

CHINA MONTHLY

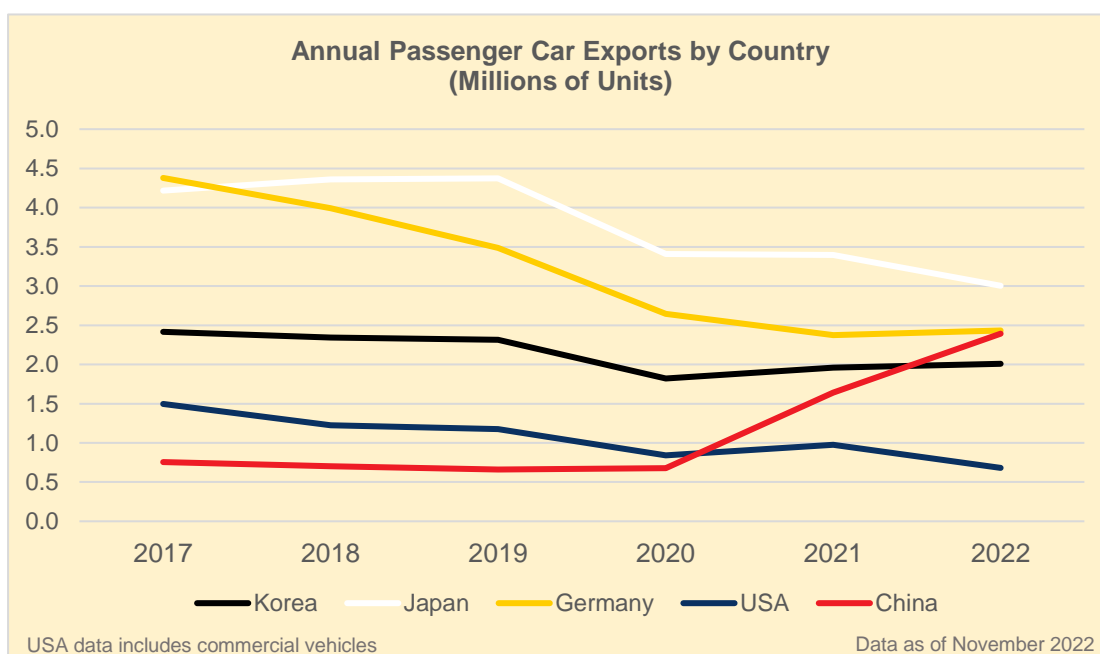
MARCH 2023

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The Big Picture



China is on the cusp of becoming the world's No. 2 exporter of passenger vehicles, quietly reshaping the global auto industry. Overseas shipments have tripled since 2020 to reach more than 2.5 million last year, and APS estimates China can become the world's largest exporter by the end of 2023.

THE BRIEFING

IPO Reform

China's across-the-board registration-based initial public offering (IPO) system came into effect in February, a milestone in the reform of China's capital market, said the China Securities Regulatory Commission (CSRC). The rules simplify listing requirements, optimize registration procedures, improve regulations on underwriting and on major asset restructuring of listed firms, strengthen oversight and law enforcement, as well as beef up investor protections.

Consumers Recover

China's consumer price index rose 2.1% in January from a year earlier, the National Bureau of Statistics said, up from 1.8% in December as the country reopened and the Lunar New Year holiday spurred demand, although gains remain muted enough for the central bank to keep easing monetary policy to support the economy's recovery. Core inflation, which doesn't include volatile food and energy prices, rose to 1% — the highest since June — a sign of stronger demand in the economy.

Ghosts of Price Wars

China's internet firms that laid low or sought to limit expansion during the years-long crackdown announced a flurry of aggressive campaigns in recent weeks, reviving the specter of intensifying competition manifested by debilitating price wars that tend to severely depress profit margins. Such concerns pushed the Nasdaq Golden Dragon China Index down by 16% from recent peak at one point in February.

Baby Stimulus

Hangzhou announced subsidies for families that have second or third babies while other cities are giving up to 30 days of marriage leave. These moves intend to turn around falling birth rates after China announced its first declining population in 2022.

Unmasked

Hong Kong, one of the last holdouts still with pandemic restrictions, announced the end of its mask mandate on March 1. Mainland China had already dropped its official restrictions on face coverings, and Hong Kong Chief Executive John Lee signaled "It is a clear message to show Hong Kong is resuming normalcy".

THE PENDULUM SWINGS BACK TO PRAGMATISM?

