Economic Analysis

China | What to expect from the fifth plenum?

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The 200 members of the 18th Central Committee of the Communist Party are convening in Beijing this week for the Party's fifth plenum. The heavily-guarded meeting, which concludes tomorrow, will focus on the formulation of China's 13th Five Year Plan (FYP) for the period 2016-2020. Some staff changes may also be announced. Although the content of the 13th FYP may not be finalized until next March, after it is ratified by the National People's Congress, the outcomes of this week's meeting will set the tone for China's economic policy making over the next five years. The implications are all the more important at this juncture, a time when China's growth is subject to increasing growth headwinds from the debt-laden corporate sector, volatile domestic financial markets and accelerated capital outflows. In order to inspire confidence in the Party's ability to steer China through times of economic turbulence, Xi Jinping needs to deliver on his promises for reform. In particular, we anticipate that the outcomes of the meeting will set a policy direction that: 1) steers away from purely quantitative growth targets, focusing instead on aspects related to the quality of growth; 2) stresses the need to spur overdue state-owned enterprise (SOE) reform, while simultaneously deepening financial reforms; 3) promotes "green economic" development and innovation; 4) addresses issues related to China's ageing population; and 5) formally acknowledges China's "One Belt, One Road" (OBOR) strategy.

- **More focus on the quality, instead of quantity of growth.** The market is following the events closely, for it is expected that the new growth target for the 13th FYP period (2016-2020) will be announced shortly. The consensus formed by other market analysts is hinting towards a growth target of 6.5% for the period 2016-2020, lower than the 7.0% for the period 2011-2015. Whereas generally we agree with this point, we also anticipate that the authorities will downplay the importance of an overarching hard target. Instead, they are likely to shift the focus to the quality of growth.
- **The need to spur SOE reform…** Another area that will be highlighted in the fifth plenum is the need to prioritize SOE reforms. China's corporate debt has soared alarmingly since the global financial crisis and is now six times bigger than it was in 2007, equivalent to 156.7% of GDP in 2014 compared to 98.3% in 2007. The rising debt level is more pronounced among SOEs, exacerbating concerns regarding the efficiency of China's national champions. Our estimates show that the return-on-assets of state firms are 33% that of private firms and 50% that of foreign enterprises. In October this year, the State Council issued a set of measures that aim to "modernize SOEs, enhance state assets management, promote mixed ownership and prevent the erosion of state assets". However these were underwhelming and generally lacked substance. The Plenum gives the authorities another chance to clarify their plan for reform, thereby reinforcing people's confidence.
- **…while simultaneously deepening financial reforms.** One area where there has been significant progress is that of financial reform. Interest rate liberalization has been advanced very successfully, with the deposit rate ceiling completely lifted as of last week, in line with our expectations. But reforms in the financial sector are still on-going. In particular, we expect that the fifth plenum will highlight the need to move towards a free floating currency and fully liberalize the convertibility of the RMB under the capital account by 2020.
- **Boost "Green Economy" and promote innovation.** In keeping with the drive to shift towards slower growth of better quality, the Plenum could introduce an avenue for addressing looming pollution concerns. In addition to announcing a number of new pledges – like a coal consumption cap and more clarity regarding the establishment of a national emissions trading system – the Plenum

could also result in more support for the development of China's "Green Economy". Again, it is unlikely that full details will be unveiled until early next year, but support could be in the form of a favorable legislative environment – by drafting the pledges into domestic the legislation – as well as fiscal support to industries of strategic importance, namely solar and wind. Similarly, the Plenum will also elevate the importance of achieving higher levels of endogenous innovation in order to move up global value chains. We expect the support to follow the "Made in China 2025" plan, announced earlier this year. This plan seeks to pursue innovation-driven and green development, apply smart technologies and enable China to transition from being a manufacturer of quantity to one of quality.

- **One Road One Belt.** We anticipate that the 13th FYP could include the successful implementation of the OBOR strategy as one of the targets – even if no quantitative goals are introduced at this stage. China has amassed an impressive amount of foreign reserves, equivalent to roughly USD 3.8 trillion in 2014. An estimated two-thirds of these reserves are held in USD denominated assets, primarily low-yielding government bonds and institutional bonds. Beijing could use foreign investments via the OBOR as an alternative to holding government debt securities. Finally, Chinese ODI is a relatively new phenomenon, so its global stock remains underrepresented compared to other major economies. In addition, the OBOR could help China to export part of its overcapacity, particularly in the construction, steel and equipment sectors.
- **Promote a sustainable model of urbanization.** China's population is ageing, which not only leads to a tighter labor market, but also adds pressure on the country's welfare and pension systems. Therefore, it wouldn't be surprising to see a relaxation of the "One-Child" policy and *hukou* system feature as part of the 13th FYP. The former would increase plummeting fertility rates while the latter would enable more equitable access to the country's welfare services.

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