Research Institute - Insight

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#China / #Politics / #Growth

Here is what emerged from China's "two sessions"

Centralisation of power at the centre of government continues, while economic self-reliance is being prioritised.

Key Takeaways

- The "two sessions" has continued existing trends in Chinese policy, furthering the consolidation of power at the centre of government, focusing on scientific and technological development, and maintaining the foreign policy strategy.
- Centralisation of financial policy as well as research and development strategy will reinforce a top-down style of politics. This will enable China to pivot policy rapidly when needed, but also amplifies opaque decision-making processes, creating the potential for investor surprises.
- China's push for technological self-reliance will add tension to its relationship with the US. The decision to not change foreign policy course in the face of US pressure demonstrates that China is comfortable with increased geopolitical competition.

China commits to existing policy direction

China's "two sessions" — the annual meetings of the legislature (National People's Congress) and the political advisory body (the Chinese People's Political Consultative Conference) — laid out key changes to government structure, while providing a few clues to economic priorities and foreign relations as Xi takes the helm for his third term.

At a high level we can conclude that existing trends towards centralisation of power and an increased focus on self-reliance have continued. Changes to the regulatory architecture appear incremental, with new measures to de-risk the economy unlikely to be unveiled, constrained by the need to finish existing changes (real estate) and a need to put the economy on a firmer footing. Steps to buttress key strategic technologies, combined with further encroachment of the Chinese Communist Party (CCP) into China's data flows, are however likely to amplify tensions with the US.

Cautious 2023 GDP target tempers pro-growth rhetoric

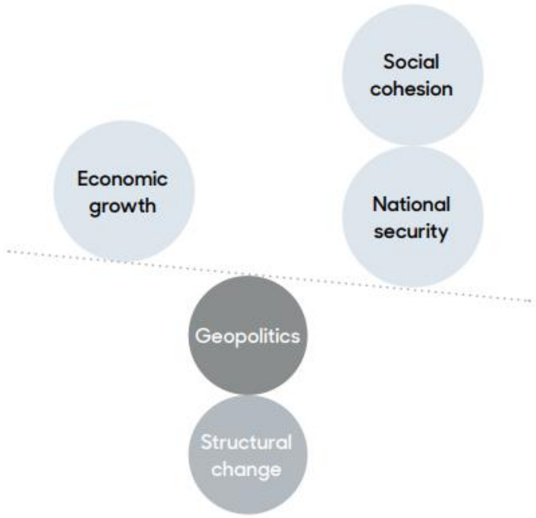
We continue to forecast an above consensus 5.7% GDP growth rate for 2023, driven by consumption and services rebounding decisively in H1 following the end of zero-Covid (for more see here). The government's relatively conservative growth target of "around 5%" implies some risk that policy support will be weaker than we anticipate, or that the policy priority set is not as growth friendly as recent rhetoric has implied.

Indeed, the new Premier Li Qiang noted that this year's growth target "wouldn't be easy" (even though it should be). This adds to other statements that set a cautious tone by emphasising resilience: "it is essential to prioritise economic stability and pursue progress while ensuring stability".

US-China tensions and other domestic policy priorities clearly mean that growth is increasingly competing with other aims, a point hammered home by President Xi, who stated that: "security is the foundation for development, stability is the prerequisite for prosperity".

But we believe that this caution is likely due to the large miss to the 2022 growth target and to the ongoing moves to de-emphasize headline GDP growth, rather than a signal that a 2023 economic recovery is slipping further down the pecking order. Indeed, while there are clear downside risks from a false dawn in property and the repairing of local government fiscal holes, the authorities are still providing more support in some areas, as illustrated by the 25bp reserve requirement ratio (RRR) cut in March.

Figure 1: A difficult balancing act



Source: abrdn, March 2023

Changes to government structure reinforce the centralisation of power

While it had already become increasingly difficult for observers to identify the boundary between the CCP and the state, the announced reforms put the CCP — and by implication President Xi — firmly in charge of policy across financial regulation and science and technology, offering less scope for government departments and local authorities to carve their own paths. Premier Li Qiang highlighted this point, noting "the job of this government is to carry out well and implement well the decisions and plans of the Party Central Committee".