By Tan Kong Yam

Latest Indicators on Pragmatism

Contrary to some Western analysts' assessment, China's Communist Party has always been highly adaptable and pragmatic. In 1921, it started out as a group of ultra-orthodox Marxists who looked to the industrial proletariat to lead the revolution. Yet in 1935 during the Long March, it morphed into a Maoist rural-based party that focused on fomenting a peasant rebellion. After 1949, it then metamorphosed into a ruling party dominated by a personality cult built around Mao Zedong. With Deng Xiaoping in 1978, it repudiated the Maoist class struggle model to focus on economic development. Under Jiang Zemin in 2001, it redrafted the Party Constitution to admit capitalists previously persecuted by Mao. The lodestar that guides the CCP is that it remains China's dominant political power, to drive China's modernization. Political ideologies are but a means to that end. In essence, the CCP is more pragmatic than dogmatic.

The latest swing of the pendulum is towards pragmatism. With the party congress and confirmation of his third term behind him, President Xi Jinping is now attempting a course-correction towards a softer, more pragmatic stance on a whole range of national priorities. His face-to-face meeting in Bali with US President Joe Biden in November 2022 – the first since both men reached the top – took on a warmer tone, easing investor concerns around cross-strait as well as Sino-US relations.

China's new foreign minister Qin Gang, who was Beijing's ambassador in Washington DC for 17 months before his appointment, has called for the two nations to find the "right way" to get along. "The future of both our peoples – indeed, the future of the entire planet – depends on a healthy and stable China-US relationship," he wrote in an opinion piece in The Washington Post on 4 January 2023.

Le Yucheng, who at the time of Russia's invasion of Ukraine was a vice-minister of foreign affairs and the ministry's top Russia expert, has been demoted. He was responsible for the term "no limit" relationship. In Chinese official circles, Le had been widely tipped to succeed Wang Yi as the next foreign minister. In June 2022, Le was demoted and now occupies a post as deputy head of the National Radio and Television Administration.

The CCP's policy towards Russia has also undergone subtle changes. Qin Gang proposed a new version of the China-Russia relations policy during a phone call with Russian foreign minister Sergei Lavrov on 9 January 2023.

It emphasized the new “Three Noes” (三不): “non-alignment, non-confrontation, and non-targeting of third parties” (“不结盟、不对抗、不针对第三方”), superseding the previous “Three Noes” principle that defined Sino-Russian cooperation as having “no bounds, no restricted areas, and no upper limit” (“三无” 原则: 中俄合作无止境、无禁区、无上限).

In another sign that China is seeking to dial back its antagonistic stance towards the West, it has also side-lined Zhao Lijian, one of its most prominent “wolf warrior” diplomats. Under Qin Gang, the foreign ministry’s former official spokesperson is now one of three deputy directors for the ministry’s relatively obscure Boundary and Ocean Affairs Department.

Beijing has also downshifted into a more cautious mode.

Xi’s Chinese New Year message a year ago stated that "we are striding forward on the road to realize the great rejuvenation of the Chinese nation."

This year's congratulatory message had a far less confident tone. Xi quoted Su Shi, a renowned Chinese poet, "Charge at the toughest and aim at the farthest." It means to take on the biggest challenges and go after the most ambitious goals. Long as the journey is, we will reach our destination if we stay the course; difficult as the task is, we will get the job done if we keep working at it. As long as we have the resolve to move mountains and the perseverance to plod on, as long as we keep our feet on the ground and forge ahead with our journey by making steady progress, we will turn our grand goals into reality."

On 31 December 2022, the Chinese Communist Party's "Seeking Truth" magazine published Xi's speech at the First Plenary Session of the 20th Central Committee on 23 October 2022, which was also Xi's first internal speech after his re-election.

The article emphasizes "a deep understanding of the situation facing our country's development", "external risks and challenges have always existed and become increasingly prominent"; "black swans and grey rhinos and unpredictable factors are increasing", "the risks and challenges that need to be dealt with, and the contradictions that need to be prevented and resolved are more severe and complex than before".

The Economic Work Conference of the Communist Party of China from 15-16 December 2022 also quickly "revised" the economic policies of the 20th National Congress.

