

# ***MIZUHO CHINA MONTHLY***

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**China's Economy**

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**The 19th NCCPC and the Challenges for the Xi Government in its Second Term  
~Questions regarding the status of state-owned companies**

*October 2017 Edition*

## - Executive Summary -

### China's Economy

### The 19th NCCPC and the Challenges for the Xi Government in its Second Term

After the 19th National Congress of the Communist Party of China, on October 18, 2017, the top leader of China for the next five years will be decided. The general public is almost unanimously expecting current President Xi Jinping to maintain his post. President Xi has been making efforts for his political goal of “finishing building a moderately prosperous society” by 2020, and he succeeded in performing well enough to have his achievement visible, which is considered to be a factor for his strong base of authority. However, it is also true that China’s economic growth saw some elements of uncertainty, such as concerns over a downturn in its economy, and it is said that excess investment and debt problems created such instability. President Xi has taken various measures against these problems, and a certain level of achievement has been recognized. However, the rectification of the excess investment and debt problems has not yet been completed. A big challenge for President Xi in his second term would be to smoothly correct the implicit guarantees by the government for state-owned companies—which is an issue that runs deep under the excess investment and debt problems

# **The 19<sup>th</sup> NCCPC and the Challenges for the Xi Government in its Second Term**

## **Questions regarding the status of state-owned companies**

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### **1. 19th National Congress of the Communist Party of China Re-election of President Xi Jinping: Almost a certainty**

The 19th National Congress of the Communist Party of China (NCCPC) starts on October 18, 2017. There is a general consensus by the general public that President Xi Jinping will be re-elected as the top leader of China for the next five years, at the First Plenary Session of the 19th Central Committee of the Communist Party of China, held immediately after the closing of the NCCPC.

The reason for this consensus is that President Xi is seen to have steadily strengthened the base for his authority since his initial inauguration in November 2012. For example, at the Sixth Plenary Session of the 18<sup>th</sup> Central Committee of the Communist Party of China held in October 2016, President Xi was positioned as the “core” of the Communist Party of China, along with Mr. Mao Zedong, Mr. Deng Xiaoping, and Mr. Jiang Zemin, which is seen as a symbol of the strong base of his authority.

It can be said that President Xi has strengthened his base of authority through the promotion of the anti-corruption movement as well as through leadership on key political measures at the top of many important organizations,<sup>1</sup> while achieving certain goals set out at the beginning of his term. However, it can also be pointed out that, during his first term, there was a phase of instability in the Chinese economy, mainly in the financial market. This was caused by the aftermath of the global financial crisis of 2007–2008 as well as the distorted structures of the Chinese economic development model that accumulated through the process of dealing with said crisis. Even though some evaluate that the stability of the Chinese economy has increased compared to the past, the questions are: to what extent have the structural problems that can influence the sustainable development of the Chinese economy been resolved and what are the remaining challenges for the second term?

Based on such questions, this article will review the political goals of the Xi government during its first term and then examine the achievements seen in economic policy management, along with the challenges for the Xi government for its second term.

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<sup>1</sup> President Xi has newly established the Central Leading Group for Deepening Overall Reform, the China’s National Security Commission, the Central Internet Security and Informatization Leading Group, and the Central Military Commission, as well as the Central Military Commission’s Leading Group for Deepening Reform of National Defense and the Armed Forces, in order to manage them as their top leader, in addition to his current post as the President, the chair of the PRC and CPC Central Military Commission, the head of the Central Leading Group for Financial and Economic Affairs, and the head of the Central Committee Taiwan Work Leading Group.

## **2. Policy goals for the Xi government during its first term: Advancement toward the achievement of “finishing building a moderately prosperous society”**

### **(1) Reconfirming the “finishing building a moderately prosperous society” project to be carried on until 2020: Also aiming to eradicate poverty in rural areas**

At the time of the takeover of the presidency from former President Hu Jintao to President Xi in November 2012, the government re-confirmed its goal of finishing building a moderately prosperous society by 2020. This “moderately prosperous society” refers to “a society with a certain prosperity.” The Chinese government has generally seemed to be achieving its goal of building a moderately prosperous society by the end of the 20th century. However, this has not seen “completion.”<sup>2</sup> In terms of specific figures, one of the goals is to double both the GDP and the income per capita of urban and rural areas from that in 2010, by 2020.

