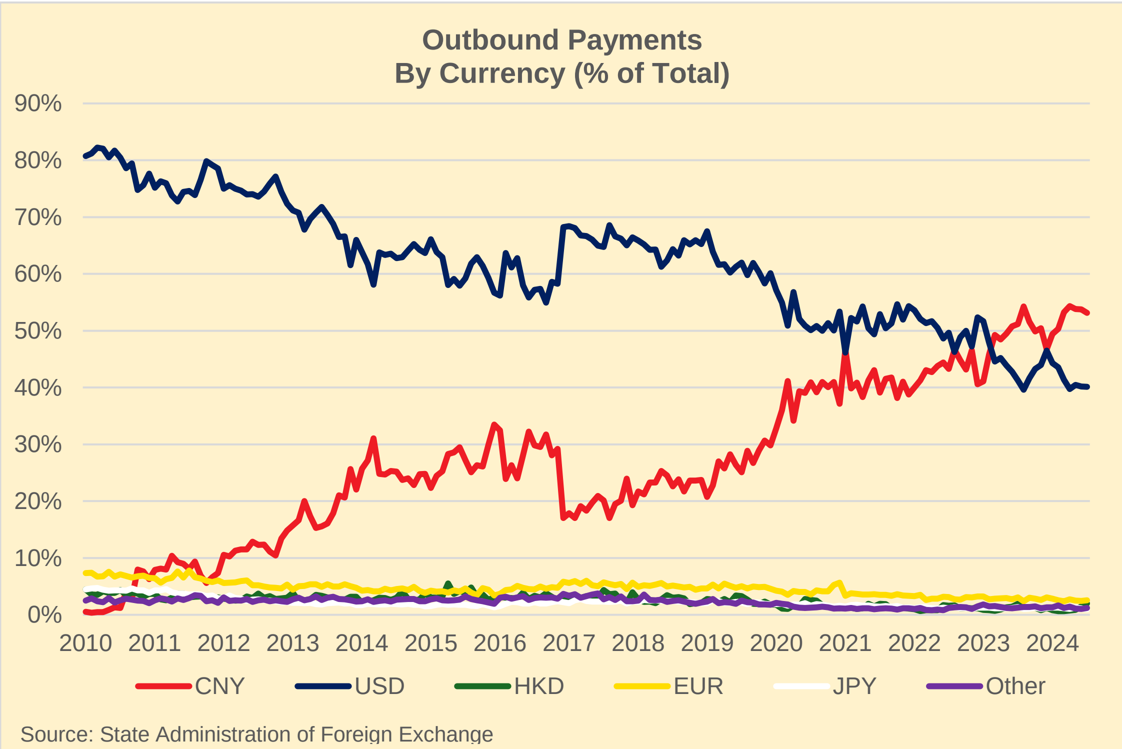
CHINA MONTHLY

SEPTEMBER 2024

The Big Picture



China's use of the yuan in cross-border transactions has reached record highs this year as Beijing boosts efforts to internationalize its currency.

SINGAPORE SHANGHAI BEIJING SHENZHEN

THE BRIEFING

High-tech a Bright Spot

Shenzhen's high-tech sector has emerged as a bright spot as the city's value-added output of the city's large-scale computer, communications and other electronic equipment manufacturing rose by 16.5% year on year in the first seven months of 2024. Total industrial investment surged by 45.1% year on year, with manufacturing sector investment increasing by 51.2%.

Italy PM, US National Security Advisor, Visit China

In August 2024, Italian Prime Minister Giorgia Meloni and US National Security Advisor Jake Sullivan both visited China. Meloni aimed to reset Italy-China relations after Italy's exit from the Belt and Road Initiative, signing agreements on economic cooperation with Chinese Premier Li Qiang. Sullivan's late August visit — the first by a White House national security advisor in eight years — focused on maintaining open channels to manage US-China relations and is widely seen as laying the groundwork for another summit between China President Xi Jinping and his counterpart Joe Biden.

Dubai & China Connect

Dubai and China signed a memorandum of understanding between stock exchanges, with an agreement to explore cooperation on dual-listings, ETFs, and other financial activities. The Dubai Financial Market and Shenzhen Stock Exchange will look at cooperation regarding indexes and fixed income products while exchanging experience and insights on market and product development, regulatory and ESG practices.

