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Battening Down the Hatches : China's Path Ahead

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Well, that was a different Party Congress. China watchers had become used to inferring future policies from carefully crafted and balanced texts, speeches, and personnel appointments in prior Party Congresses; this time, the message was obvious for all to see. From the opening speech to the escorting of his predecessor Hu Jintao off the stage, it is clear Xi Jinping is in charge to an extent that no Chinese leader has been since Mao Zedong.

Observers who had hoped for a policy recalibration against the background of significant external and home-grown economic challenges were likely disappointed. Instead, the new Party leadership - now comprised of Xi Jinping loyalists, will likely batten down the hatches and double down on the current policy course. This post explores the economic and investment implications from the 20th party congress.

Xi Jinping Consolidates His Power

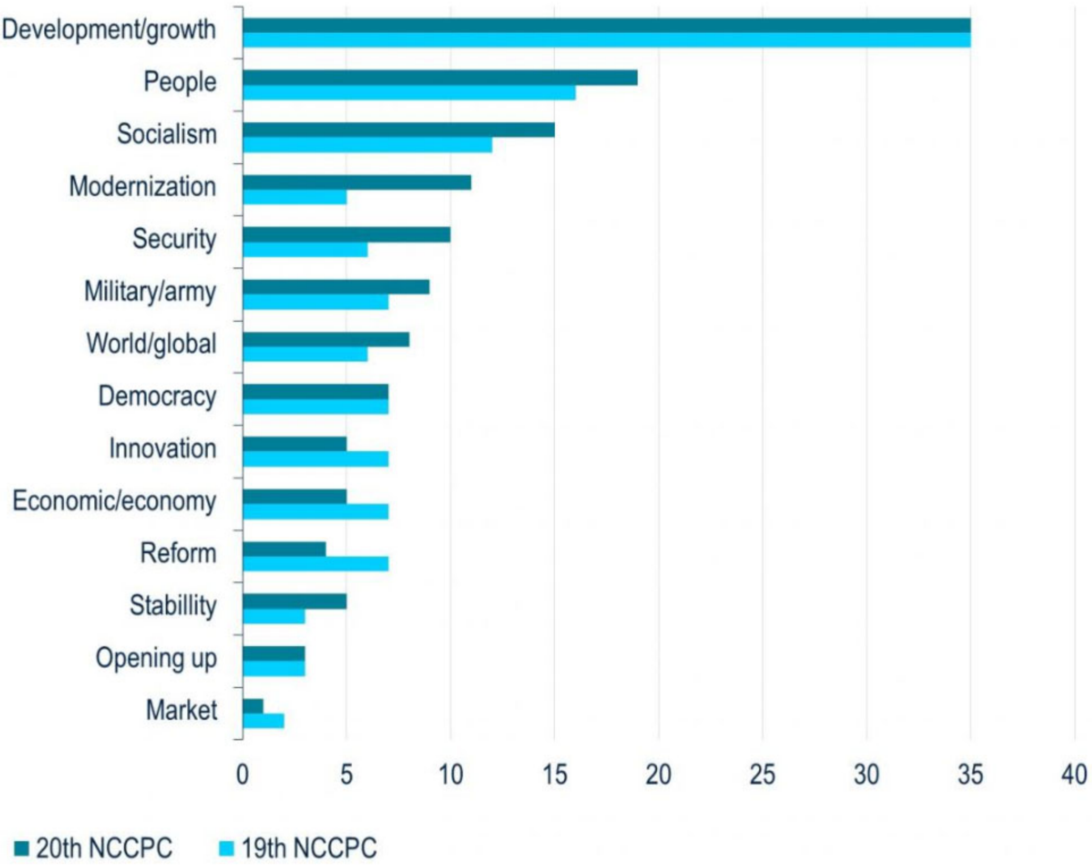
The biggest non-surprise was that Xi Jinping, age 69 and having served two terms, claimed his third term as Party Chairman and General Secretary - thereby defying prior term limits and retirement conventions (the so-called 'stay for 67, retire at 68' rule). However, the extent to which Xi was able to install allies and unseat presumed internal critics was surprising. Key personnel appointments - most critically to the seven-member Politburo Standing Committee - selectively defied retirement conventions as well as previously established promotion requirements. For example, Premier Li Keqiang, 67, who spoke out about the adverse cost of broad lockdowns, not only lost his renomination to the 24-member Politburo, but also to the 205-member Central Committee. Vice PM Hu Chunhua, seen to be allied to Li Keqiang and a potential successor to Xi, also did not make it into the new Politburo even though he is only 59. Meanwhile, General Zhang Youxia, 72, kept his place on the Central Military Commission and Politburo, while Foreign Minister Wang Yang, 68, was promoted to the Politburo.

