

October 2, 2017

## **The 19<sup>th</sup> Party Congress**

On October 18<sup>th</sup>, the Communist Party of China (CPC) will meet for the 19<sup>th</sup> Party Congress. China's leadership for the next five years will be determined at this meeting.

In this report, we will offer a background on China's government, focusing on the difference between *de jure* (what is the official structure of China's governance) and *de facto* (how it really works). From this discussion, we will examine the likely developments from this meeting and what they will mean for China and the world over the next five years. As always, we will conclude with potential market ramifications.

### **China's Government (Official Version)**

China's government has a parallel structure. The CPC operates alongside the government of China. Since the CPC is the only political body in China, the governance of China is dominated by the CPC, but there are elements of power that are separate from the party. For example, Xi Jinping is both the President of China (head of government) and General Secretary of the Central Committee (head of the CPC). He is also the Commander in Chief of the People's Liberation Army. There exists a National Party Congress (as noted below, the most powerful body in China, at least in theory) and a National People's Congress, which is the primary legislative arm of the government. The President has a strict legal limit of two five-year terms, while the General Secretary's term limit is based on

tradition. In theory, a General Secretary could remain in that role after relinquishing the presidency. This extended control of the CPC hasn't happened since Mao Zedong,<sup>1</sup> who remained in control of the party from 1943 until his death in 1976. Deng Xiaoping brought order to the transition of power, and since then General Secretaries have held office for 10 years, consisting of two five-year terms.

China's most powerful body is the National Party Congress. It meets every five years; in 2012, it had 2,268 members.<sup>2</sup> Its primary job is to elect the Central Committee. The Central Committee, which had 376 members in 2012, elects the General Secretary, the Politburo and the Standing Committee of the Politburo. The Politburo consists of 25 members and is the executive body of the CPC. The Standing Committee of the Politburo has seven members, all of which are also members of the Politburo. The Central Committee meets annually, while the Politburo meets monthly and the Standing Committee of the Politburo meets weekly.

Thus, in theory, the most powerful body in China is the National Party Congress. The second most powerful is the Central Committee, followed by the Politburo and the Standing Committee of the Politburo.

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<sup>1</sup> Mao was referred to as "Chairman of the Central Politburo" or "Chairman of the Central Committee."

<sup>2</sup> As a point of reference, the CPC has 85.13 mm members out of a population of 1.4 bn, roughly 6.2% of the population.

**China's Government (Actual Version)**

The Standing Committee of the Politburo is the most powerful body in China. The Standing Committee and the Politburo select the members of the National Party Congress. The Central Committee essentially ratifies the selections made by the Standing Committee of the Politburo. The National Party Congress and the Central Committee provide two roles for the CPC. First, they give the veneer of democracy. Although the CPC doesn't represent a large number of Chinese, maintaining the myth that a fairly large number of party members select the highest officers of the CPC does suggest modest local input. Second, these two bodies are something of a "minor league" for future leadership. Senior leaders within the CPC put their favorites into the National Party Congress and the Central Committee not only to enhance their own power base but to also raise the profile of their protégés for potential future elevation.

It should be noted that the official structure has mostly been in place since the early beginnings of the CPC in 1921. However, in practice, the CPC wasn't part of government until the Communist Revolution in China successfully ousted the Nationalists in 1949. Mao controlled the CPC after the revolution until his demise in 1976. Although a governmental structure was in place, in reality it didn't do much more than execute the whims of Mao. After his death, there was a period of uncertainty on how to actually govern China. Deng Xiaoping ousted the leadership that Mao had put in place at the time of his death and began to create the structures that remain in use today.

Deng's primary goal was to avoid another cult of personality that Mao fostered. For this to work he had to create a structure that would allow for the peaceful transfer of

power. A consistent transfer of power would require mechanisms that prevent a general secretary from holding onto power. In a single-party system, the selection process of new leaders occurs within the party. By consistently cycling new leaders into power, China can avoid the ossification that often occurs in single-party states.

General Secretaries have their allies and protégés. Thus, when a General Secretary's second term ends, his influence lives on in those aligned with him that he has groomed. However, as time passes, this generation "ages out" and younger party comrades, usually tied to a younger General Secretary, gain power.