Smash Iron Pots, Sell the Steel

A district government in Chongqing has set up a team to monetize government assets, with the move coming after China's third plenum which explored the management of the country's asset-rich balance sheet to address its local government debt issue. According to data from Chongqing's finance department, while the city's tax revenue grew by only 2.8% year on year to 80.1 billion yuan in the first half of the year, non-tax revenue jumped by 31.2% to 50.6 billion yuan, driven mainly by asset disposals.

Canada's 100% China EV Tariff

Canada in August said it would impose 100% import taxes on China-made electric vehicles effective 1 October, and 25% levies on aluminium and steel effective 15 October. Canadian imports of automobiles from China to its largest port, Vancouver, jumped 460% year over year to 44,356 in 2023, when Tesla started shipping Shanghai-made EVs to Canada.

A HIGH-QUALITY SOCIALIST MARKET ECONOMY

By Tan Kong Yam

Principal Contradiction: First Shift in 36 Years

The recent shift in China's principal contradiction, the first in 36 years, underscores the new economic challenges facing the country. Local government debt and fiscal imbalances have become central concerns as the old growth model, heavily reliant on real estate and government spending, is no longer viable. Addressing these challenges requires balancing the need for structural reforms with the demand for short-term economic stability. The government's ability to navigate this transition is crucial for achieving long-term sustainable growth, as it shifts focus from quantity to quality in its economic development approach.

A more deliberate ideological course correction was announced at the 19th Party Congress in 2017, when the principal contradiction facing Chinese society shifted from one between the people's underdeveloped state and the need to unleash the factors of production, to one between unleashing the factors of production and addressing imbalances in the economy as well as in society. At the time, President Xi Jinping recharacterized the principal contradiction facing Chinese society as "the contradiction between unbalanced and inadequate development and the people's ever-growing needs for a better life."

The last time the party changed its view on this principal contradiction was in 1981, under the late paramount leader Deng Xiaoping.

> "在 2017 年举行的第十九次党代会上，宣布了更为审慎的意识形态路线调整，将中国社会面临的主要矛盾从人民的落后状态与释放生产要素之间的矛盾，转变为释放生产要素与解决经济和社会不平衡之间的矛盾。这是在 36 年意识形态连续性之后的重大转变——上一次党对主要矛盾的看法发生变化是在 1981 年。" [i]

It is very likely that Xi concluded in 2017 that if the economy continued to evolve as it had, it would create problems for the future viability of the Communist Party of China and Marxist ideology, and potentially have negative effects on China's social order.

Therefore, Xi moved ahead on two fronts. The first was to correct the fundamental structure of the economic base, including reining in the private sector and asserting more state control. The second was a series of tactical assaults on the social structure, including attacks on extreme wealth. This ideological shift set up a conflict over whether industrial policy or market forces would be the principal mechanism for allocating resources within the economy.

Xi noted, “The easy, universally welcomed reforms have already been completed. All the good meat has been eaten; what remains are the hard bones that are difficult to chew.” Xi emphasized that reforms must “adhere to the comprehensive leadership of the Party.”

His reforms have consistently broken through difficulties, as he aims to dismantle more entrenched interests. He stated, “At this moment, we need the courage to head towards the tiger's mountain, even knowing there's a tiger there, and continuously push reforms forward.”

The “zero-tolerance” anti-corruption campaign has been relentless for over a decade, and in the past year, it has continued to sweep through sectors like finance, food, healthcare, semiconductors, and sports, leading to the downfall of hundreds of senior officials, bank executives, hospital directors, and even the heads of the Football Association and the national football team coach. Xi remarked, “Offending thousands is worth it if it means not failing 1.4 billion people.”

<u>60 Weighty Clauses</u>

Tang Fangyu, Deputy Director of the Central Policy Research Office, pointed out that the last of the 60 clauses in July’s “Third Plenum Decision” carries significant weight.

He quoted Xi Jinping, saying: “If we do not focus on implementation, even the best goals and the most beautiful blueprints will remain as nothing more than “flowers in the mirror” and “the moon in the water.”

“He emphasized that “the deeper the reforms go, the more complex and acute the conflicts of interest become, and the harder it is to overcome challenges. Every step forward is not easy.” He stated that only by making “greater efforts in implementation” can we “overcome various resistances and break down the barriers of entrenched interests.”