Thus, on the face of it, Xi Jinping has a much stronger personal imprimatur on the Politburo, its Standing Committee, and the Central Military Commission than was the case in his prior two terms. However, experience has taught observers not to linearly link China's personnel decisions to future policy directions, so it is important to understand the policy announcements from the congress as well.

Security Became a More Prominent Theme

Many observers were initially relieved that Xi's opening speech - and its underlying report - did not elevate "security" to the same government priority as "economic development."

FIGURE 1: Relative Importance of Key Concepts in Xi Jinping's Speeches to 20th Party Congress



Source: PGIM Fixed Income.

Indeed, "security" did not make top billing along with "economic development". However, textual analysis indicates that the term was in much more prominent use this time than in the 2017 congress, especially when the increased mention of the word "military" is also considered (Figure 1). This has raised worried eyebrows, but one should not forget that the reference to security encompasses dimensions beyond military matters, such as health, energy, supply chain, and food security. Even so, the mention is reflective of the authorities' concerns about a more challenging backdrop for China's development.

"Modernization" further gained substantial importance in the Chinese policy lexicon, and for the first time, an entire section on technology upgrading was included. Of course, this is consistent with Xi's vision of a modern China and offers hope for more rapid development. However, this desire is not new and has been a feature of Chinese policy planning for at least two decades. The actual experience - most prominently the failure to develop high-end aircraft-engine and semiconductor industries despite lavish funding, not to mention the bankruptcy of chipmaker Tsinghua Unigroup, a key recipient of state funding - would suggest a more nuanced future path, but that was not evident in the policy documents presented at the Congress.

Finally, social themes continued to gain importance, as mentions of "people" and "socialism" similarly increased while mentions of "market" and "reform" waned in importance. Thus, the "Common Prosperity" agenda remains a priority with attendant moves to lower income disparities and rein in animal spirits via state intervention and regulation.

