

*March 5, 2018*

## **Emperor Xi: Part I**

On February 25<sup>th</sup>, the Central Committee of the Chinese Communist Party (CPC) announced that it would recommend an end to term limits on the offices of president and vice president. Previously, an officeholder was limited to two five-year terms. We fully expect the recommendation to be approved (recommendations from the Central Committee are always approved). Thus, President Xi Jinping will be able to maintain his current position beyond his second term, which ends in 2023.

Although there were clear indicators that Xi intended to stay in power beyond 10 years, the timing of the announcement was a surprise. As we will discuss below, it's not obvious why this action was even necessary. The president's role is mostly ceremonial; the real power resides with the general secretary of the CPC, which has no term limit.

We see this move as part of a much broader trend in China's evolution as a regional power. President Xi has situated himself as the central figure in this evolution. This week, we will discuss China's power structure and how this suspension of term limits changes recent precedents. From there, we will examine what President Xi has done in his first term to consolidate power and prepare for the next phase in China's transformation. The next area of discussion will be the reasons for moving now and what it potentially signals about Xi's view of his power and political capital.

In Part II, we will examine China's challenges of shifting from the world's high growth/low cost producer to a slower growth, "normal" economy. We will show how these challenges fit into China's overall geopolitics and Xi's response to these constraints. From there, an analysis of America's policy toward China in the postwar era will be offered with specific discussion on the critical assumptions regarding democracy and markets that have clouded policymakers' expectations toward China. Finally, we will conclude with market ramifications.

## **China's Power Structure**

China's governance has three offices of power. The president is the head of state. The primary role for this office is to represent China on state visits. The general secretary of the CPC is the most powerful office in China because the country is a single-party government. The third office is the commander in chief of the military. Although an important office, the People's Liberation Army (PLA) was, for most of the postwar period, a force focused on maintaining internal order and thus was not all that powerful. That framework has been changing. Xi Jinping currently serves as general secretary, president and the chairman of the Central Military Commission.

Mao Zedong, who mostly held the office of general secretary, was the prime revolutionary leader. However, he developed a cult of personality and implemented two disastrous policies, the "Great Leap Forward" and the "Cultural Revolution," that led to millions of deaths and great societal tumult. Each generation

of leaders since Mao's death has been affected by the Cultural Revolution. Mao's successor, Deng Xiaoping, was determined to avoid another iteration of Mao and thus created a structure of collective leadership with specific term limits.

Governmental transfers of power are often fraught with risk; one of the major benefits of democracy is that elections convey legitimacy to an incoming successor. In other forms of government, the incumbent usually selects his successor and, in the absence of term limits, the incumbent tends to choose an heir-apparent that isn't an immediate threat to power.<sup>1</sup> Deng seemingly addressed this issue by allowing the incumbent to select the next general secretary with "guidance" from CPC elders. Implementing term limits was a key element of Deng's reforms; although unwritten for the CPC and the commander in chief, leaders generally accepted that they would serve two terms and leave office. In addition, age limits were established, which meant that anyone over the age of 65 could not be appointed to the Standing Committee of the Politburo (a body similar to the U.S. cabinet) or accept a second term as general secretary. The age limits prevented a "gerontocracy" from developing; authoritarian regimes are prone to such developments and aging leadership can lead to stagnation. Finally, because the leadership knew their time in office was short, they tended not to eliminate opponents because, once out of office, the cohorts of a disgraced figure could move against a former leader who would be vulnerable without the protections of office. This understanding reduced the chances that

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<sup>1</sup> A recent example of this condition is Hugo Chavez appointing Nicolas Maduro. Maduro was generally considered to be no threat to Chavez. However, when Chavez died, Venezuela was left with a suboptimal leader.

a losing rival would face imprisonment or worse from the winner.

After the tumultuous years of Mao, China enjoyed a series of peaceful transfers of power because of these changes. However, the plan wasn't perfect. Because there was little fear of purge due to the short stints in office, corruption flourished. While China enjoyed robust growth, the impact of corruption was thought to be manageable. However, corruption did undermine confidence in the CPC, and the costs of corruption would become more difficult to manage if the economy stumbled.