Tang further mentioned that some of the most challenging issues currently facing China, such as local debt problems, government fiscal imbalances, and the resulting financial risks, are difficult to resolve. He pointed out that reforms inevitably involve issues related to economic development and the allocation of economic resources among various interest groups, which are highly complex.

Therefore, while implementing policies may seem like a matter of “one part planning and nine parts execution,” in reality, it may end up being the other way around, with “nine parts planning and one part execution.”

The Chinese economy’s hangover following the “binge-eating” in real estate cannot be resolved by short-term, easy fixes of further binging or large-scale stimulus measures. Instead, painful, deep structural reforms like deleveraging and building stronger foundations in genuine industrial prowess and the development of advanced manufacturing know-how are required. This hard-nosed, diligent approach will ensure sustainable long-term competitiveness and growth for China. Though its real estate policy measures has pros and cons — such as higher unemployment, capital flight, dented consumer confidence and muted business sentiment — Beijing does not need to play to the gallery.

Central to China's economic strategy is the belief that long-term structural reforms, rather than short-term fixes, will yield sustainable growth. This strategy emphasizes quality over speed, balancing growth and stability while prioritizing innovation, fiscal responsibility, and technological leadership. A key focus is tax reform and stabilizing local government finances, which remain a significant weakness in the Chinese economy. By defending supply chain dominance and supporting critical industries like electric vehicles (EVs) and artificial intelligence (AI), as well as strengthening social safety nets and avoiding large-scale stimulus, China is positioning itself to emerge as a high-quality socialist market economy by 2029.

Shifting to Quality of Growth

Prior to the Third Plenum that concluded on 18 July 2024, the draft of the "Third Plenum Decision" was circulated among "senior Party leaders" as well as "relevant enterprises and experts and scholars." This drafting of the Third Plenary Session's "Decision" was led by President Xi Jinping, with Wang Huning, Cai Qi, and Ding Xuexiang serving as deputy leaders of a drafting group with over 70 members. Curiously, Premier Li Qiang, who is responsible for the economy, was not named by Xi as a member of the drafting team in his remarks.

By 30 May, 1,911 suggestions for revisions were received from members of the circulation list, and 221 modifications were subsequently made. On the morning of 18 July, the revised draft was once again submitted to the plenary session for group feedback, after which two additional changes were made. This iterative process resulted in a significant document outlining the party's economic and social policies for the coming years.

On 21 July, China published the full text of the decision to further deepen reform and advance China's modernization with an advanced socialist market economy that promotes private sector development, where market forces are key to resource allocation. China will steadily, gradually postpone the retirement age, while improving incentives to boost births as well as support for parents.

Beijing will formulate laws to promote private sector development, while supporting competent private firms to lead major technological breakthroughs. The central government will also improve policies and governance systems for promoting the development of strategic industries such as new-generation information technology, AI, aerospace, new energy, new materials, high-end equipment, biomedicine, quantum technology, etc.

High-Quality Socialist Market Economy by 2029

By 2029, China aims to achieve a high-quality socialist market economy, transforming its growth model from investment-led to innovation-driven, with Xi solidifying his position as the driving force behind this effort. During the 120th anniversary of late Communist Party patriarch Deng Xiaoping's birth in August, Xi paid tribute to Deng's political legacy while also identifying with it, calling on the country to rally behind his own policies on establishing a modern economic system, promoting hi-tech self-reliance, and safeguarding development interests.

"As we embark on this new journey in a new era, we must deeply study and apply Deng Xiaoping Theory to navigate the complexities of our time," Xi told top government and party officials as well as Deng's relatives and former staff at Beijing's Great Hall of the People, according to state news agency Xinhua, directly linking his policies to Deng's foundational efforts.

"Reforms should be bold in spirit but steady in pace, managing the relationship between reform, development, and stability, with stability being paramount. The key to handling China's affairs lies in the party, which must focus on both reform and opening up, and on combating corruption," he said.

Reforms in tax policy, local government financing, and financial systems are crucial to stability as well as support for advanced manufacturing and high-tech industries. Fostering private sector growth and supporting technological advancements will ensure that the benefits of growth are distributed across society, laying a foundation for long-term stability and economic resilience.

