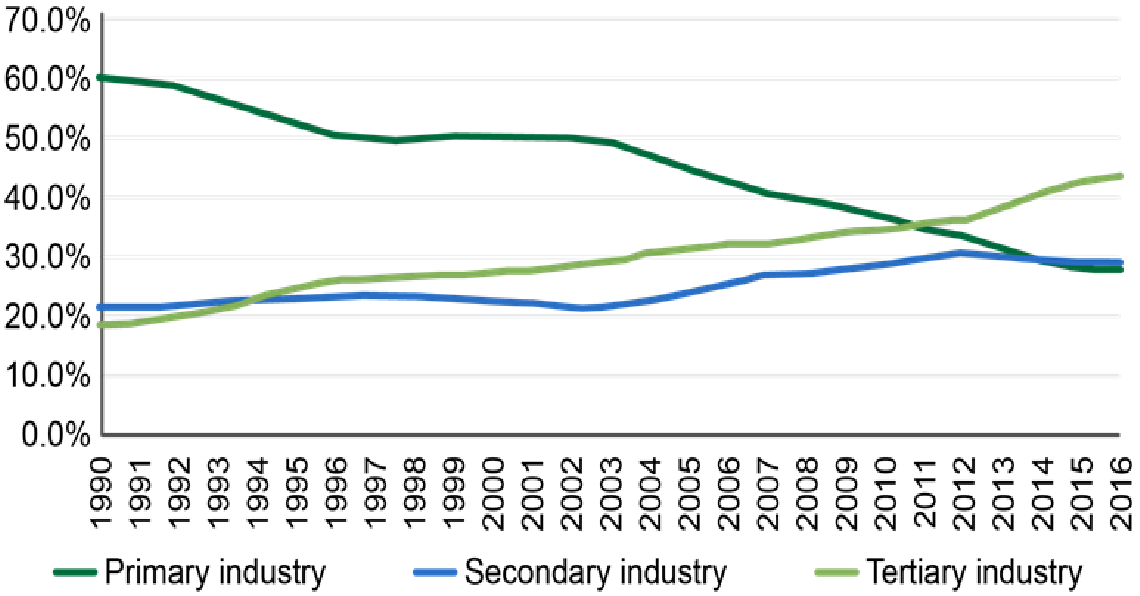
We are also not too concerned by the recent mild deceleration in some of China's "hard" economic numbers[6]. This mostly reflects policy decisions to cut output in heavy industries that suffer from excess capacity, rather than any weakening in private sector aggregate demand. For example, the declines in fixed asset investment and industry value added in September were mainly in areas like ferrous and nonferrous metals, plastics and chemicals[6].

[4] New York Times, 30 October 2016.
[5] People's Bank of China, 2 November 2017.
[6] National Bureau Statistics of China, as of October 2017.

The continued rise of the "New China" economy

While heavy industry will continue to act as a drag on activity for the next year or two, the negative impact is being offset by strong double-digit growth in manufacturing areas like electronics, autos, machinery, and equipment. At the aggregate level, GDP growth for the third quarter of 2017 of 6.8% suggests an economy that is continuing to outperform the government's growth target of "around" 6.5%[6].

Figure 1: China's economy is rebalancing rapidly[7]



Note: The percentage share of total employment.

China's key policy aim of rebalancing their economy away from fixed asset investment towards domestic consumption continues to make steady progress. Such deep restructuring cannot be achieved quickly, and was always going to be spread over many years. Consider the following[8]:

- The share of consumption in GDP has risen steadily from a trough of 36% in 2007.
- At the margin, consumer expenditure accounts for the major share of the increase in GDP year-to-date, 65% or 2.8 percentage points more than in 2016.
- Progress in economic rebalancing is also reflected in the faster growth of the consumer-intensive services sector compared to the overall economy.
- Services in real terms grew by 8.0% year-on-year in the third quarter of 2017, considerably faster than the growth rate of manufacturing.

[7]CLSA, China HQ, 17 August 2017.
[8] National Bureau Statistics of China, October 2017.

Meanwhile, the western financial media continues to focus obsessively on the troubles of heavy industry in China's north eastern "rust belt", a comparatively small part of the modern economy. We are, however, starting to see greater awareness by foreign investors of the strengths of the "New China" economy, driven by rapid innovation in areas like IT, e-commerce, biotechnology and automation.[9]

Online sales in China last year were US$366 billion, as much as the US and UK combined.[10] In some areas, China has already taken the lead, leapfrogging developed market economies in its adoption of new technologies. To give one important example: Chinese auto companies last year accounted for over 50% of the global output of electric vehicles[11]. In 2014, China's total research and development spending (according to Battelle[12]) was US$300 billion versus US$500 billion for the US, and is expected to overtake the latter within the next five years.

Beijing believes that China is highly competitive in IT-related innovation and that rapid diffusion can drive the next phase of economic growth, allowing China to avoid the "middle income" trap that has prevented other developing economies from achieving high income status.

[9] For an interesting survey of China's growing IT prowess, see 'Byron Wien Measures China's Tech Success,' Barron's, 26 October 2017.
[10] The Economist's 'Special Report on E-commerce' describes China's rapid growth in ecommerce, 28 Oct – 3 Nov edition.
[11] Financial Times: Electric cars: "China's highly charged power play", 12 October 2017.
[12] Battelle, "2014 Global Funding R&D Forecast", December 2013.