



Chi on China

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MEGA TRENDS OF CHINA (6): EVOLUTION OF CHINA'S GROWTH MODEL

In formal logic, a contradiction is the signal of defeat, but in the evolution of real knowledge it marks the first step in progress toward a victory.

Alfred North Whitehead

SUMMARY

- Chinese President Xi Jinping has changed the government's policy objective function from maximising growth rates to improving growth quality, subject to the reform and debt-reduction constraints. Many players are expecting China's GDP growth to fall below 6% soon. Really?
- What is revolutionary about Mr. Xi's approach is his forceful change of the political and economic incentives that had governed the country for over three decades. He has a much bigger agenda than what most analysts see as the power-grabbing move.
- China's new economic model is based on strategic usage of markets under state guidance with very limited privatisation of state-owned assets. Key-man risk is the ultimate China risk that the world has to face in the future.

To ensure President Xi Jinping has enough time and power to make the necessary structural changes, the Communist party revised the constitution to remove the presidential term limit at the National People's Congress in March 2018. The move not only showed that Mr. Xi had the power to break with past conventions and change the constitution, but also that he dared to challenge and to alter the unwritten rules that have long guided the Party bureaucracy. For better or worse, he is moving China to a more centralised and top-down system.

Two crucial questions follow from these changes. First, as China's policy moves from maximising growth rates to improving growth quality, when will its growth rate fall below the 6% mark that Beijing has vowed to protect?



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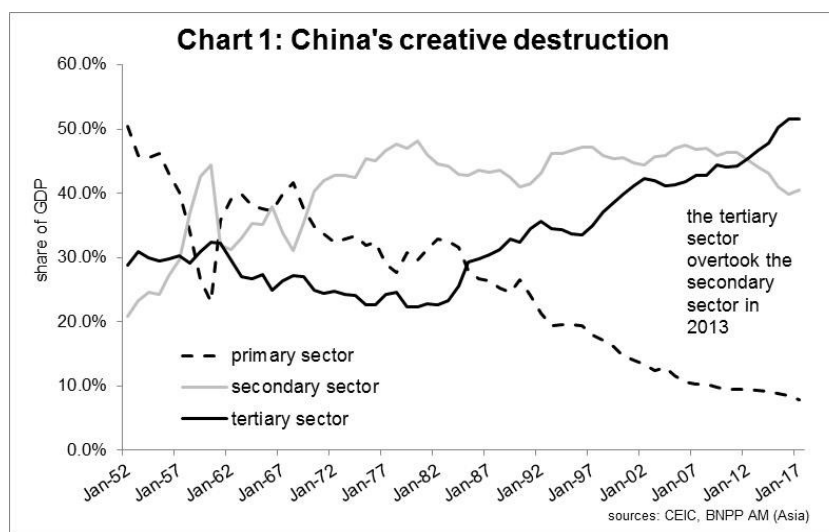
Second, why does President Xi want to re-centralise power? Is this simply power-grabbing with self-interest to crown himself the emperor of modern China?

WILL GROWTH FALL BELOW 6% SOON?

Many players expect that China's growth rate would fall below 6%, or even 5%, in the next three to five years if not sooner because of various reasons, including capacity constraints due to economic distortions and Beijing's desire for slower growth in exchange for structural reforms. Indeed, at the 19th Communist Party Congress in October 2017, President Xi announced his vision of a "new era" in which China will achieve national supremacy by pursuing high-quality growth and de-emphasising high-speed growth.