For example, "internal circulation" became "dual circulation"; "self-reliance" was no longer mentioned, it was renamed "comprehensively deepening reform and opening up"; "common prosperity" and "primary distribution, redistribution, and third distribution" have both disappeared, replaced by "the requirements for equal treatment of state-owned and private enterprises must be implemented based on the system and law". Common prosperity encourages “third distribution”, which refers to creating opportunities for high-income groups and enterprises to give back to society, including through voluntary gifts and charitable donations. This contrasts with "primary distribution", which is based on market

principles, and "redistribution", which is largely done through fiscal measures such as taxation and transfer payments.

The China Securities Regulatory Commission (CSRC) has also been proactively addressing investors' concerns, including providing more clarity on policy setting and by signing an audit agreement with the US-based Public Company Accounting Oversight Board (PCAOB), which on 15 December confirmed its ability to inspect audit papers of US-listed Chinese companies. The CSRC also said it will further enhance the connectivity of China's capital markets with overseas investors via different connect programs. There will also be further relaxation of foreign ownership rules in the financial sector, though there is currently no plan to adjust the foreign ownership limit in single A-share stocks. However, the CSRC is open to the overseas listings of Chinese companies and has been proactively engaging other jurisdictions on the compliance frameworks. The regulator is also highly supportive of ESG initiatives and welcomes the inclusion of Chinese assets into global indices.

The Private Sector's Critical Role In Employment Creation, Growth, And The CCP's Political Legitimacy

Unlike the Maoist era, after 40 years of opening up and reforms kickstarted by former paramount leader Deng Xiaoping, China's private sector is now an external check on China's political system. If domestic policies are not conducive for economic development, there is the risk of an exodus of talents and companies, as well as capital, albeit to a more limited extent.

During Mao's time, you can strangle the goose. Now the goose can fly out of the country, and you end up with no golden eggs.

Hence even though the party is not directly elected in a popular vote, political leaders and government policies are subjected to considerable pressure from, and accountability to, the people. Last year's street demonstrations in several cities are a clear illustration.

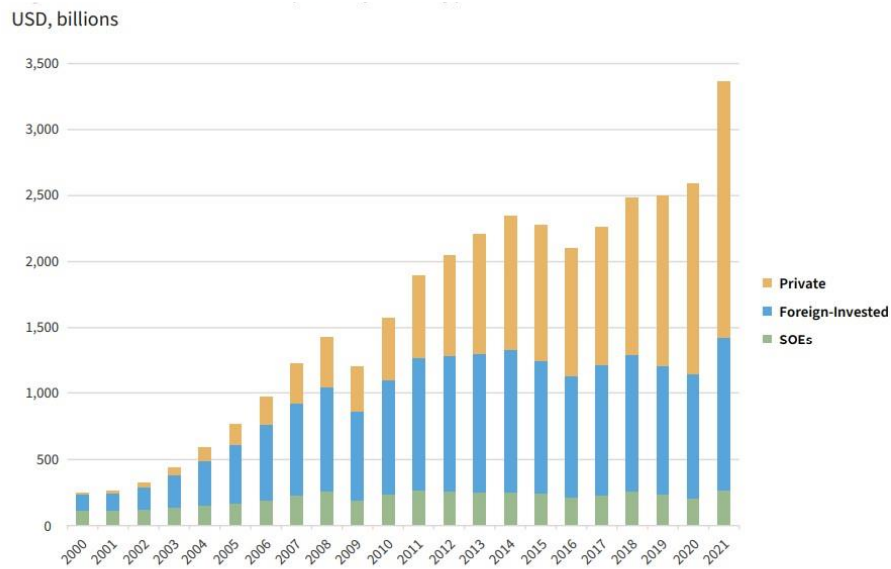
This ensures that policies cannot deviate too far from a pro-business stance for a sustained period.

Before too long, the pendulum will eventually swing back.

Additional constraints on the ruling regime include competitive pressures from the Sino-US rivalry and global economic performance, the government's need to enlist the private sector tech companies in the Chip War against a US-dominated block, as well as Beijing's reliance on China's economic prowess and market power as its key source of leverage in international relations.

As of 2021, the private sector in China accounted for about 70% of GDP, 80% of total employment, and 90% of new jobs created. It generated 58% of exports, much larger than that of the foreign-invested sector (34%) and the SOE sector (8%).