Furthermore, at the Fifth Plenary Session of the 18th Central Committee of the Communist Party of China held in October 2015, the eradication of poverty in rural areas by 2020 was added to the items in the project for “finishing building a moderately prosperous society.”

### **(2) The Four-Pronged Comprehensive Strategy, Five Development Concepts, and supply-side structural reform: Based on the recognition that it is inevitable to deal with the new normal in economic development**

In March 2016, at the National People's Congress (NPC), the 13th Five-Year Plan was adopted, reconfirming the overview of the policy measures for the period 2016–2020, while also clearly presenting the target figures. With regard to the overview of the policy measures, in addition to the Four-Pronged Comprehensive Strategy of finishing building a moderately prosperous society, other existing strategic goals were maintained, such as deepening all areas of reform, fully advancing the law-based governance of China, and strengthening every element of Party self-governance, in order to realize the Five Development Concepts: Innovation, Coordination, Green, Opening up, and Sharing. With regard to the target figures, the contribution ratio of the advancement in science & technology to economic growth, reflecting the principle of focusing on economic growth through innovation, was identified as an essential goal, along with the overall eradication of the number of people in poverty in rural areas, housing renovation in areas with temporary shelters, the mean length of education for the working-age population, and the target figures related to resources and the environment. As sustainable development would be difficult through existing development patterns, these policy principles and target figures were set out based on the understanding that the new normal in economic development should be taken into consideration (see Fig. 1).

Furthermore, in 2016, the Xi government has added supply-side structural reform as the main pillar in his economic policy in order to aim for the resolution of the important issues that were newly created or

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<sup>2</sup> 中国共产党历次全国代表大会数据库, 全面建设小康社会, 开创中国特色社会主义事业新局面 在中国共产党第十六次全国代表大会上的报告, issued on November 8, 2002

that are still remaining under the existing growth pattern. In detail, the important issues to be resolved include: (1) cutting excess production capacity, (2) reducing corporate costs, (3) reducing housing inventory, (4) expanding effective supply (expanding the supply of goods and services that are not responding to potential demand as a result of a lack of supply capacity), and (5) preventing and resolving financial risks.

Fig. 1: Detailed description of the changes and overview of the prospects of the Chinese economy under the new normal

Category	Past	Future
Consumption	Imitation and going along with the trends	Pursuing uniqueness and diversifying consumption models
Investment	Large-scale development and construction that last for more than 30 years	Existing industry saturated, while investment opportunities increasing in the fields of infrastructure inter-connection as well as new technologies and new products
Export, international balance of payment	Exports leading growth	Demand globally falling; cost competitiveness declining; exports still essential to support the economy
Production capacity, industrial organization	Main problem used to be lack of supply	Excess supply in conventional industries; essential to develop and aggregate the industry, to minimize and specialize production, and to use smart technologies for production
Relative advantage	Labor costs low	Becoming essential for innovation to lead growth, facing the aging society and the decline in excess labor in rural areas
Characteristics of market competition	Competition mainly in scale and price	Competition based on quality, and diversification becoming mainstream
Limitation in resources and the environment	Very few limitations	Reproduction capacity of the environment being reached or approaching the upper end
Economic risks	-	Along with slowdown in economic growth, risks gradually becoming visible; solving various risks characterized by high leverage, and bubbles taking time
Resource distribution, macro adjustment	-	Overall effect of economic stimulus evidently declining; necessary to promote the development of new industries by solving the problem of excess production capacity while making use of market mechanisms



**The economy has entered the new normal phase, currently shifting from “high growth” to “moderate high growth.” It would be necessary to adopt the new normal.**

Source: Prepared by the Mizuho Research Institute based on the 中央经济工作会议在京举行 (新华网 issued on December 11, 2014)

### 3. Achievements of the Xi government in its first term

#### (1) The target figures have become generally feasible for the purpose of finishing building a moderately prosperous society by 2020.

First of all, let us examine how much the Xi government has achieved the above goals at the current moment. With regard to the goal of doubling both the GDP and income, as the central element in finishing building a moderately prosperous society, the actual average annual GDP growth rate for 2013–2016 after the formation of the Xi government was +7.2%. Thus, in order to achieve the goal, the figure needs to grow by an average of +6.4% annually in the remaining four years according to the calculation (see Fig. 2). The actual GDP growth rate for 2017 is expected to be +6.8% year-on-year, while there is still fiscal capacity and room for further monetary easing from a short-term perspective. Judging from these factors, it can be said that the achievement of the target to double the GDP is within

grasp. With regard to the real disposable income per capita as well, the average annual growth rate for 2013–2016 was +7.4%, and therefore the target figure can be achieved if the figure grows by an average of 5.3% annually within the remaining four years.