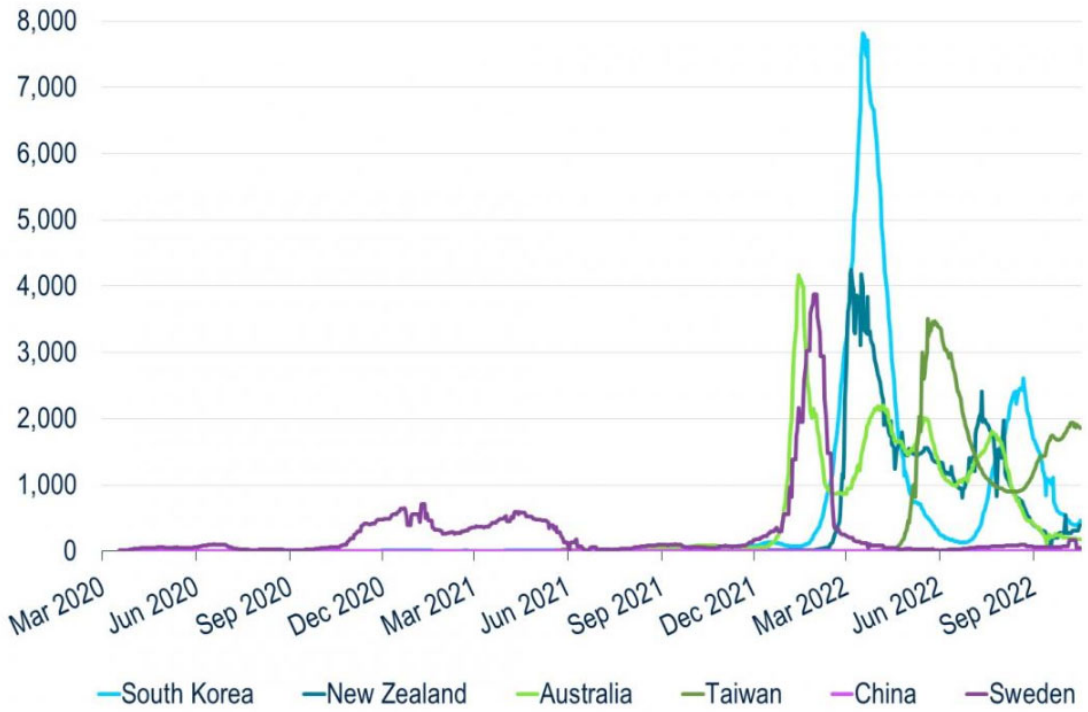
Of course, such broad policy intentions are to some extent abstract, not to mention partially inconsistent, but they do carry important implications, especially for growth prospects and their attendant investment implications.

No Change to 'Dynamic' Zero Covid Policy

Hopes for relaxing China's "dynamic zero-Covid policy," a prospect that could usher in a return of consumer confidence and spending as well as greater planning certainty, were dashed. Xi expressly lauded the policy's key role in protecting the Chinese population, and Li Qiang - who as Party Secretary of Shanghai oversaw the city's severe and lasting lockdown -

was promoted to the No. 2 slot in the new standing committee. The recent Omicron experience of regions including Australia's New South Wales, New Zealand, Taiwan, and South Korea likely played a role in the authorities' caution. Just like China, all of them had previously been able to withstand Covid but experienced extremely large and repeated omicron outbreaks after their respective re-openings, likely reflecting weak immunity due to low exposure to the virus(Figure 2). Moreover, China lags behind these regions' healthcare resources and high vaccination rates of vulnerable populations, such that a relaxation of Covid restrictions may indeed be some way off.

FIGURE 2: The Risk of Prior Successful Covid Restrictions



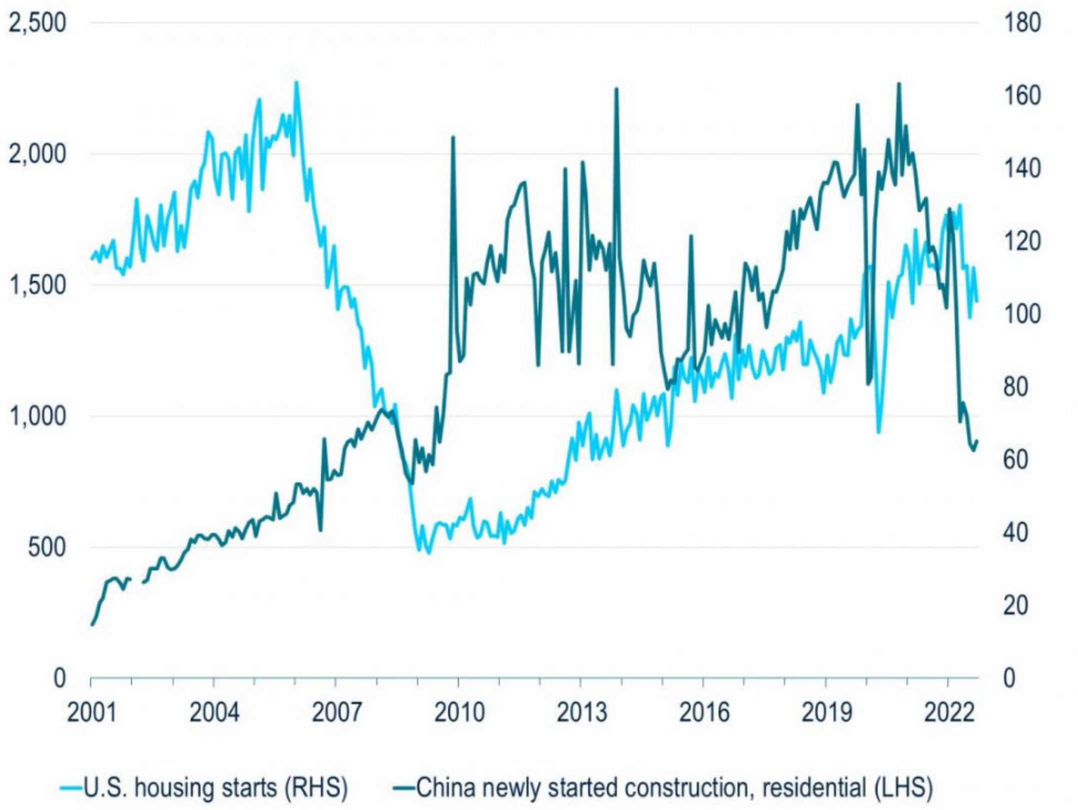
Source: PGIM Fixed Income.