China's Goods Exports by Firm Type

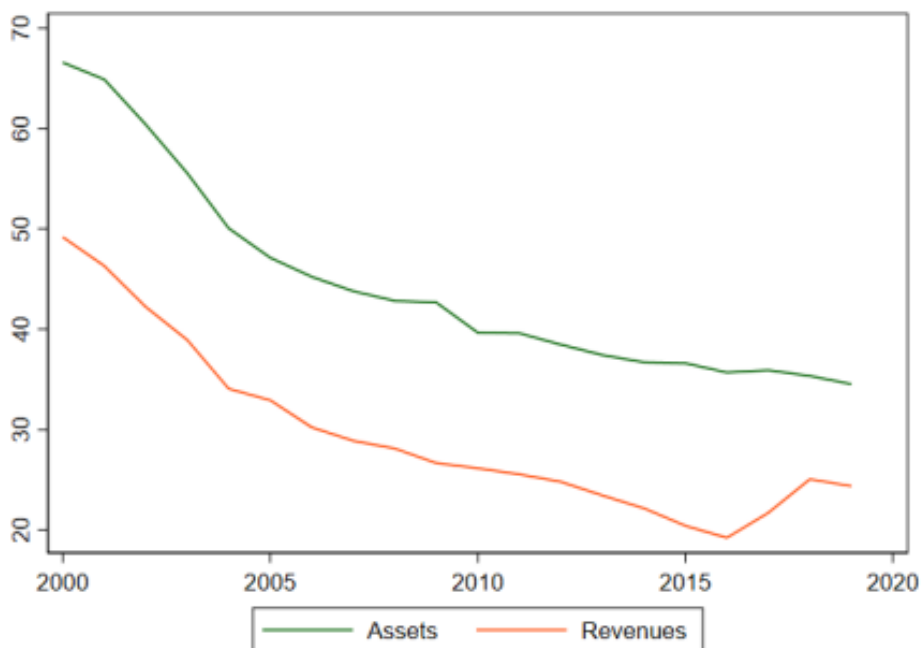


Source: "General Administration of Customs, Exports by Type of Enterprise," CEIC, <https://www.ceicdata.com/en>.

This is why despite rising US-China tensions and tepid economic growth, total trade between the two giants rose by 5.1% YoY, from USD657.4 billion in 2021 to USD690.6 billion in 2022.

In the final analysis, Deng's reforms over the past forty years have created an irreversible trend whereby the survival and political legitimacy of the CCP and the regime is dependent on the dynamism of the private sector and citizenry support.

State-Owned Enterprise Share



On the eve of the December 2022 Central Economic Work Conference (CEWC), Xi made a profound serious internal statement: "Whoever does not wholeheartedly invigorate the economy will have to step down!"

He affirmed that "In the first year of the new government, we will comprehensively stabilize the economic fundamentals, eliminate all noises, and strive for the economy in an all-round way, stabilizing employment, finance, supply, industry, foreign investment, and foreign trade."

Xi has long taken to heart the lessons from the collapse of the former Union of Soviet Socialist Republics (USSR). He is determined to avoid the pitfalls of poor economic growth and a deteriorating standard of living compared to the West. The former USSR was also unable to keep up with the West in terms of both military spending and technological progress in its rivalry with the West. Ultimately, its citizens lost faith in the ruling party.

Xi made a major speech in support of the private sector during the CEWC. He firmly stressed that the 20th Party Congress clearly stated that "promoting the development and growth of the private economy" is a long-term strategy, not a temporary measure. He said that private enterprises developed under the leadership of the party, relying on the party's policies as well as their own efforts.

He added that he has always supported private enterprises, and also worked in places where the private economy was relatively developed. He pointed out that, "As early as in Zhengding, Hebei, I focused on talent recruitment. In Fujian, my experience with the private sector had far-reaching influence. Then in Zhejiang, I supported the growth of private enterprises."

After working in the central government, Xi hosted a symposium on private enterprises in 2018 and noted: "Private enterprises and private entrepreneurs are our own people."

In Xi's October 2022 plenary session speech, he had said, "Comprehensive and strict governance of the party and encouragement to take responsibility, emphasize internally unified, not mutually exclusive tendency"; "Overcome empty slogans, mechanical execution, passive coping and other bad tendencies."

Beijing also started 2023 by dialling back its stringent "three red lines" policy, with a barrage of 16 measures to buttress the ailing property sector, including a plan to ease restrictions on borrowing by developers. State-run banks have pledged an estimated USD256 bn in potential credit to specific developers. The government was also looking at extending lower mortgage rates to fuel home purchases and capping commissions for real estate agents.