Food security is another emphasis. The plenum communiqué mentions "deepening reform of the land system" (深化土地制度改革). Over the past few months, observers have discussed the possibility of new regulations on the "reorganization of land plots".

This refers to rural land left fallow due to a lack of farmers, as millions have flocked to cities to find work in factories. Xi appears to be contemplating some degree of return to land collectivization. This could be seen as a way to boost agriculture's contribution to the economy while simultaneously addressing the unemployment problem, by encouraging more young men and women to return home from the cities to work in agriculture. I expect Xi to proceed with a less ambitious land reorganization program, though the exact form it will take has yet to be articulated.

In a constantly shifting geopolitical environment, China's government is sharpening and testing its tools for controlling technology-related outflows. As domestic firms climb up value chains, there is increased emphasis on controlling foreign access to retain critical innovation capacity within China. China is unique in having a parallel, civilian technology export control regime designed to protect domestic innovation and industrial capacity. This regime is increasingly being deployed to establish and defend China's supply chain dominance.

Defending Supply Chain Dominance

Strengthening its supply chain eco-system is critical to China's long-term strategy. The country is committed to solidifying its position in global supply chains, particularly in high-tech sectors like semiconductors, EVs, and AI. Continued investment in infrastructure, technology, and talent development is necessary to maintain this dominance. China's success in developing the EV supply chain demonstrates its capacity to lead in global industries. By focusing on these strategic sectors, China seeks to build resilience against external shocks and secure sustained economic growth in an increasingly competitive global market.

The currently slower growth is not likely to pause China’s climb up the technological value chain and capturing a larger share of global markets for a wide range of technology-intensive manufactured goods. China’s manufacturing ecosystem remains competent, diverse, entrepreneurial, and broadly competitive, having built over many decades a vibrant, dynamic, and remarkably competitive manufacturing sector with many cost advantages.

Ideologically, it seems difficult to conceive of China changing course.

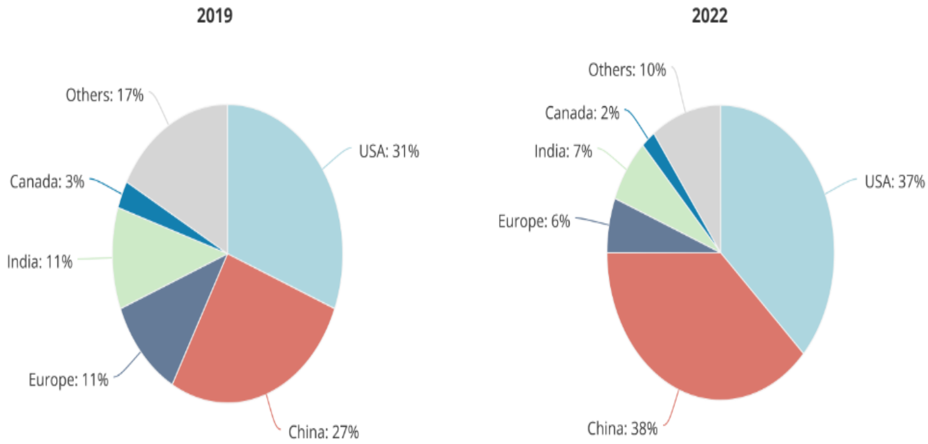
Continuing Policy Support for EV Supply Chain and Infrastructure

China remains committed to supporting the EV supply chain and related infrastructure. Policies that have fostered the growth of a robust EV ecosystem will continue, with an emphasis on expanding charging networks and investing in research and development. While government subsidies and policy guidance certainly played a role, much of China’s manufacturing success is attributable to its entrepreneurial dynamism, which is crucial to global leaders in EVs and batteries, such as BYD and CATL, who excel at what they do.

Driven by significant policy support, the Plenum aims to position China’s economy to lead future industries based on more disruptive technologies and the country’s growing capabilities in research and development.