Similarly, the revision to the National People's Congress (NPC) Legislative Law may offer an opportunity to modernise China's legal code, but consistent implementation, and the rolling back of local law-making powers, will put more power at the centre.

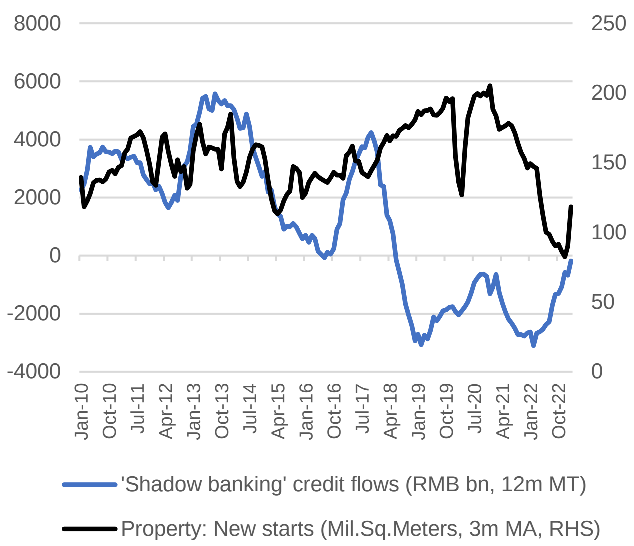
The NPC Standing Committee also gains emergency law-making powers; with "emergency" undefined, the scope for rapid pivots is clear. Being able to move quickly when an economy is undergoing rapid structural change can be optimal, allowing policy to look ahead, for example. But the centralisation of power in an opaque system — which will be able to change laws more quickly — implies that policy changes will have even more potential to surprise investors.

Bold headlines, but new regulatory architecture is an incremental change

A key question is whether the changes announced to financial regulation could signal an unexpected expansion of the de-risking campaign which began in 2017 with shadow banks, and turned its attention to property in 2021.

The new Central Financial Commission (CFC) takes over from the Financial Stability & Development Committee (FSDC) as the pre-eminent body shaping China's financial regulation. The FSDC had been chaired by President Xi's former economic tsar, Vice Premier Liu He, while the People's Bank of China (PBOC)'s Governor Yi Gang served as vice chair. In practice, financial regulations and coordination largely resided with the PBOC. And, while the new CFC may put more onus on the top of the Party for large regulatory changes, the PBOC will retain macroprudential oversight and still play a key role in influencing the setting of the regulatory perimeter.

Figure 2: Is de-risking a job half done?



Source: Haver, abrdn, March 2023

The transformation of the China Banking & Insurance Regulatory Commission (CBIRC) into the National Financial Regulatory Administration (NFRA) confers some additional responsibilities, specifically monitoring all financial firms outside of the securities markets. This moves China's overall regulatory architecture closer towards a "twin peaks" model, limiting the scope for firms to engage in regulatory arbitrage as supervision is conducted on entities (rather than activities) while the central bank concentrates on monetary policy and systemic risk.

While the "two sessions" announced a near bewildering array of financial committees, commissions and administrations reporting to various degrees to the Politburo or the State Council, China's regulatory architecture had already moved in this direction and the latest moves should be viewed in this context. The National Finance Work Conference — scheduled for mid-year — will provide a good crosscheck on this assessment.

The focus on science and data both reflects and amplifies US-China tensions

The push to become more self-reliant, which has been in train for some time via "dual circulation", got a further rhetorical boost as President Xi declared a "whole-nation system" was needed to advance interests in strategic technologies.

The Central Science & Technology Commission will play the key role in directing endeavours, and the Ministry of Science & Technology (MOST) will be increasingly focused on implementation and oversight. MOST will still be in charge of key areas such as semiconductors, but the shift to centralisation of policy making is unambiguous.