### **Recent Actions**

General Secretary Xi's first term in office, which began in 2012,<sup>2</sup> was characterized by widespread actions against corruption. Hundreds of cadres were arrested, including several high-ranking officials from previous administrations. Given the rampant corruption in China, it wasn't difficult to find violators. The surprise was that Xi was making lots of enemies and was sure to face scrutiny for his own behavior once he left office. In addition, there was grumbling that Xi was using the anti-corruption campaign to eliminate political enemies. The anti-corruption campaign was a clear break from precedent.

He also bypassed much of the Standing Committee of the Politburo by creating working groups that were usually headed by loyalists who reported directly to Xi. This action reduced the influence of rival factions that were usually associated with former general secretaries. Thus, the influence of older leaders was undermined.

Xi has also aggressively supported a personalized form of nationalism. Political leaders of all stripes in all nations tend to

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<sup>2</sup> Xi took the office of president in March 2013.

support some degree of nationalism. Xi's particular twist was to elevate his thinking on the constitution in such a manner to be on par with the "thinking" of Mao. This development made any criticism of Xi or his policies a direct attack on the CPC and China. This personalization has been accompanied with steady restrictions on speech in China. The internet has been increasingly censored and there are restrictions on gaining access to outside information. For a while, internet users were able to employ virtual private networks to evade the "great firewall," but reports suggest that recent attempts have become less effective. Xi has also pressed foreign publishers and technology platforms to adhere to Chinese rules. If anything, China under Xi has become less liberal.

Finally, at last October's CPC meetings, Xi made it clear that he wouldn't appoint an heir-apparent. Since Deng, general secretaries have indicated who will replace them when they begin their second (and presumably last) term in office. Given that Xi refrained from signaling a replacement, there has been growing speculation that he might be planning to stay for another term. He also selected a Standing Committee with more allies and is continuing to use working groups to isolate rivals.

### **Why Now?**

The decision to end term limits, by itself, was not completely unexpected. When Xi didn't choose a successor for general secretary, he signaled an intention to remain in office. Additionally, there is no written rule preventing Xi from staying in charge of the CPC or remaining as commander in chief. However, the constitution does restrict the presidency and vice presidency to two terms. To stay on as president, Xi would need to change the constitution.

Even in authoritarian regimes, leaders have limited political capital. Every leader, despite efforts to suggest otherwise, faces opposition. Not every policy is going to be universally favored. Thus, when any political leader endorses a policy, he uses political capital, essentially everything from favorable sentiment to the ability to offer favors, to support that policy into fruition.

What is interesting is that Xi is using up political capital for a small benefit. The only official duty that China's president performs is the representation of China on state visits. If Xi had given up the post of president and visited another country, he would not have been received as the representative of a foreign state. Other than a parade, it isn't obvious that this was a major impediment to ruling China or being seen as the leader of China by foreign governments.

The other surprise was that he made this decision so early in his second term. The timing of this decision suggests either (a) Xi feels he is unusually powerful right now and wants to act while he can, before his political capital diminishes over time, or (b) he feels rather insecure and wants to leave no room for anyone to doubt his authority.

The general read from China watchers is that urban professionals and long-time members of the CPC are uncomfortable with this policy change. The former are worried that as Xi amasses power he will be able to implement policies that could harm them and they will have less ability to protect themselves as opportunities for foreign investing are restrained. The latter remember the Cultural Revolution and an all-powerful Mao, raising concerns that giving a leader this much authority without term limits increases the potential for similar purges.

The strongest support for Xi, outside his immediate circle, appears to be from the less affluent and rural citizens. They like Xi's strong nationalism and appreciate the anti-corruption campaign that led to the comeuppance of lesser CPC officials who preyed on the poor.

At the same time, Xi properly understands that China faces formidable adjustments. Xi's predecessor, Hu Jintao was seen as ineffectual; it does appear Hu was well aware of China's predicament but lacked the power to execute change. We suspect that Hu's failure to address China's problems has prompted the preponderance of senior CPC leaders to acquiesce to Xi's rise. It is doubtful that he has overpowered all of them, nor are all of them likely allies. But, they undoubtedly understand the issues China is facing and have concluded that the

only way to resolve them is to consolidate power with the general secretary and give him the authority and time to make the painful adjustments required. At the same time, Xi now "owns" the problem—he has been given ample authority to act and, if he fails, he will be fully responsible.

## **Part II**

Next week, we will continue this report with the challenges China faces by ending its role as the world's high growth/low cost producer. We will examine China's geopolitics and show how it affects the process of ending the high growth/low cost producer role. We will conclude with a reflection on U.S. policy toward China and market ramifications.

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