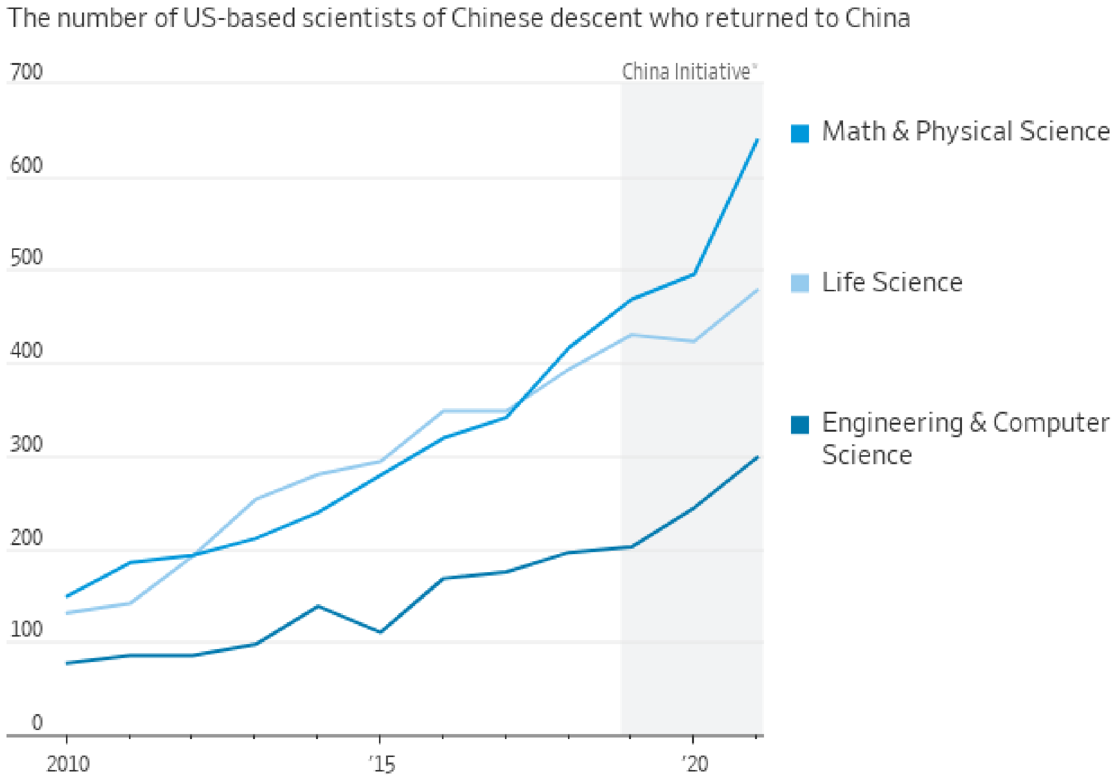
This support is reinforced by a rising pool of AI talent and a growing STEM (Science, Technology, Engineering, and Mathematics) workforce, which together will fuel further innovation in the EV as well as AI sectors. China was the leading country of origin for the top 20% of AI researchers working in US institutions in 2022, gaining ground from 2019, despite the China Initiative launched by US Department of Justice in 2018 under the Trump Administration.

Leading Countries of Origin of Top-tier AI Researchers (Top~20%) Working in US Institutions



Its primary goal was to address concerns about economic espionage and theft of intellectual property by Chinese researchers and institutions, focusing on individuals of Chinese descent working in sensitive fields like STEM. It is perhaps no coincidence that the tide of US-based scientists returning to China has been rising since 2019.

STEM Tide



*Note: China initiative cases rose against academics in 2020.

Source: Xie et al.

By remaining at the forefront of the global transition to sustainable energy via sectors like EVs, solar panels, batteries, wind turbines etc., China positions itself as a leader in this vital industry, ensuring long-term growth as well as environmental sustainability.

Tax Reform: Addressing Fiscal Imbalances and Local Government Debt

Tax reform is a key component of China's strategy to address fiscal imbalances, particularly between local and central governments. Historically, local governments have been responsible for the majority of public spending, while the central government has collected most of the tax revenue. This imbalance has led to an over-reliance on real estate as a revenue source for local governments, which in turn created excesses in the property sector. Recent reforms, including the crackdown on tax evasion, are part of a broader effort to correct these imbalances. Beijing will give cities full autonomy in regulating their own real estate markets, moving away from a one-size-fits-all approach, while setting up a system to monitor and regulate local government debt. While these measures may cause short-term challenges, they are essential for strengthening the fiscal health of local governments and reducing risks associated with volatile revenue sources.