In order to realize the goal of finishing building a moderately prosperous society, it is symbolically important to eradicate the number of people in poverty in rural areas. (The definition of the “number of people in poverty in rural areas” is “people living under a net income per capita of less than 2,300 yuan” [2010 constant price].) If the current pace of reduction can be maintained, it is evaluated that this goal is also possible to achieve. As of 2016, the number of people in poverty in rural areas was 43.35 million (see Fig. 3). If this figure can be cut by an average of 10.84 million annually within the remaining four years, the figure will be zero by 2020. Judging from the actual pace of reduction between 2013 and 2016 (annual average of 13.91 million), it can thus be said that this goal regarding the number of people in poverty in rural areas is also possible to achieve.

## **(2) Taking the new normal in economic development into consideration**

In addition, with regard to the need to take the new normal in economic development into consideration, statistical indices show that the performance of the Xi government was strong in its first term.

While some point to excessive investment, mainly in traditional industry, the Xi government has been taking certain political measures, claiming that China should shift from the current investment-dependent growth model, for example, through the strengthening of personal consumption. The share of total fixed assets in the nominal GDP has been on a decline after peaking out in 2013 at 45.4%, and reached 42.7% in 2016. On the other hand, the share of personal consumption has been on the rise, increasing from 36.7% in 2012 to 39.2% in 2016.

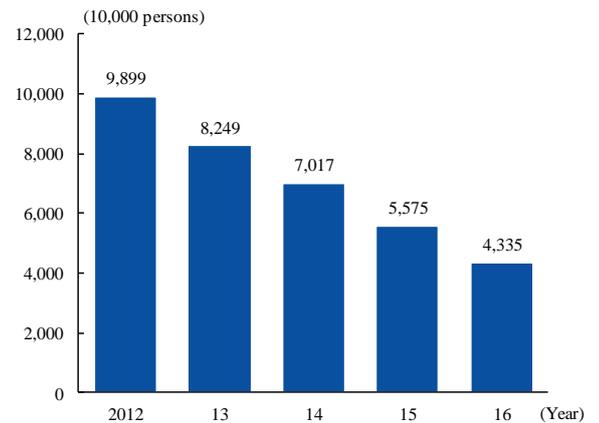
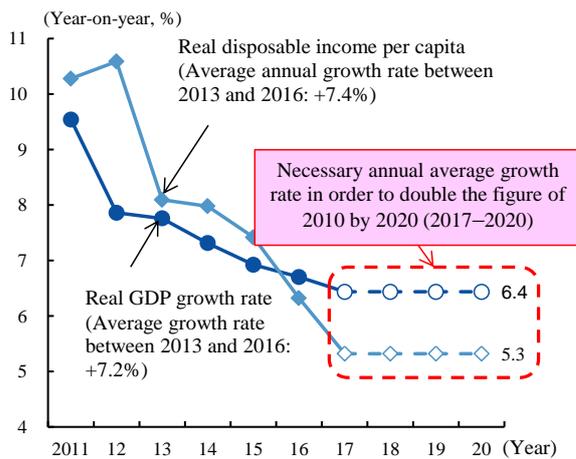
Furthermore, there has also been some development in terms of shifting from a development style highly dependent on industrial production. As of 2012, the shares of the secondary and tertiary industries were both 45.3%, but the figures changed to 39.8% and 51.6%, respectively, in 2016, revealing the economic growth of the service industry. Along with the advancement of the manufacturing industry, the share of the equipment industry and the high technology industry in valued-added production in the industrial sector has expanded from 28.2% and 9.4%, respectively, in 2012 to 32.9% and 12.4%, respectively, in 2016. The growth of electronic commercial transactions and the sharing economy also symbolizes the changes in the economic structure under the Xi government in its first term. According to the China Electronic Commerce Research Center, the trading volume of the online retail sales market rapidly grew almost four times larger, from 1.3 trillion yuan in 2012 to 5.3 trillion yuan in 2016.<sup>3</sup> The volume of the sharing economy also doubled from 1.7 trillion yuan in 2015 to 3.5 trillion yuan in 2016, according to the State Information Center.<sup>4</sup>