In practice, new General Secretaries and Premiers<sup>3</sup> are appointed during the "even years" Congresses. However, the former General Secretary usually appoints his cronies who are also competing for positions with the allies of the previous General Secretary. Thus, the incoming General Secretary has a Standing Committee that is not filled with his allies. This gets rectified in the second term. After the first term, many of the former General Secretary's appointees have "aged out" and the current General Secretary now has the opportunity to fill the Standing Committee with his allies. Unlike the American system, where a president is at the peak of his power at the inauguration of his first term, in China's system, a General Secretary has more power in his second term.

Deng didn't create a series of rules but instead built traditions that act as rules. For example, members of the Politburo Standing

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<sup>3</sup> In China's system, the Premier is second in command on the Standing Committee and usually has the mandate for economic policy. This name causes confusion among Westerners, who expect the Premier to be the superior position.

Committee are expected to retire at 69. This practice prevents a former General Secretary's allies from staying in power for an extended period. A General Secretary is expected to only serve two consecutive terms. This guidance is also designed to preclude a General Secretary from staying in power indefinitely. Although these are not statutory measures, CPC leaders have adhered to these measures even without the force of law.

The primary reason successive administrations have maintained Deng's guidelines is due to the trauma this age group experienced during the Cultural Revolution. The Cultural Revolution occurred because Mao was attempting to regain his influence after the disastrous "Great Leap Forward."<sup>4</sup> Mao's prestige fell after the Great Leap Forward's failure; in 1959, he resigned from the presidency of China and senior CPC members began to question his ability to lead. After stewing for seven years, Mao lashed out by claiming his enemies were bourgeois counter-revolutionaries who were trying to bring capitalism back to China. Mao created a massive reaction against the established leadership of the CPC; led by students and lower level workers, party leaders were sent to the countryside for "re-education," precious artifacts from Chinese history were destroyed and social order broke down. The Cultural Revolution rocked China's

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<sup>4</sup> Mao's economic plan was essentially to boost economic growth by collectivizing farming and focusing industrial activity on making steel. The program was an abject failure; much of the steelmaking occurred in small facilities in rural areas that turned out lots of poor quality pig iron. Agricultural collectivization reduced food production but farm managers lied about output to meet Mao's goals. Mao then forced the farms to export foodstuffs to gain hard currency and ended up reducing the food supply to dangerously low levels, leading to a horrific famine.

leadership to its core; education was seen as corrupting and former leaders were suspected of disloyalty. The social disruption has scarred at least three generations of Chinese leaders.<sup>5</sup> In the wake of the Cultural Revolution, Chinese leaders, though naturally wanting to expand their personal power, have acquiesced to Deng's guidelines due to their residual fears of personality cults.

In the wake of the Cultural Revolution, the CPC has created a leadership transition method that has worked rather well. Change comes slowly; the pattern of previous allies in the Politburo and on the Standing Committee prevents a General Secretary from making aggressive policy changes.

However, two dangers lurk within this system. First, sometimes a nation needs radical change. Foreign events, economic restructuring, internal dissent, environmental problems, etc., can create conditions where impediments to aggressive action can cause a crisis or prevent effective action to stop a crisis. Deng's structure impedes aggressive actions to change policy. Second, the next generation of leaders, the one that replaces Xi, will have mostly been spared direct injury from the Cultural Revolution. Although Deng's unwritten rules have prevented a new cult of personality, "intergenerational forgetfulness"<sup>6</sup> will, at some point, ask why a leader should be restricted by rules that are not codified.<sup>7</sup>

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<sup>5</sup> It should be noted that Xi himself was forced into the countryside and forced to denounce his father, one of the founders of the CPC.

<sup>6</sup> A term we use to describe how the initial reasons for implementing policy are steadily forgotten by successive generations until eventually the policy is overturned by a generation that is only aware of its costs and has become inured to its benefits.

<sup>7</sup> A classic example is Franklin Roosevelt, who held the presidency for three full terms and was elected to a fourth. Up until his presidency, administrations

Thus, over time, there are rising risks of a General Secretary deciding to stay past 10 years, especially if there is a significant crisis that needs to be addressed.