China has been at the forefront of efforts to harness the power of data, with new regulations treating data as another factor of production for a modern economy.

The new National Data Bureau is another step in this direction. Operating under the influential National Development & Reform Commission (NDRC), it has been tasked with promoting the digital economy and is also likely to be key in bringing stability (or otherwise) to a technology sector that has been rocked by sharp policy swings.

While much will depend on policy setting and implementation that we cannot be sure of, we are reasonably confident that these changes will contribute to ongoing US-China tensions. The Chinese decision to continue its current policy trajectory in the face of US pressure is likely to result in a similar "doubling down" in US policy, entrenching current issues. Of course, as we have written previously, the self-reliance drive is in part a natural reaction to actions undertaken by current and past US administrations. But unfortunately, it is also hard to conclude that firmer efforts to gain self-sufficiency will not amplify the technological arms race. Moreover, greater state involvement in data flows will add to US fears about technologies such as TikTok, as seen in the recent evidence session in the House of Representatives.

Foreign policy statements indicate China is more comfortable with open competition with the US

President Xi accused the United States of "containing, encircling and suppressing China" while Foreign Minister Qin Gang warned US policy was exacerbating conflict risks. This marks a more explicit criticism of US foreign policy than we have typically come to expect from China.

However, this did not come with any new policy announcements, making it unlikely that these comments in isolation will spark a further downturn in US-China relations. More likely is that we will see the CCP leadership become more comfortable with matching US language on active geopolitical competition, effectively bringing the rhetoric in line with existing policy.

With neither side likely to move away from their current foreign policy objectives, the US and China are moving towards an era of more explicit competition.

Despite this more open embrace of competition with the US, China has moderated its approach in other areas

The sidelining of notable "wolf warrior" diplomats, particularly across Europe, is a sign that this uncompromising tone will not be pursued everywhere.

Maintaining strong commercial ties in Europe is key to China's strategy for offsetting the risks posed by US relations. This will likely lead to a more subtle dissemination of Chinese foreign policy messages among US allies, as China seeks to prevent the emergence of a coalition that could undermine its strategic aims. China will continue to attempt to present itself as a reliable commercial partner, with the aim of creating doubts in the West over how necessary US hawkishness on China really is.

China-Russia relations remain a potential flashpoint

Xi's three-day trip to Russia reaffirmed China's commitment to its alliance with Russia, but lack of overt support for the invasion of Ukraine demonstrates clear limits to the relationship. President Xi is likely to continue to push his proposal for peace negotiations, while deepening bilateral ties with Russia. Despite the reputational cost to China among Western countries of aligning with Russia, China continues to see benefits from doing so.

In many ways these positions are contradictory: China is keen to present itself as a responsible actor on the geopolitical stage mending fractious relationships, as seen recently by its work brokering the restoration of diplomatic ties between Iran and Saudi Arabia. At the same time, strengthening diplomatic ties with states opposed to US hegemony, particularly autocracies like Russia and Iran, demonstrates China is now seeking to compete with the US in all spheres. Work to build anti-US alliances will continue, just as the US will seek to encourage countries in the global south to "pick a side" going forward.

Implications for investors

- The further centralisation of power keeps the door open for further policy surprises. However, the still relatively pro-growth tone suggests de-risking is not at the top of the agenda. Indeed, despite the notable reorganisation, the change to financial regulation appears incremental rather than wholesale.
- A greater prominence of industrial policy and protectionism on both sides of the Pacific will help some firms boost pricing power, but firms who benefit from globalisation will suffer. Infinitely scalable software is limited by technological fragmentation, for example.
- Over time, the weakening of globalisation via decoupling and regionalisation is likely to push down on potential growth and real equilibrium interest rates (r*). It may also steepen the "Phillips's Curve", implying greater need to hedge inflation volatility as the relationship between slack and inflation becomes more sensitive.

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