<sup>3</sup> 中国电子商务研究中心, 2017 上半年中国电子商务报告发布 交易额 13.35 万亿, issued on September 22, 2017

<sup>4</sup> 国家信息中心分享经济研究中心 and 中国互联网协会分享经济工作委员会, 中国分享经济发展报告 2017, issued in February 2017

There has also been improvement in terms of the achievement of sustainable development based on environmental consideration. For example, the energy consumption per 1 GDP unit decreased 17.9% in 2016 from the figure in 2012, among which the use of water decreased 25.4%. In the cities that did not reach the PM2.5 standard in 2016 (for “prefecture”-level cities or above), the annual average density of PM2.5 was 52 micrograms per cubic meter, still very high compared to 15 micrograms per cubic meter, which is the environmental standard in Japan. However, the figure has improved by 5.5% year-on-year.

Fig. 2: Achievement toward the target of doubling the GDP and the average income  
 Fig. 3: Number of people in poverty in rural areas



Source: Prepared by the Mizuho Research Institute based on materials from the National Bureau of Statistics of China and CEIC Data

Note: The definition of the “number of people in poverty in rural areas” is “people living under a net income per capita of less than 2,300 yuan” (2010 constant price).

Source: Prepared by the Mizuho Research Institute based on materials from the National Bureau of Statistics of China and CEIC Data

### (3) Importance of the presence and opinions of China in the global economy

As a result of the economic performance discussed above, China has seen increased importance in regard to its role in the global economy during the first term of the Xi government. The share of China in the gross world product (GWP) expanded from 11.5% in 2012 to 14.9% in 2016.<sup>5</sup> The share of China in global trade has been growing mainly in exports, increasing from 10.4% in 2012 to 11.5% in 2016. In addition, China has become important not only as a recipient of foreign direct investment but also as a donor. As of the end of 2012, the share of China in foreign direct investment in the balance of global direct investment was only 2.3%. However, as of the end of 2016, the share grew to 4.9%, and China became the sixth largest donor of global direct investment, following the U.S., Hong Kong, the U.K., Japan, and Germany.<sup>6</sup> The importance of China has also grown in terms of international finance, which is symbolized by the introduction of the Chinese yuan into the SDR (Special Drawing Rights) currency

<sup>5</sup> IMF, *World Economic Outlook Database*, issued on April 2017

<sup>6</sup> It should also be mentioned that the share of China’s inward direct investment in the global domestic direct investment balance grew from 3.7% as of the end of 2012 to 5.1% as of the end of 2016, making China the world’s third largest recipient of direct investment following the U.S. and Hong Kong (UNCTAD, *World Investment Report 2017*).

basket in October 2016.

Based on such increase of China's importance in the global economy, the Xi government attempted to have more influence throughout the world through the proposition of the Belt and Road Initiative, the organization of the One Belt One Road Summit, and the establishment of the Asian Infrastructure Investment Bank (AIIB). It can be said that these actions are the fruits of the efforts made by President Xi in order to realize the Chinese Dream (announced in November 2012) and the rejuvenation of the Chinese nation.

#### **4. Challenges remaining for the second term: The supply-side structural reform and the reforms of state-owned companies have not been complete.**

##### **(1) During the first term, advancement inevitably went along with some factors of instability.**

Even though the Xi government implemented the policy management under the slogan of “advancement in stability” in its first term, this was exactly because of the fact that the Chinese economy was always facing elements of instability.

In June 2013, some banks had concerns about a lack of liquidity, leading the SHIBOR to rapidly rise. In June 2015, stock prices fell sharply, and in August of the same year, the depreciation of the Chinese yuan continued due to increasing pressure for capital outflow, fueling concerns over a downturn of the Chinese economy.

Such factors of instability became visible for many factors, but in general, economic instability was directly and indirectly caused by the excess investment problem that surfaced through excess production capacity and accumulating real estate stocks, as well as the excess debt problem involving increasing shadow banking. While it is essential to resolve these problems for sustainable development, the Xi government has been facing the dilemma in which economic stability may be lost if President Xi moves too fast in solving such problems. Thus, it can be said that, in this dilemma, oscillating policies and changes in investor thought patterns and reactions toward policies caused the economic and financial instability discussed above.