Official and unofficial media have hinted at a potential broadening of tax categories, especially for consumption or sales taxes. Sales tax collected will be distributed between the central coffers and local governments, with the larger share going to the latter. This is intended to relieve fiscal difficulties, particularly the massive debts amounting to some CNY100 trillion (USD13.8 trillion) accumulated by provincial, city, and county governments, as well as the firms they support. This is not a highlight for now, as raising consumption taxes now would be counterproductive, impacting already weak consumer spending.

Changes in the tax system cannot come quickly enough for privately owned firms. Many such enterprises have recently been compelled to pay off taxes and late fees dating back several years, with one firm reportedly being forced to pay thirty years' worth of backdated taxes following an audit. These measures are being implemented by money-starved local administrations as a creative way to recoup funds. In this long-standing practice, the precise level of taxes is negotiated between firms and tax collectors.

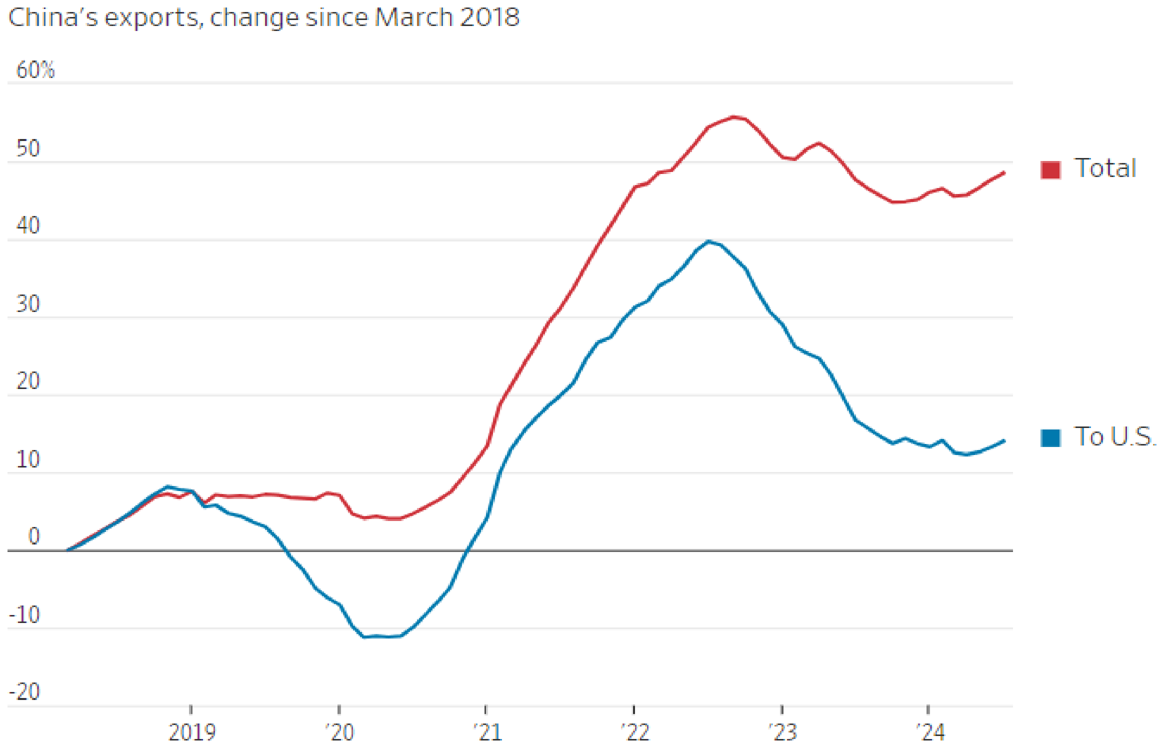
Another new twist is the police supposedly cooperating with local tax authorities to extract the levies ("警税合作"). Local authorities have denied that this is taking place. Nevertheless, this dampens the prospects for the development of private firms. Allocating a larger share of tax revenue to local governments will help make such harsh methods unnecessary.