The Red Line: Never Challenge Party Supremacy

In February 2021, Alibaba Group founder Jack Ma was left off a list of Chinese entrepreneurial leaders published by state media — the snub underscoring just how far he has fallen out of favour with Beijing. Instead, Huawei Technologies' Ren Zhengfei, Xiaomi Corp's Lei Jun, and BYD's Wang Chuanfu were lauded for their contributions to national development. In January 2023, Jack Ma's voting rights in Ant Group was also reduced from more than 50% to 6.2%. That is to say, Jack Ma has lost control of Ant Group.

On the other hand, while Pony Ma's control and influence on the tech sector as well as public discourse via Tencent is far greater than that of Jack Ma's via Alibaba, he is treated much less harshly. Pony Ma has been a National People's Congress (NPC) delegate since 2013. In December 2022, Tencent received approvals for a clutch of blockbuster online games, as Beijing further lifting rigid curbs that have hammered the industry for 18 months.

The CCP is cognizant of the control that Tencent and Alibaba can exert over the flow and nature of information consumed by Chinese citizens, hence the government is taking tiny stakes in units of the two firms. These so-called "Golden Shares" theoretically allow the government to nominate directors or sway important company decisions and could be a tool for government officials to influence the industry over the longer term, even as Beijing prepares to loosen its grip on the sector and move past a bruising crackdown that's enveloped almost every internet sphere for two years.

While the move suggests Beijing wants to retain the option of controlling material aspects of the firms' power to shape popular discourse, for both Alibaba and Tencent, the government stake could potentially help them get the greenlight for businesses in new areas, and perhaps lowers the risk of further clampdowns by the regulators.

Beyond gaining a seat or voice at the table, it could also help the government with access to important data.

Another contrasting case was the treatment of Sun Dawu. Sun, chairman of Dawu Agricultural and Animal Husbandry Group, runs one of China's largest private agricultural businesses in the northern province of Hebei. Viewed as a troublemaker, he was eventually sentenced to 18 years in prison in 2021. On the other hand, an even more successful private businessman in agribusiness, Liu Yonghao, the founder and chairman of New Hope, has kept clear of trouble. Liu joined the Chinese People's Political Consultative Conference (CPPCC) in 1993 as a representative of private enterprise. He was appointed vice president of the All-China Federation of Industry and Commerce the same year. In 2011, Liu was among the few private businessmen who helped establish the China Minsheng Bank, owning 7% of the bank's shares.

Ren Zhiqiang, a real estate tycoon and an outspoken critic of the government, was sentenced to 18 years in jail on charges of corruption in September 2020. In March 2020, he wrote an essay saying that he saw "not an emperor standing there exhibiting his 'new clothes', but a clown stripped naked who insisted on continuing being emperor".

In stark contrast, the chiefs of far larger private property developers, like Country Garden's Yang Guoqiang and Sunac's Sun Hongbin have not faced any serious problems.

The message is crystal clear. Businessmen are critical for party legitimacy, and they are strongly supported within the system. Those with the hubris to challenge the party's supremacy often have skeletons in the closet that will drag them under.

On 7 February 2023, Xi gave a speech at the "Seminar on the Spirit of the 20th National Congress" organised by the CCP's Party School. This was also his first speech after the high-altitude balloon incident over the continental United States.

In this speech, he continued to promote "Chinese-style modernization". He said that "the party's leadership determines the fundamental nature of Chinese-style modernization. Only by unwaveringly adhering to the party's leadership can Chinese-style modernization have a bright future and prosperity."

Post Xi Dynamics

Over the next 10 years, the power dynamics between the different factions under Xi Jinping will take shape.

As noted by several analysts, presently there are four key factions under Xi. They include officials from Fujian, Zhejiang, and Shanghai who have worked with Xi Jinping, and Shaanxi officials with strong family ties to Xi. The fifth and smaller faction includes officials from the military and key industries, officials related to Tsinghua University, members of the Central Party School, officials with ties to Xi's wife, Peng Liyuan, and internal security officials.

Taking the new State Council as an example, Li Qiang is from Zhejiang, He Lifeng is from Fujian, and Ding Xuexiang is from Shanghai. The only common denominator for the trio is their loyalty to Xi. They have little to do with each other. Each one has their own network, patronage system, and personnel.

The divides between his proteges works in Xi's favour, each serving as a check and balance on the others, with Xi as the final arbiter. A State Council full of Li Qiang's people will not be ideal for Xi.

In the next five years, the various factions under Xi will scramble to recruit their own loyalists, and new factions may emerge and rise rapidly.