The silver lining is that the near-term growth effects of maintaining the status quo are unlikely to be large, in contrast to what many investors and pundits suggest because these policies have now been in effect for almost three years and have not resulted in very different high-frequency mobility and impact data over the period. That does not mean that relaxing Covid restrictions might improve growth prospects going forward, since these restrictions have brought with them longer-term scarring effects, further fueling imbalances by raising household savings and lowering consumption.

No Floor for Property Sector

The Q3 data release confirmed China's economy contracted in H2, due to the free-falling property sector on the heels of the Three Red Line Policy that in turn led to a loss of confidence in properties as a safe asset among Chinese people. This policy severely curtailed new financing for property developers and subsequently forced them to raise cash via fire sales or stalling new projects (Figure 3). The sharp downtrend in a sector that accounts for a quarter of GDP and the vast majority of household wealth needs to be arrested, and the relevant policies, in our view, need recalibration.

FIGURE 3: China's Housing Sales are Back to 2008 Levels - Much Worse than in the U.S. and Elsewhere



Source: PGIM Fixed Income, National Bureau of Statistics of China.

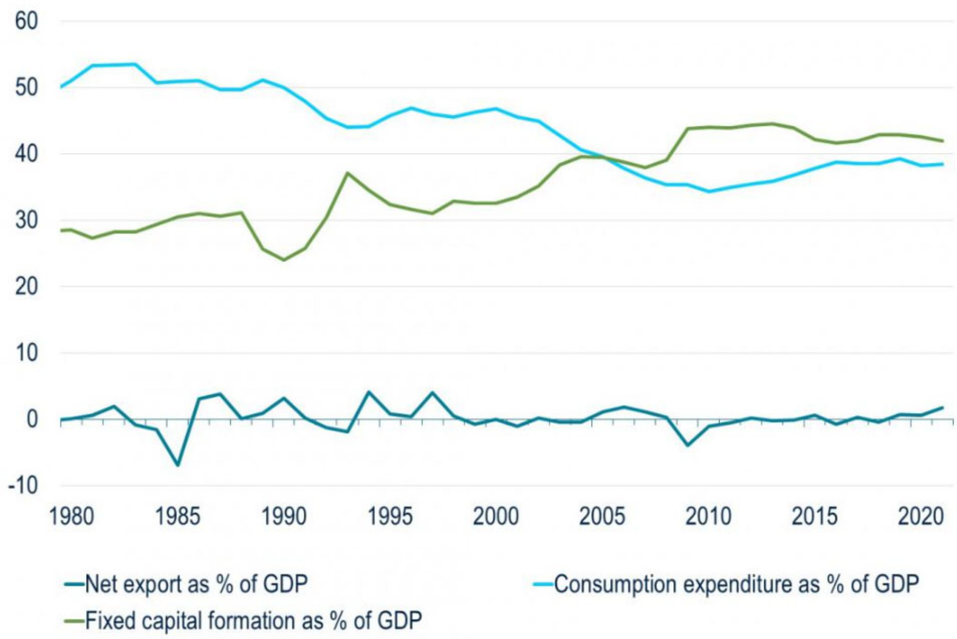
Unfortunately, there were few signs this issue was even on the agenda, and indirect references suggest that housing pain will continue. In particular, the statement "housing is for living in, not speculation," synonymous with the Three Red Line policy, resurfaced in the report. All the while, the very high property ownership ratio of Chinese households and the very large share of real estate assets as a percentage of personal wealth by international comparison suggest the oppositive: Housing is a key investment for Chinese households, and a loss of their confidence in the asset class imparts very large macroeconomic risk. The policy details from the party congress suggest that a deeper slowdown may yet be in prospect; if the intention is really to drain investment demand for property, construction will have significantly more to fall.