Stimulus: Avoiding the Pitfalls of Short-Term Solutions

China's decision to avoid large-scale stimulus measures is a reflection of its commitment to a healthy fiscal position, not passing on the burden to future generations and creating moral hazards via government bailouts, prioritizing long-term economic health rather than succumbing to the pressures for short-term relief. Moreover, with potential challenges like severe tariffs under a possible Trump administration in 2025, China is wary of over-reliance on quick fixes. Instead, Beijing is focused on long-term reforms, such as strengthening the pension system and improving social security.

While former US President Donald Trump's first tariff war against China took its toll, the Republican party's nominee has said he would raise tariffs on Chinese imports to 60% or more if he wins the White House again. The damage would be much deeper than in Trump's first term, with China's economy in worse shape now.

Trading Blows



Note: 12-month moving average in USD

Source: CEIC Data

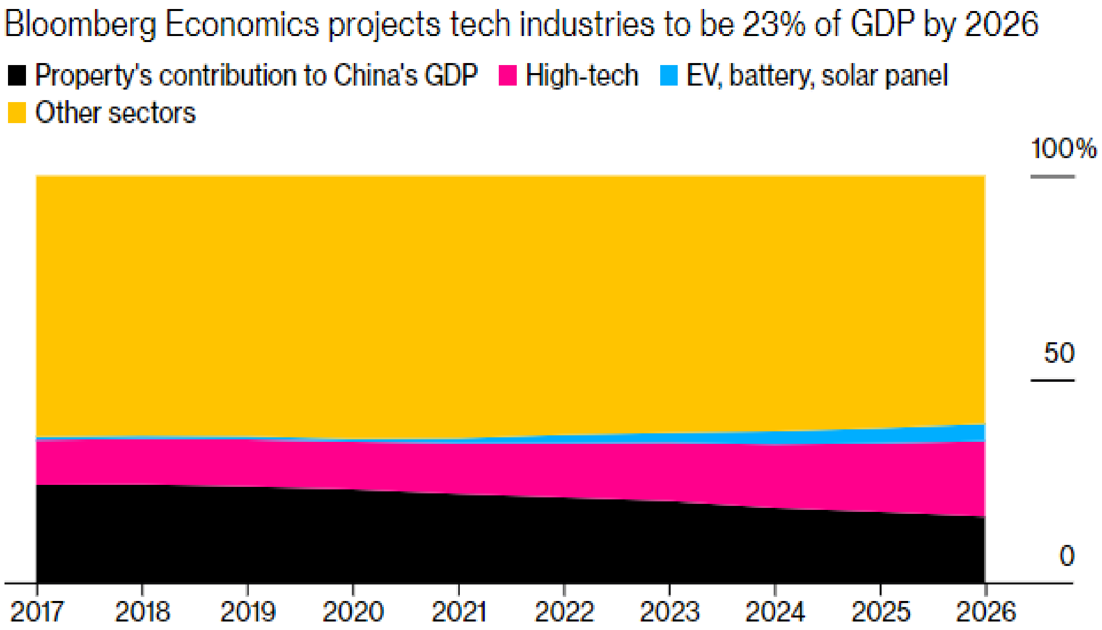
Raising tariffs to 60% on all Chinese goods, as Trump has proposed, might pull China's growth in 2025 down to around 3.4% from an expected 4.8%. However, UBS estimates that tariffs of 60% on US imports of Chinese goods would drag back GDP growth by about 2.5 percentage points in the 12 months after imposition, though the drag could be just 1.5 percentage points if China takes offsetting actions.

Conclusion: Long-Term Positives Amid Short-Term Pain

The Chinese government's response to the economic slowdown demonstrates that much of it was anticipated and strategically managed. The real estate slowdown, for example, has been painful in recent years, but its effects are expected to moderate over time, as shown by declining GDP contributions from the sector. Similarly, tax reform and other structural policies, though challenging in the short term, will contribute to a stronger economic foundation in the long term.

Bloomberg Economics projects technological advancements will account for 23% of GDP by 2026.