##### **(2) Goals of the supply-side structural reform**

Then, facing such a dilemma, what sort of achievement has been made in supply-side structural reform, in particular, in solving the problems of excess investment and debt?

###### **(a) Cutting excess production capacity**

The Xi government has taken many measures, starting from the “Guiding Opinions of the State Council on Resolving Serious Production Overcapacity Conflicts” of 2013, which is the basic principle in cutting excess production capacity. In particular, at the Central Economic Work Conference held in December 2015, the plan of cutting excess production capacity was clearly identified as the pillar of the economic policy, as was discussed above, after which the reduction of production facilities accelerated in the steel

and coal sector. First of all, in February 2016, the target figures were identified in order to reduce production capacity by 100–150 million tons within five years from 2016 for steel and by around one billion tons within three to five years from 2016 for coal (see Fig. 4). Based on these goals, production capacity was reduced by over 65 million tons in 2016 for steel, and it is said that the goal to reduce 50 million tons has generally been completed for 2017.<sup>7</sup> In addition, the production capacity of low-quality steel materials made from steel scrap, which is not included in the above production capacity statistics, seems to have been reduced by around 120 million tons from 2016 until now. With regard to coal as well, the production capacity was reduced by over 290 million tons in 2016 and by 128 million tons (approximately 85% of the annual target) in 2017, as of the end of July.

Fig.4: Achievement and goals in reducing production capacity

	Steel	Coal
Production capacity	1.2 billion tons	5.7 billion tons
Production volume	0.8 billion tons	3.7 billion tons
Excess production capacity	0.4 billion tons	2 billion tons
Operating rate	67%	65%
Mid-term reduction goal	100–150 million tons in five years from 2016 (8.3–12% of the production capacity)	Around 1 billion tons in three to five years from 2016 (approximately 17.5% of the production capacity)
Reduction goal for 2016	45 million tons	250 million tons or above
Reduction achieved in 2016	Over 65 million tons	Over 290 million tons
Reduction goal for 2017	Around 50 million tons	150 million tons or above

Note: The production capacity of steel is based on the figures announced by the China Iron and Steel Association. The production capacity of coal is based on the figures announced by Mr. Lian Weiliang, vice chairman of the National Development and Reform Commission. The production volume is based on the figures announced by the National Bureau of Statistics of China. Excess production capacity = Production capacity – Production volume. Operating rate = Production volume / Production capacity. The reduction target figure for coal includes the 500 million tons cut through organizational restructuring. The reduction achievement in 2016 and the goal for 2017 are based on the government work report.

Source: Prepared by the Mizuho Research Institute based on the materials from the State Council, the China Iron and Steel Association, the National Development and Reform Commission, the National Bureau of Statistics of China, the Government Work Report on March 5, 2017, and various media reports.

However, some point out that the practical reduction of production capacity has not advanced considerably, as (a) many of the facilities eliminated so far had already been rendered unfunctional and (b) while some facilities were eliminated there were also facilities newly installed.<sup>8</sup> Furthermore, it has also been reported that some companies are reactivating their production facilities that have not been dissolved although treated as eliminated, as the prices of steel and coal are rising as a result of controlled production for the purpose of environmental consideration.<sup>9</sup> It is considered that this phenomenon is caused by the fact that local governments are hesitant to reduce production capacity, saying that it can lead to difficulties, such as that support for the reduction of production capacity is limited in terms of

<sup>7</sup> 经济参考报, 今年煤钢去产能有望提前收官, issued on September 27, 2017

<sup>8</sup> For example, with regard to steel, 绿色和平 and 中国联合钢铁网, 问诊2016年中国钢铁行业去产能, issued in February 2017; while the steel price is appreciating, the sales volume profit ratio in the steel industry was 3.4% in the January-July period in 2017, remaining low compared to approximately 6% for the average industrial sector. (财新网, 钢铁“去产能”效果明显, 但钢企“去杠杆”任重道远, issued on September 25, 2017)

<sup>9</sup> 中国证券报, 深水区“攻坚克难”去产能多点发力, issued on September 22, 2017

both scale and target, along with the difficulty of securing stability for the people that will be affected by cutbacks.<sup>10</sup> It has also been pointed out that the reduction of excess production facilities is necessary not only in the steel and coal industries but also in the electrolytic aluminum, thermal power generation, chemistry, glass, and vessels industries. Thus, while the reduction of production capacity has certainly been advancing in some industries, it is expected to take some more effort to solve the problem of excess production capacity.