Investors will thus have to place their hopes in the supremacy of the broader economic-development objective, which should eventually trigger additional policy support, especially bigger fiscal stimulus. This is just one example - though a very important one - of the potential conflicts between the various policy objectives enunciated at the party congress: In this case, a desire to level the disparity between property-owning households and those priced out of the market. Redressing this inequity within currently devised policies, however, turns out to have severe economic costs. Economists tend to view this conflict as an equity-efficiency tradeoff. With respect to the Party Congress policy outlook, such tradeoffs are not limited to the near-term housing and GDP outlook but also concern the medium-term outlook.

Looking Back, and Looking Ahead - The Longer-term trend

Before turning to our medium-term outlook, it is useful to take stock of the outcomes of the last decade that marked Xi's first two terms. While many in the West continue to view China as a continuously growing economic behemoth for whom the sky is the limit, the numbers tell quite a different story. Even though the overall slowdown in growth was expected, the composition of growth defied the rebalancing objective, as investment still outpaces consumption and the switch toward consumption has stalled in recent years and growth has once again come to require a contribution from external demand (Figure 4).

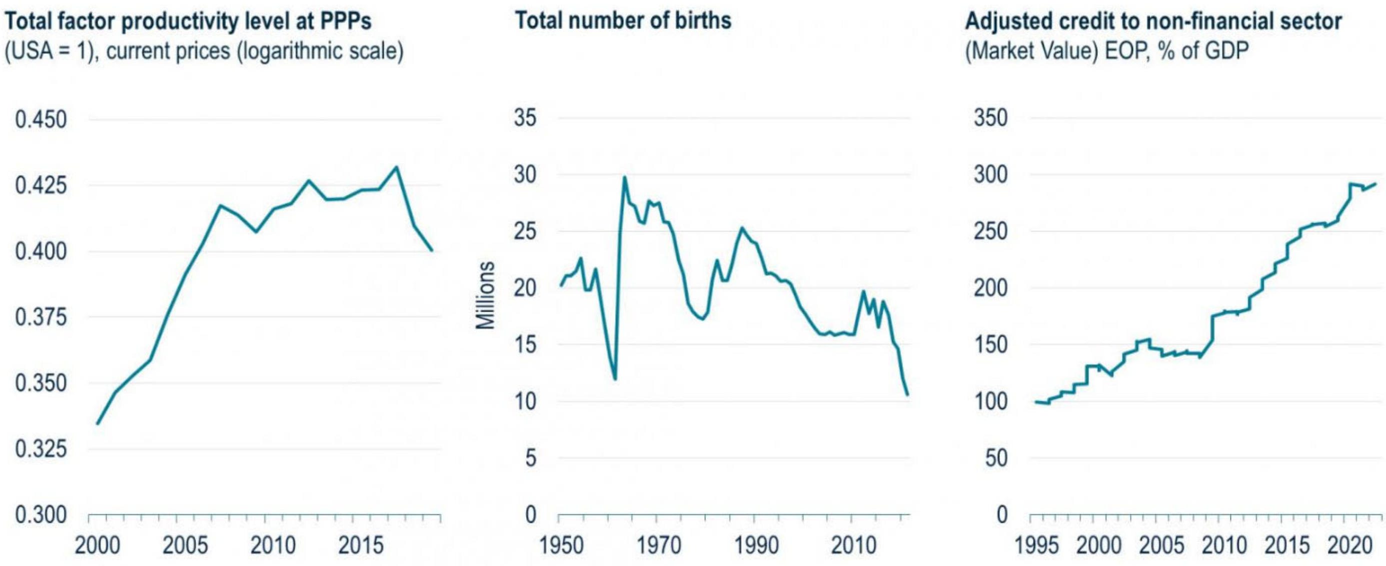
FIGURE 4: Growth Has Declined but Rebalancing is MIA