However, none of the present key factional leaders within Xi's power structure have princeling backgrounds. The first generation of revolutionary leaders like Mao Zedong, Liu Shaoqi, Deng Xiaoping, Chen Yun, Xi Zhongxun, and Bo Yibo were followed by the second generation of "Red genes" like Xi Jinping, Liu Yuan, Chen Yuan, Bo Xilai, and Zeng Qinghong. Currently, no third-generation princelings are emerging, as all of Xi's existing major proteges are not princelings.

The dynamics of China's development in the post-Xi era and the key policies could be quite different, likely to the surprise of the western China watchers.

Taiwan – Velvet Glove

Wang Huning, the fourth ranked member of the Politburo Standing Committee and chairman of CPPCC, is now in charge of China's "United Front" against Taiwan. Xi recently asked Wang to come up with a set of strategies to replace the no-longer-viable Taiwan strategy of "one country, two systems".

Wang Huning is a strategic ideological adviser known as the "National Teacher of the Three Dynasties (Jiang Zemin, Hu Jintao, Xi Jinping)". He is likely to invent brand-new "United Front" theories and tactics to woo Taiwan. In 1939, Mao Zedong published a speech in the "Communist" magazine, saying that the "United Front" is one of the "Three Magic Weapons" of the CCP. "United Front" means that the Communist Party must master the basic principle of "uniting with secondary enemies and attacking primary enemies" in political struggles.

When Xi Jinping mentioned Taiwan in his Chinese New Year speech in January 2023, he avoided using the word "unification" and instead said "Both sides of the Taiwan Strait are of the same family" (两岸一家亲). He avoided repeating his declaration during the October 2022 20th National Congress, that he would not give up the option of the "military reunification of Taiwan".

It is also very significant that 67-year-old Song Tao took over the CCP's Taiwan Affairs Office on 28 December 2022 despite his age. In June 2022, Song resigned as Minister of the International Liaison Office and became a member of the National Committee of the Chinese People's Political Consultative Conference and deputy director of the Education, Science, Health and Sports Committee due to the age limit. In addition, Song did not become a member of the CCP's Central Committee. His Taiwan Affairs Office appointment broke many CCP officialdom conventions.

Further indicating Xi's laser focus on Taiwan, at the 20th Party Congress, a large number of Xi's proteges entered the Politburo. Among the members of the Central Military Commission, Zhang Youxia, the vice chairman of the CMC, stayed on despite being 72 years of age. Another CMC vice chairman He Weidong, has a background in Fujian province, which is a Xi power base. By the time of the NPC sessions in March 2023, Xi's new team on Taiwan would be fully formed.

On 10 February 2023, Kuomintang (KMT) Vice Chairman Andrew Hsia (夏立言), who is leading a delegation on a visit to China, met with Wang Huning, a member of the Politburo Standing Committee, and Song Tao, the head of Beijing's Taiwan Affairs Office, as well as Yin Li, the CCP party secretary of Beijing.

The current ruling party of Taiwan is the Democratic Progressive Party, which holds the most seats in the Legislative Yuan. Song wanted to avoid the DPP and negotiate on unification with the Kuomintang (KMT) in Taiwan. This is the Communist Party's strategy of "joining with the secondary enemies to attack the primary enemies", part of its "United Front" strategy.

Investment Implications

It would be fool hardy to bet against the priorities set out in China's 14th Five-Year Plan and the 20th Party Congress. The Party Congress documents and pronouncements are useful guidelines, and ought to be scrutinised, to discern the key priorities and focuses that have material investment implications. Bet on potentially competitive and well-behaved horses led by the likes of Pony Ma, not wild horses like Jack Ma.

Technologies or developments in areas like factory automation and health care that can help China successfully adapt to a shrinking and aging population, can also be profitably exported to the many OECD nations facing very similar Gordian Knots. Food security is another national priority, where land consolidation and mechanization are interesting areas to explore. For energy security, EVs, batteries, solar, wind, and new tech breakthroughs in those areas may generate sustainable returns. In terms of China's technological security, it is worth looking at companies that can help China clear choke points in the "semiconductor war", escaping the stranglehold of the American-led block. To keep inequality manageable to strengthen party legitimacy, companies that benefit from policies like rural development are possible investments.

Xi's consolidation of power has given him a freer hand to wear a velvet glove over his gauntlet, and loosen his grip on many matters, ranging from zero-Covid to regulatory crackdowns to the Taiwan question.

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