

Issues to Watch in 2017

After a volatile year (or two), China-watchers are anxiously anticipating what the Year of the Rooster has in store for the world's second largest economy.

From the policymaker perspective, stability is the key goal for the coming months—a message declared unequivocally at the conclusion of the Central Economic Working Conference planning session in mid-December. The quinquennial National Congress will convene in November and President Xi seems poised to maintain stability at any cost ahead of his bid to consolidate power at the gathering. Achieving such serenity, however, will not be so straightforward in a post-Trump, post-Brexit world of slowing domestic growth, dwindling Foreign Exchange (FX) reserves, and a perilous debt burden. We outline below what we believe to be the ten most critical issues for the coming year, categorizing the obstacles into those related to foreign relations, economics, and domestic politics.

Foreign Relations:

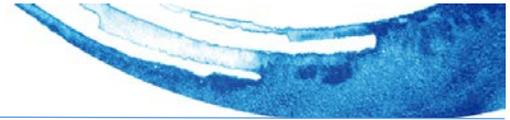
1. US-China Relations

Spoiled by decades of US leadership committed to the one-China policy, Beijing's top brass is bracing for uncertainty under a Trump presidency. Although onlookers assumed Trump was bluffing with his tariff and “currency manipulator” campaign rhetoric, several actions indicate he is more serious than was previously believed. The first worrisome sign was Trump's post-election phone call with Taiwan's president, a communication that broke nearly 40 years of taciturn precedent. Although Trump interprets the “One China” policy as a bargaining chip to motivate concessions in the trade arena, Beijing has stated unwillingness to compromise what it considers to be the foundation of US-China relations. It remains unclear which side will yield first, though experts caution Trump against kicking the proverbial hornets' nest without a strategic reason to do so.

The second disquieting signal is appointment of economist, author, and China-critic Peter Navarro to the White House National Trade Council. Fears of a potential trade war linger if the US decides to take action on Trump's 45% tariff plan, a plan which Navarro supports wholeheartedly. A range of economists hope that cooler heads prevail, warning that a trade war would severely harm both US companies and US consumers dependent on inexpensive imports from China. Such onlookers also doubt that taxing Chinese goods would bring back factory jobs, fingering automation over exportation as the real killer of manufacturing employment.

2. China's ascendance on the world stage

The retreat of US leadership coupled with President Xi's desire to consolidate his own power will likely result in a more assertive China in 2017. The power seeking is witnessed most obviously in China's aggressive marketing of the RCEP in the aftermath of the Trans-Pacific Partnership's (TPP) dissolution.¹ Also worth noting is China's massive “One Belt, One Road” (OBOR) infrastructure initiative, a mandate important both strategically and symbolically. By encouraging members of the Asian Infrastructure Investment Bank to both borrow funds and hire Chinese companies to build infrastructure, China seeks to solve its overcapacity and excess liquidity issues by effectively outsourcing industrial and financial resources. In addition to the strategic employment of OBOR as a release valve, the initiative will also bring symbolic prestige to China. The planned OBOR Summit in May is rumored to top 2016's G20 Summit in Hangzhou and could



serve as an official ‘coming out’ party to celebrate the country’s ascendance as a global power broker.

3. South China Sea

Although China’s adventures in the South China Sea receive considerable news coverage, much of it misses the point. The contested islands are a proxy, a symptom of other problems rather than an issue in and of itself. When China feels threatened or otherwise disrespected, the country launches military exercises as a way to showcase force. Facing a slowing economy and occasional domestic unrest, China leverages the South China Sea as a distraction. The country understands the risk calculus and seems to accept the prospect of regional war as a suitable way to divert attention from deeper structural issues and unite the populace against a constructed boogeyman.

Despite China’s relative inaction there in recent months, any new moves in 2017 will be closely analyzed. Beijing rebuffed The Hague’s July ruling sanctioning China’s territorial claims, but the legal precedent is important. It sets a benchmark to which China might officially be held accountable should controversy continue in 2017.

Economics:

1. Slowing growth

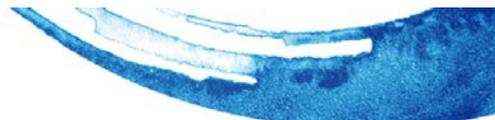
President Xi recently indicated openness to a sub-6.5% economic growth rate for 2017, signaling flexibility to revise targets downward if the stated 6.5% goal creates untenable and cascading risk. Preventing and controlling such risk will be a key goal in 2017, with emphasis given to avoiding asset bubbles rather than promoting economic growth—a lesson learned the hard way in 2015 and 2016.

It bears mentioning that given the scale of China’s economy, a growth rate closer to 5 or 6% is still impressive when compared with other major economies. Investors should also note that sectors such as internet, consumption, healthcare, education, and advanced manufacturing are growing much faster than the average GDP growth rate, offering investment opportunities.²

2. Excess credit/non-performing loans

Despite the noteworthy nature of a 6% growth rate, onlookers are worried about a slowing economy because of China’s corporate debt burden—a load estimated around 170% of GDP. The problem’s roots stem from the Global Financial Crisis. In 2008, China launched a USD 600 billion stimulus package, doling out funds to corporate and municipal borrowers to ward off the most deleterious effects of the liquidity crunch. According to the IMF, credit in China grew an average of 20% per year from 2009-2015, leaving behind a slew of issues related to the sustainability of non-performing loans in an environment of slowing economic growth.

