



## China's New Era

### **Oxford Analytica Open Conference Call summary**

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Addressing the five-yearly Chinese Communist Party Congress in October, President Xi Jinping proclaimed a 'new era' in which China will assume a more active role in international affairs for the good of humankind.

The Congress saw Xi, China's most powerful leader in decades, further strengthen his hold on the country's politics. A leadership reshuffle filled the Politburo with his allies and associates, and gave no sign that Xi is grooming a successor, suggesting that he intends to remain China's leader until 2027 at least. Xi's name was written into the Party's charter, equating loyalty to the Party with loyalty to him, as were slogans representing his signature policies, foremost among them the Belt and Road Initiative.

### **What should we make sure we understand about Xi's China?**

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There are three key points to make.

- This leadership is not an autocratic leadership. The political report Xi presented to the Congress suggests a new agenda, and some aspects suggest new directions for China. Regarding the extent of Xi's power, it is important to remember that China has a collective leadership. The new seven-member Politburo Standing Committee, which is the top leadership committee and makes the most important decisions, has followed the strict rules for appointments. No members are over 67 and all have held key ministerial posts. This is not a committee of sycophants. A number of Xi loyalists have joined the wider 25-member Politburo.
- For the first time since 1989, the Politburo Standing Committee does not include a nominated successor -- a potentially destabilising change. However, some members will be eligible to remain on the committee at the next reshuffle in 2022, so there will be some continuity at least.
- Regarding the importance of the inclusion of Xi's personal ideology into the Party's charter, incorporating new ideology into the constitution has in the past indicated that important political differences have been settled, such as the idea introduced by President Jiang Zemin in the early 2000s that the Party represents businesspeople as well as workers and officials. However, it is not clear that including 'Xi Jinping Thought' does something similar because it is not clear what issue this is supposed to have settled.

Xi has not become a 'pope' who can set doctrine. Domestic politics will continue. The group of men who govern China with Xi have their own views on how China should develop.

The amendments to the Party constitution clarify some of the things that we can expect to see in China and the most important is the redefinition of what is called the 'principal contradiction'. Previously this was the contradiction between the proletariat and the bourgeoisie in the Mao period. The Xi era version is the contradiction between unbalanced development and people's need for a better life. There is a new focus on regional distribution and inequality.

On foreign policy we will see a more confident and strident China.

In terms of the economy, two priorities may be reform of the fiscal system and reforms to health and social insurance.

## **What does Xi's 'new era' mean for the world?**

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We are going to see a more confident and assertive China. What we saw at the Party Congress was a clear declaration from Xi is that the Deng Xiaoping era is over. The period of 'reform and opening' is over. In foreign affairs, China is not 'hiding its capabilities and biding its time' anymore.

However, it would be wrong to see this more confident China as one that will become even more assertive in the South and East China Seas. The second Xi administration will not be soft, but it will not focus on expanding in those areas. The South China Sea situation has stabilised with the coming to power of President Rodrigo Duterte in Manila. Whether this lasts is another issue, but China is keen to avoid problems in that region.

The centrepiece of the new confident foreign policy is the Belt and Road Initiative, which has also been written into the Party constitution. It is China's signature foreign policy and it will not be allowed to fail regardless of cost. The Belt and Road Initiative will be the most important driver of Chinese foreign policy over the next five years if not longer.

The relationship with Taiwan will get tenser and more difficult but the People's Liberation Army is in no position to invade; it is being reorganised and it will be years before it is ready for operations outside China.

In Hong Kong, there will be more pressure from Beijing and less scope for young activists to push for anything in terms of autonomy and democracy.

To understand China's North Korea policy we need to go beyond the conventional national interest calculations and see it about the Communist Party's interests. The Party is not seeking to solve the North Korea issue for the benefit of the United States, but merely to contain it while avoiding pushing the regime to the brink of collapse.

The relationship between China and Japan is difficult and will need to be managed carefully. The Chinese government does not trust Prime Minister Shinzo Abe and will question his real intentions. Abe has managed to project that he is being as friendly as could be expected towards China while cementing a strong personal relationship with US President Donald Trump. He will not take steps that make China uncomfortable in spite of the rhetoric. The Chinese are not overly worried about Japan getting nuclear defence capacity as a result of the nuclear and missile tensions with North Korea.

## **How is the economy expected to evolve under Xi's second term?**

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It is clear from the Congress that Xi is looking to define his legacy as the leader that made China prosperous. This would cement his place among the country's great leaders including Mao Zedong and Deng Xiaoping. This is a tough task as is illustrated by the targets that the government has set. China wants average incomes to have doubled from 2010 levels by 2020 and China is on track to meet this target. However, the next targets are more challenging: prosperity by 2035 and a slew of institutional reforms in place by 2050 geared to market-supporting institutions. These long-term goals indicate that Xi does not intend to disappear after two terms, though in China politicians can exercise power without being in office. Deng Xiaoping was still 'paramount leader' in the 1990s after his formal retirement.

Economic reform is ongoing. There have been some successes in the reform of the financial system, but there have also been incursions of the state into the private sector with Communist Party committees taking a great role in private firms.

Nonetheless, there are significant reforms. One of these is that foreign financial institutions will soon be able to take controlling stakes in Chinese financial institutions. This is an attempt to pick up the pace of flagging financial sector reform, which are essential for realising China's growth potential and avoiding a financial crisis by introducing more efficiency.