Source: PGIM Fixed Income, National Bureau of Statistics of China.

The contemporaneous occurrence of the expected slowdown in growth and the reversal in rebalancing depicts a worrying trend, which fundamentally reflects key factors of production and growth having ground to a halt or reached unsustainable levels (Figure 5).

FIGURE 5: A Tough Last Decade for Key Growth Drivers



Source: PGIM Fixed Income, Penn World Tables, BIS.

- This is most evident in the sharp decline of the birth rate, notwithstanding the phasing out of the one-child policy and subsequent incentives for citizens to produce larger families. While the party congress raised the issue, as it has in the past, no new policy steps were provided. However, new births (and/or immigration) would be essential to reverse a population downtrend. If population growth is not forthcoming, more reliance on capital and productivity will be required for any given growth rate to be sustained.

- Many observers, however, note that China may have reached the point of overinvestment, as China now invests more than other countries at similar development levels to generate the same growth and – crucially - more than those that successfully escaped the middle-income trap. Meanwhile, the rate of return on investment, especially in the state-owned sector, is quite low, according to the IMF. At any rate, China’s current debt ratio to soon above 300 percent of GDP limits any future spurts in investment.
- The absence of population growth and productive investments leaves productivity as the last engine of growth. The repeated mentions of the need for modernization and innovation in policy statements could suggest productivity reforms will be forthcoming. Yet, the last ten years - with similar policies in place - offer a sobering perspective. Productivity growth has ground down to some 0.7 percent on average over the five years pre-pandemic.

Given messages from the congress will form the basis for the country’s economic policy for the next five years, they do not suggest an optimistic outlook for China’s growth. Indeed, the congress suggests that policymakers have accepted their policy choices’ cost on growth. Perhaps the starkest indicator is that references to the goal of doubling China’s income levels by 2035 were dropped. There is a possibility, though, that these policies’ negative economic impact may be significantly higher than what policymakers currently assess. The official response to the so-far un-arrested property slowdown and the broader macroeconomic spillover over the coming quarters will be telling.

In summary, the party congress provided some clarity for investors, like us, who were puzzled by China’s increasingly evident deviation from prior policies and norms. Was China’s primary long-term growth objective being upended by an unfortunate series of exogenous adverse events? Or was a more fundamental policy shift underway? The congress suggests updating our priors toward the latter. This shift, in our view, carries important investment implications:

- First, China is not about to retreat in the face of external pressures, implying that event risk (e.g., sanctions, export controls) remains elevated and risk premia will likely have to rise, especially in credit and rates.
- Second, China’s policymakers seem comfortable with lower growth, at least for now. This will have an impact on equity and FX valuations.
- Third, China’s international footprint is set to change, due to efforts aiming to improve the security of its supply chains, food, and energy and to replace high-value-added critical imports. These shifts will have important spillovers internationally.
- Lastly, to the extent that the West’s policies resemble those of China, the world could be on a path to creating separate economic ecosystems and less globalization, with adverse implications for global growth and standards of living.

In short, the party congress shows that China’s tail risk - like so many other tail risks facing the world - has risen.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of October 31, 2022

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