To contend with these issues, “prudent and neutral” monetary policy will be a main theme 2017 as the central bank seems determined to curb excessive liquidity. After consolidating power through “Core” status last November, President Xi appears to be tolerant of the short-term pain caused by a tighter monetary environment. As for the most noteworthy aspects of his plan,



President Xi has announced stricter regulation of the shadow banking industry and launched 20 new municipal Asset Management Companies to help dispose of bad loans.

3. SOE Reform³

China's bloated state sector was a disproportionate recipient of stimulus funds, a fact evident in SOE's production of 40% of industrial assets and employment of 18% of the population. Despite this concentration of resources, the sector's returns are lackluster. Whereas private sector assets return 10.6% on average, SOE assets deliver a paltry 2.8%. To remedy the overreliance on uncompetitive state assets, top leadership announced aggressive SOE reform as a primary initiative in 2017. Strategic sectors like utility generation, oil and gas, railway, commercial aviation, telecommunication and military are expected to improve incentive systems and increase competitiveness through additional reliance on private investment. Bankruptcy too will be a major policy tool, with groundbreaking reforms in 2015/2016 establishing the legal infrastructure to accommodate failing companies in an orderly fashion.

The theory dictates that the mixture of carrots and sticks will force SOEs to adapt to a more competitive market economy, appeasing overseas investors long suspicious of China's state sector. However, not all onlookers support the methodology guiding the reforms. Some contrarians argue that the reforms will consolidate multiple underperforming SOEs into gargantuan conglomerates, resulting in monopoly and less market competition.

4. RMB depreciation and capital outflows⁴

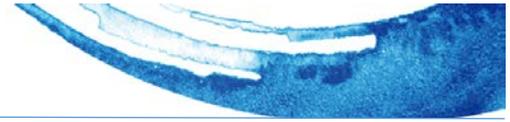
China has witnessed a vicious cycle of capital outflows in 2H2016, devaluing the RMB and in turn motivating further outflows. The US Fed's December rate increase has further hindered the RMB recovery, with projected US rate increases in 2017 forcing China to adopt stricter currency controls.

On the last day of 2016, PBOC and SAFE announced a series of measures to restrict the exchange and overseas transfer of RMB into USD, effectively tightening capital account control.^{5, 6} Although the annual USD 50,000 quota has not been reduced, Chinese residents will be required to provide more information about their planned use of the individual FX allocation. New rules were also announced forbidding individuals from purchasing FX for the purpose of investing in overseas properties, securities, or insurance policies. Although increasingly tolerant of two way volatility and a widened FX band, policymakers are expected to impose additional controls of this sort in 1H2017 rather than further deplete already-dwindling currency reserves.

Domestic Politics:

1. Xi consolidates leadership

All eyes are on November's 19th Party Congress, China's widely anticipated political transition that occurs every five years. Although it will only mark the beginning of Xi's second term, the gathering is important for several reasons. First, Xi is rumored to seek a third term. Although the extension would defy convention, it is neither illegal nor impossible—especially after Xi secured "Core" status in November 2016, assigning him the broadest possible control over the economy, military, and polity. The second important event is possible replacement of 5/7 members of



China's top decision making committee. The Congress could see ousting of Premier Li and promotion of anti-graft boss Wang Qishan. Some political onlookers in Beijing already consider Mr. Wang the second most powerful man in the party, behind only President Xi.

The combination of Xi's potential third term and Wang's heightened stature lead many watchers to believe that 2017 will be a year of political tightening. Although some liberal-minded onlookers worry about the potential for authoritarian overreach, others applaud the political concentration. The latter camp is hopeful that a united front could reverse the "two steps forward, one step back," mixed-message approach to policymaking that resulted in China's greatest economic missteps in 2015 and 2016.

2. Hong Kong and Taiwan

After spearheading the suppression of two pro-independence politicians on Hong Kong's Legislative Council in October, China's focus is back on Hong Kong following the resignation of Hong Kong's chief executive. In an environment of increasing pro-independence fervor, China is reportedly working behind the scenes to ensure election of a sufficiently loyal leader in the city-state's March 26th election. Despite rising discontent from those criticizing Beijing for overreaching, a major shakeup of the political scene is not expected.

Relations between Beijing and Taiwan are more contentious, however, with all official Cross-Strait channels of communication shuttered since the May election of President Tsai. The ill-will began with Tsai's refusal to acknowledge the 1992 Consensus on "One China," and has been amplified since Trump's Taiwan phone call. Although that exchange served as a confidence boost, the territory has been dealt several blows recent months. Aside from a faltering economy, Taiwan has seen defections from a range of nations including Sao Tome and Principe to Norway to Malaysia, whose collective recommitment to Beijing has lowered the count of nations formally supporting Taiwan to 21. Onlookers expect the coalescence of pressure to force Tsai to become increasingly, though begrudgingly, cooperative with Beijing.

3. Domestic unrest

Despite the government's best attempts to maintain stability ahead of November's Party Congress, China's slowing growth and increased political consolidation could represent a perfect storm for domestic unrest. Although the government is already attempting to push forward reform of the pension system, critics assert that a more robust social security net needs to be constructed if the state intends to implement the promised SOE restructuring and attendant layoffs that could displace millions. As new social security net will be expensive, fierce debate is anticipated over striking an appropriate balance between incurring further debt and risking political disruption.

Notes:

1. RCEP: Regional Comprehensive Economic Partnership
2. GDP: Gross Domestic Product
3. SOE: State-owned enterprises
4. RMB: Renminbi, the national currency of China
5. PBOC: People's Bank of China
6. SAFE: State Administration for Foreign Exchange