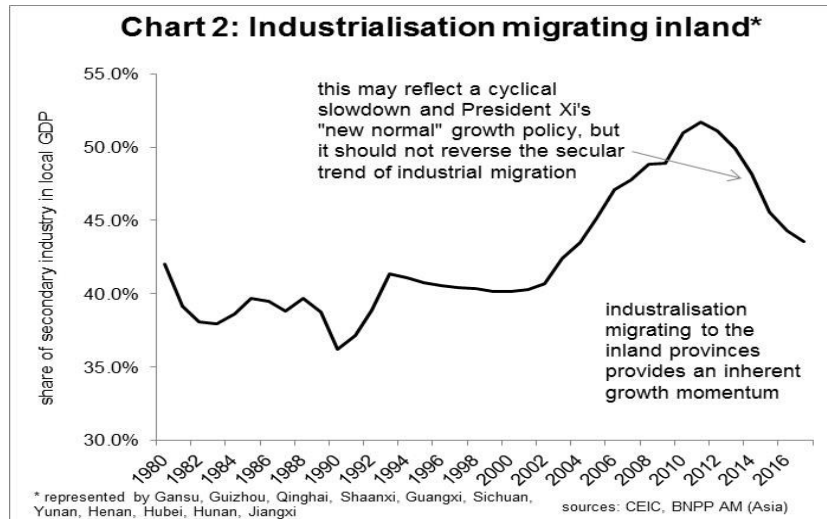
In practice, the focus on high-quality growth will not end the pressure to deliver economic growth, nor does it mark a shift to a smaller role of the government/Party in the economy. There is a Party goal of doubling China's per capita real GDP in 2020 from its 2010 level. This is a hard target for the President to deliver. This means that China will have to grow by an average of 6.3% a year between now and 2020 to hit that target.

Structurally, China's GDP growth may remain at around 6% for much longer than most players have expected. Firstly, China is going through a creative destruction process that will generate an inherent growth momentum. For example, China's tertiary sector, a proxy for the new economy, has grown bigger than the secondary sector, a proxy for the old economy, since 2013 (Chart 1).



Secondly, there is a developing trend of industrial migration towards the inland provinces (Chart 2), leading to reverse-migration of labour (Chart 3)¹, uncovering and employing cheaper and untapped resources, spreading job creation, income growth and consumption to the poor parts of the country. They are signs of economic rebalancing. The combination of the growth of the new economy and industrial migration will likely generate growth momentum to offset some of the growth drag from structural reforms, deleveraging efforts and even an ageing population in the medium-term.

¹ See "Chi on China: Progress on China's Structural Rebalancing and Reverse Migration", 8 November 2017.



IS IT SIMPLY POWER-GRABBING?

The media has mostly framed the discussion on Xi Jinping's scrapping of the presidential term limit as a power-grabbing move to make himself the life-time ruler of China. The move is a shock even to many Chinese because he is uprooting one of Deng Xiaoping's most important legacies of institutionalising leadership succession that was meant to end the political instability stemming from chronic power struggle in the Mao Zedong era. For the West, the term limit is a mechanism that constrains a system from moving towards dictatorship.

From Mr. Xi's perspective, the de-centralised power structure that evolved after Deng Xiaoping has become a set of outdated political conventions that need to be overturned so that he can deliver his "Chinese Dream" to make China a global power because de-centralisation has not worked as intended. For the two decades before him, Beijing delegated more autonomous power to the regional governments to encourage them to try out economic reforms. They were given powers to run major regional affairs, including land allocation, business development, infrastructure construction, local fiscal policy, law making and enforcement, and allowed to own state companies.