Risk and capital allocation is still distorted in China. This has a lot to do with the slow pace of reform of the state-dominated financial system. Improving efficiency, productivity and innovation will involve reforming the financial system to give more financing options to firms.

**Will the economy remain statist? Will there be parallel economies?**

China has studied the French example of protecting nationally important industries. A number of strategic industries will not be privatised. There is tension between the efficiency that China needs to grow and the way that China deals with this by introducing competition into these sectors to galvanize state-owned enterprises to perform better. In the 1990s, this approach did work in some sectors but China will continue to have around 300,000 state enterprises. What is not clear is whether equity ownership will change those state-owned enterprises enough to push China forward in areas such as high technology.

**How much power does the 'Shanghai faction' still have?**

Caution needs to be exercised regarding the faction model in order to explain behaviour. What are factions? They are not political parties. Factions describe the overlapping loyalties, responsibilities and worldviews of officials. Many have more than one factional allegiance. Xi is a former party chief of Shanghai so technically he could be considered part of the faction. Nearly every former Shanghai party chief has made it onto the Politburo Standing Committee.

The officials on the Standing Committee have different ways of seeing China. For example, Wang Yang is seen as more 'free market' than his peers because of reforms he introduced as party chief of Guangdong, whereas Wang Huning, China's premier ideologist, appears to be more 'statist' and authoritarian.

**The China-EU relationship and China's relationship with NATO**

China's relation with the EU will not change in any fundamental way apart from Brexit. Negotiating a new trade relationship with China will be tough for the United Kingdom. There will be some adjustments in the China-UK economic relationship because the United Kingdom previously served China as an entry point to the rest of the EU.

China will not have a direct relationship with NATO. Russia's resurgence in Europe is likely to be the focus of NATO's attention. NATO is unlikely to be looking beyond that.

**How strictly is China enforcing sanctions on North Korea?**

China is doing sufficient to keep the United States and the international community on board. The Chinese authorities banned Chinese citizens visiting North Korea the day Trump arrived in China on his state visit earlier this month, to reassure Trump that they are serious about North Korea. It is possible that Chinese pressure stopped North Korea from conducting missile tests and other provocations while Trump was in Asia.

That Xi had the confidence to schedule Trump's visit so soon after the 19<sup>th</sup> Communist Party Congress suggests that he was certain there would be no embarrassment from a Pyongyang escalation. The Chinese have more leverage over North Korea than they publicly acknowledge, if less than Washington asserts.

**Is Chinese public opinion divided on North Korean policy?**

In 2010, there appeared to be a divide which prevented China from responding to US overtures. China is putting more pressure on North Korea than it generally has. In June this year, the China National Petroleum Corporation suspended exports to North Korea. Beijing appears to have less influence than in previous years. In 2006, for example, China forced Pyongyang to apologise for a nuclear test.

**Will China escape the middle income trap and if so when?**

Very few countries have ever escaped the middle income trap. Prosperous countries were propelled forward by 'general-purpose technologies' such as electricity and the steam engine. China is trying to raise productivity at a time when it is not clear whether digital technologies can function in the same way.

China's large state apparatus in key sectors creates distortions. It is difficult to envisage China's 1.35 billion population, which is one-fifth of the global population, becoming universally rich. China will be a sizable economic

power and there will be a rich urban class, but the aim of making all citizens prosperous including rural people poses a significant challenge.

There will be opportunities in higher value-added services. The opening of the financial sector to foreign investment with majority ownership is an example of how China is trying to learn from more highly skilled foreign companies to develop its service sector. It is similar to the example of controlled investment in manufacturing in the 1980s and 1990s. China successfully upgraded manufacturing, now it wants to do the same for the service sector.

When a sector is opened to foreign investment the Chinese control the opening so there is a transfer of knowledge to local companies. A Chinese joint venture typically requires investors to hire 50% of managers locally even though Chinese managers are often inexperienced.

China has upgraded its manufacturing industry at remarkable speed. It is now on the verge of competing with high end manufacturers like Germany.

### **After financial services reform should we expect the opening of the capital account?**

The People's Bank of China has a ten-year plan for full currency convertibility. Once there is a robust financial system that can withstand heavy trading of the renminbi, capital account liberalisation will follow. China has the building blocks in place. What is holding it back is the weakness of the financial sector with its legacy of non-performing loans, the growth of shadow banking, a weak regulatory structure and poor corporate governance.

The renminbi is in demand, and traded volumes are high. However, the Chinese authorities do not want the renminbi to become like the yen; they want it to be a store of value like the US dollar.

### **How will the government manage its fiscal constraints without reform?**

Financial arrangements between the central government and the regions are changing. There is a mismatch between expenditure and revenues. China has gone through periods of fiscal centralisation and decentralisation. Much of the development of the welfare state is handled by localities. Local government bond markets are being developed and municipalities can issue debt without involving the central government, which gives them freedom and removes them from the shadow banking market.

A fiscal crisis could happen in the next decade as ageing demographics increase the need for more social spending on health and pension provisions. Chinese government spending is 21% of GDP -- small by international comparison. This means that China will have to ramp up the fiscal system, which it can afford to do given current growth rates. The issue is now becoming urgent as China has experienced two years of population shrinkage — worse than any country except Japan, and China's income is nowhere near Japan's income level.

### **What will be the major achievement of Xi Jinping's second five-year term?**

- He will have changed the way politics is done in China.
- China will be a moderately prosperous society. Living standards will have improved and extreme poverty will have been eradicated.
- Xi will have kept the ship afloat