China's Innovative Sectors Set to Fill Property's Hole, BE Says

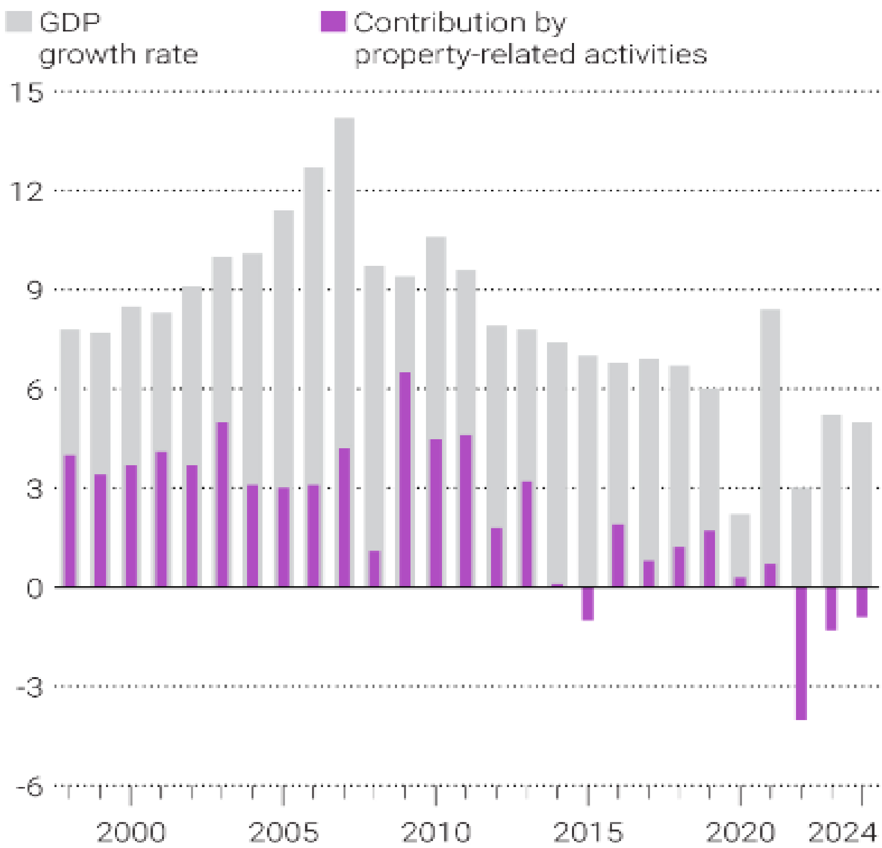


Note: Hi-tech sectors are defined as medicine, advanced equipment, IT/communications equipment and services, and research and development. Figures for 2024-2026 represent projection.

Source: Bloomberg Economics

This is more than enough to fill the void from the ailing real estate sector, which is set to shrink from 24% to 16% over the next two years.

Contribution of Property-related Activities to China's GDP



Sources: CEIC, UBS, SCMP

China is positioning itself to fill the gap left by real estate and lead in the global technology race, though it still needs to deal with the challenge of frictional unemployment during this transition.

As China navigates these transitions, its commitment to long-term stability and growth is evident. China's leaders are disinclined to fundamentally change the economy's consumption-investment balance, which they believe is central to the country's investment-driven, technologically intensive growth model.

However, social equity measures could be used to construct a new narrative around common prosperity for the people, thereby boosting domestic demand. This might include introducing effective social insurance or something more dramatic, such as reforming the household registration system, which would be politically disruptive but provide a confidence boost to the economy.

China’s recovery from its binge will hinge on the industriousness and social cohesion of its people, harnessed by a leadership team with meticulous planning and execution. It has successfully demonstrated this in spades, whether it is the global rise of its EV industry or the Beijing Olympics.

China marches on, to the beats of its own drums.

[i] 习近平：决胜全面建成小康社会 夺取新时代中国特色社会主义伟大胜利——在中国共产党第十九次全国代表大会上的报告–新华网 (xinhuanet.com)

Dr. Tan Kong Yam is a founding member and Deputy Chairman (China) of APS Asset Management. He is also professor of economics at the Nanyang Technological University. He serves as a board member at the Changi Airport Group (2015-present). From 1985-88, he was the chief assistant to Dr. Goh Keng Swee, the late Deputy Prime Minister of Singapore who was invited by Mr Deng Xiaoping to advise China on economic development strategy. From June 2002 to June 2005, he was a senior economist at the World Bank office in Beijing. In 2004, he was a member of the World Bank expert group on the eleventh five-year plan (2006-2010) for the State Council in China. He served as the chief economist of the Singapore government (1999-2002).