### **Specific Issues for the 19<sup>th</sup> Party Congress**

Although this will be Chairman Xi's chance to assemble his own Standing Committee, he will still face some competition from remnants of the Hu regime. There is some speculation that Wang Qishan, who has led Xi's anti-corruption campaign, will remain on the Standing Committee even though he is over the unofficial retirement age of 69. Given that the current Standing Committee members, save Xi and Li Keqiang, are older than 69, we would expect five current members to exit the Standing Committee later this month.

The biggest issue won't be openly discussed, although it is an issue that is often acknowledged. China has very unbalanced growth. Its investment levels are quite high but its domestic saving is even higher, which is why it runs persistent current account surpluses. This investment has mostly been funded by high levels of debt. The Chinese economy needs to rebalance by shifting a larger share of income to the household sector and away from the rest of the economy. There are three ways to accomplish this. The first is by maintaining rapid growth but boosting household incomes even more. There is nothing in the historical record of any nation doing this; virtually all nations that have developed since the industrial revolution have done so by rapid increases in investment. Investment needs to slow dramatically. The problem is how to maintain growth—if

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had voluntarily limited themselves to two terms, mostly due to the precedent established by President Washington. After Roosevelt, the U.S. Congress passed the 22<sup>nd</sup> Amendment which codified a two-term limit for presidents.

households rapidly increase spending they would probably need an even larger increase in income. The permanent income hypothesis suggests that it would take time for that spending to materialize and would also require significant structural changes.<sup>8</sup> Even if household incomes are forced higher, through wage policy and transfer payments, the mostly likely initial response would be higher household saving which would exacerbate the current imbalances. The second method is a depression, where the economy's growth falls sharply but household incomes fall less sharply. This rebalances the economy but with enormous costs. The third (and most likely) outcome is the Japan option—China's growth will slow to around 3% with household income growth also falling but exceeding investment growth. Over time, the current bad debt problem would stop getting worse and could eventually be addressed.

The key issue here is not economic but political. History suggests there are two ways to deal with this issue politically. One is to become openly democratic, which will take power away from the CPC elites and support household incomes at the expense of the wealthy and powerful. The other option is to aggressively centralize the government and force the elites to steadily lose their income and wealth advantages. It is rather obvious that Chairman Xi is going in the latter direction. He has spent his first term centralizing power and using an anti-corruption campaign to undermine opposition. We expect him to start addressing the economic imbalance problem in his second term.

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<sup>8</sup> The U.S. faced this problem in the 1930s. One of the tools used to boost spending and reduce saving was the introduction of Social Security. And, even then, it took a number of years to change American household spending habits.

What do we expect? First, the banking system will consolidate. Small banks, usually larded with bad loans and insecure funding, will be forced to merge with the large state-owned banks. The bad debt problem will be resolved over time. Second, resources will be shifted from the CPC elites to the household sector. Although this move will be unpopular within the party, it will likely be welcomed by the population.<sup>9</sup> To make this happen, Chairman Xi will need to consolidate power; in fact, he will probably need to wield the most power by a Chairman since Deng.

If this doesn't happen, China won't rebalance and the risks to the economy will worsen. We don't know if Xi will be successful but it does appear he is putting everything in place to take these steps. We don't see a crisis in China as necessarily inevitable, but we are quite confident that the current model of China's growth is nearing its expiration date. "Kicking the can down the road" is probably not an option.

Thus, the 19<sup>th</sup> Party Congress may be the most important one since the late 1970s because this is the one where Xi needs to

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<sup>9</sup> The high levels of observed capital flight from China are probably a function of high-placed, wealthy CPC members who fear their holdings will eventually be lost and thus they are trying to move funds offshore.

consolidate power and put the Chinese economy on a new path, preserving the status and power of the CPC. That is a tall order but it does appear to us that he is preparing for this moment.

### **Ramifications**

For markets, the biggest shift would be a slowdown in China's growth. Commodity markets could be vulnerable and emerging markets that sell to China could be at risk as well. China will try to use its "one belt, one road" program to dampen the effects of the restructuring (imperialism is another method of dealing with the shift away from reliance on investment), but we doubt it will ever be of sufficient size to fully offset the shift from investment to consumption. At the same time, China would become a source of slower, but steady and more reliable growth.

Our base case is that Xi will be successful in making this change. However, if he is not, the impact on global markets could be profound. Wars could potentially develop; the CPC may be unable to maintain control. Again, we don't expect this outcome but it is a possibility we will be monitoring in the coming years.

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