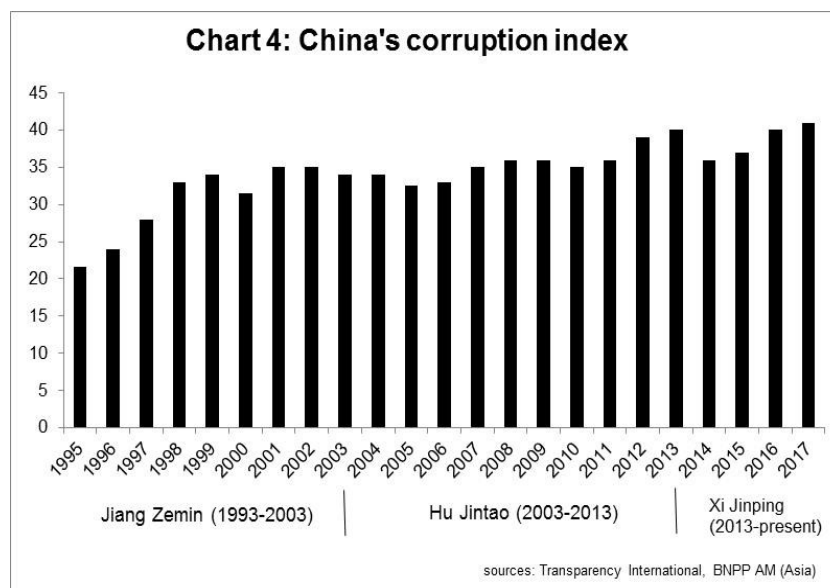


The central government had an explicit policy of encouraging regional competition to get rich as a reform motto. Hence, GDP growth became the predominant political objective with appointment and promotion of government officials being tied to local growth performance. This created an incentive scheme of “chasing growth at all cost”. It also created powerful provincial officials, who acted like regional warlords, defying the central decrees. Indeed, Chinese bureaucrats have a long history of skillfully resisting orders from above and abusing power. The ancient Chinese proverb of “the mountains are high and the emperor is far away” has been manifested in modern day practice of “whenever there are decrees from above there are counter-measures from below”.

XI JINPING'S FEAR

After five years of formulating growth and reform strategies, the leadership is poised to tackle the next phase of challenge: implementation. But the regional defiance has raised the risk of reform failure faced by Mr. Xi – in terms of failing to pull China out of the middle-income trap and risking political demise of the Party if the system's distortions are not resolved.

As power de-centralisation has backfired, the implementation risk has become a mounting concern. Using corruption as a proxy to implementation failure, China remained quite corrupt², according to the Transparency International Corruption Index (which ranges from 0 or highly corrupt to 100 or very clean) in the 20 years before Xi Jinping took office (Chart 4). Its corruption index remained below 40 under both the Jiang Zemin and Hu Jintao administrations but rose to 41 in 2017, reflecting the initial success of Mr. Xi's anti-corruption campaign and structural reforms.



Mr. Xi believes that there is a link between leadership power and reform implementation. The need for greater leadership power, as reflected in the elimination of the presidential term limit, has become a key element of his implementation efforts. From the perspective of western democracies, scrapping the presidential term limit is a disappointing governance setback by China. But from Beijing's perspective, it may be the only option to tackle its daunting reform risk.

² Evidence of rampant corruption abound. For example, see “*The Dark Side of China's Rise*”, by Minxin Pei, Project Syndicate, October 20, 2009.

CHANGING THE INCENTIVE SCHEME

Hence, Mr. Xi is changing the incentive scheme of the system from single-mindedly maximising growth to multi-targeting different policy goals, including maintaining GDP growth, alleviating poverty, reducing financial risk and protecting the environment. By replacing the old incentive, which was easy to pursue, with a complex set of priorities, which makes optimising all the policy goals simultaneously impossible, Mr. Xi is creating a political environment to ensure compliance by local officials. Since it will be so hard for local officials to know the best way to satisfy Beijing's multiple goals, they are more likely to just do what they are told rather than be creative.

So there is a big agenda behind Mr. Xi's motive to stay on as a patriarch leader. To realise his Chinese Dream, he needs time and power to make changes. Eliminating the term limit makes it clear to the local officials that there are no alternative power centres for them to appeal to, and that waiting for Xi to pass from the scene is also not an option. To survive and thrive under this framework thus requires pledging loyalty to Xi.

Thus, Mr. Xi has created an increasingly high-pressure political environment to break local defiance and emphasise strict compliance of central decrees. His vision for the future is not to reduce state intervention, but to refine the role of the state in the economy. The new economic model will continue to be a strategic mix of markets and state guidance.

THE ULTIMATE CHINA RISK

Key-man risk – that the person making all policy decisions is increasingly insulated from criticism or feedback, leading to potential bad decisions and disastrous mistakes – is the primary China risk that the world is facing. There are secondary risks also. Mr. Xi's high-pressure political environment may ensure compliance, but the local knowledge and power of the regional officials may no longer serve as a checking force on potentially ill-considered central policies. The pressure on officials to deliver on multi policy targets may also worsen the old problem of data falsification and disrupt markets and even social stability.

These risks have remained manageable so far because Beijing has shown enough sensitivity to adjust policies when implementation gets off-track. A relatively closed capital account also helps minimise the risk of potential capital flight stemming from the loss of local confidence. But history has shown that few authoritarian regimes could maintain power and systemic stability through coercion alone. China's capital account is also opening wider as economic liberalisation progresses.

Ch Lo
Senior Economist, BNPP AM

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