### **(b) Reducing housing inventory**

There has been a certain progress in reducing housing inventory. With regard to the housing sector, which accounts for a large share in the real estate market, the ratio of the vacant floor space (including vacant floor space under construction<sup>11</sup>) against the sold floor space has been declining, after peaking out in 2014 at 3.7, reaching 3.5 in 2015 and 2.8 in 2016. However, it should also be mentioned that this figure is still high compared to the 1.6 observed in 2009 immediately after the financial crisis of 2007–2008. Moreover, the ratio of the vacant floor space against the sold floor space in third-tier cities has not remarkably fallen, while the inventory levels in first- and second-tier cities have been rapidly falling. The government has also started taking action against overheating speculations in some third-tier cities, making it difficult to expect housing sales to accelerate further. As the increase of population and urbanization itself has been slowing down, the adjustment of real estate inventory is likely to take some more time, mainly in small to medium-sized cities.

### **(c) Preventing and resolving financial risks through the promotion of deleveraging**

With regard to the excess debt problem as well, it is inevitable to maintain this issue as an important political challenge, while there is a certain degree of achievement. After the financial crisis of 2007–2008, the ratio of the debt balance of Chinese companies against China's GDP has increased significantly after the economic stimulus program of four trillion yuan. While the ratio was 96.3% as of the end of 2008, it reached 166.8% at the end of June 2016 (BIS). However, this rate has recently started falling slightly, reaching 165.3% at the end of March 2017. This is mainly due to the fact that the nominal GDP, which is used to calculate this rate, recovered. However, it is also possible to say that the increase of corporate debt decelerated through the promotion of deleverage based on the “Opinion regarding the active and stable cutting of the corporate leverage rate” as well as the shift to a more neutral monetary policy for the purpose of controlling shadow banking. However, the ratio of the Chinese corporate debt balance against the GDP has still been above the highest level observed in Japan (148.9% at the end of 1993). In order to strengthen the resilience of the Chinese economy and to secure sustainable growth through the enhancement of productivity, President Xi in his second term will have to continue deleveraging as fast as possible within a range that will not cause a financial crisis.

## **(3) Key: Reform of state-owned companies**

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<sup>10</sup> 中国经济网, 煤炭去产能仍任重道远, issued on September 22, 2017

<sup>11</sup> Vacant floor space under construction = Floor space under construction – Completed floor space – Pre-sold floor space before the completion of the construction work

In order to solve these problems, it is needless to say that various kinds of reforms are necessary. However, if we were to choose the most important challenge, it would be the reform of state-owned companies. This is because the excess investment and excess production capacity problems are rooted in implicit governmental support for state-owned companies. For example, as of 2015, approximately 65% of the corporate debt balance is estimated to be from state-owned companies, according to the Chinese Academy of Social Science.

In its first term, the Xi government released “Guiding Opinions on Deepening the Reform of State-Owned Enterprises” along with 22 supporting documents, indicating the basic principles in reforming state-owned companies. Thus far, there have been pilot programs in the fields of corporate mergers (34 central companies and 136 provincial companies), expansion of the use of private capital for state-owned companies (“reform to a mixed ownership system”), the establishment of companies specialized in state asset investment and management, and corporate governance reforms (converting 90% or more of the state-owned companies into stock companies or limited companies). While the structure of state-owned companies is strengthened this way, the government is also treading the bankruptcy of 500 “zombie companies” under the umbrella of central companies as well as the approval of the default of bonds issued by some state-owned companies.<sup>12</sup>

However, the ROA of state-owned companies is still low compared to other owned companies. There have only been a few cases of default, and the implicit guarantee for state-owned companies by the government has not yet been thoroughly revised. In his second term, President Xi is likely to firmly maintain the principle of “giving decisive power to the market in distributing resources.” However, it is unknown how much this principle is respected in reforming state-owned companies. If the base of the authority of President Xi has already been strengthened as is seen by the majority, the thoughts of President Xi on the reason of being of state-owned companies would significantly impact the future path for the sustainable development of the Chinese economy. We should therefore keep an eye out for the report by President Xi at the time of the NCCPC as well as how state-owned companies will be treated at other various Work Conferences scheduled thereafter.

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<sup>12</sup> 中国网, 国新办就十八大以来国有企业改革有关情况举行发布会, issued on September 28, 2017