Doing Business in Xi's New Era

The Communist Party of China (CPC/Party) has just concluded the first session of its 19th Party Congress. President Xi Jinping, Secretary General of the CPC, emerged from the week-long event as the nation's most powerful leader since its opening to the outside world in the 1970s. Xi strengthened his political position by elevating himself to a status only previously held by Mao Zedong, stacking the Party's highest-level executive bodies with his allies, and enshrining his own eponymous philosophy in the country's constitution as a guiding vision for a new third era in the century-long history of the CPC.

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This new era starts now and will run until 2049 when the Party will celebrate the centenary of the founding of the People's Republic of China. Xi's new guiding vision, named 'Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era', will guide all aspects of China's development and policy-making over the coming decades. Whether foreign businesses like it or not, they should be paying attention as they will need to get to grips with its major thrusts and tenets.

In this report, FTI Consulting aims to explain Xi Jinping's Thought and its likely implications for China's economy, foreign business and Chinese outbound investment.

The Utmost Paramount Leader

Much of the analysis prior to the Congress focused on who would be elevated to the Politburo Standing Committee (PBSC), the Party's elite ruling body. Particular focus was given to whether the Party would depart with convention and maintain a place on the PBSC for Wang Qishan, the anti-graft tsar during Xi's first term. His commission was instrumental in solidifying Xi's power as it ensnared a number of high-level Party cadres considered opponents to Xi and his vision in the country's sweeping anti-corruption crackdown. However, Wang was not appointed and, instead, the Party stuck with its retirement norms, in place since the early 90s.

Wang's retirement signals the extent to which Xi and his team are still beholden to at least some of the norms governing intra-Party politics. Wang is believed to be a close confidant and ally of Xi, so his absence from the senior leadership circle will be a loss for Xi himself. But, the composition of the PBSC, the seven individuals at the apex of China's ruling structure, still appears to be a victory for Xi.

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The appointments to the PBSC of both Wang Yang and Han Zheng – the two people most likely to be seen as potential allies for foreign business – likely reflect an ongoing factional balancing within the Party. However, the scales appear to be in Xi's favour, with places also secured for individuals believed to be Xi's close allies, Li Zhanshu and Zhao Leji. Xi also departed from recent tradition in not naming a potential successor to the body. This means that the question of whether or not he will step down remains unanswered heading into 2022. But not appointing a successor also allows Xi to defer any portrayal of him as a 'lame duck' as the 2022 transition draws closer.

Stacking the PBSC and the larger 25-person Politburo below it with his allies is important for Xi as it ensures that his protégés and followers will continue to hold influence and the primary positions of power even beyond his tenure as President. However, the moves to cement his status as 'core' of the CPC in the Party Charter (Charter) and to consolidate his authority over the Party's guiding ideology arguably carry more weight both for his political position and his ability to maintain influence at the end of this five-year term.

Thought for the Future

By entering the phrase "Xi Jinping Thought" into the Charter, Xi has elevated his name alongside Mao Zedong and Deng Xiaoping as one of only three leaders to have their names directly associated with their guiding ideology in the document.

'Mao Zedong Thought' is seen as the embodiment of the first emancipatory era of the CPC, while 'Deng Xiaoping Theory' is seen as the guiding principle for the second era when the country began its process of reform and opening up to the world. Xi Jinping's philosophy – like Mao's but unlike Deng's – is enshrined in the Charter as a 'thought'. The nuanced difference between 'thought' and 'theory' may seem small, but in Party parlance designating Xi Jinping's guiding philosophy as the more personalized and honorific 'thought' essentially elevates Xi Jinping to a higher level than Deng and onto the same rung as Mao.

Xi achieves a number of political victories by enshrining his thought into the Charter: First, it in effect makes him the primary living arbiter of Party ideology, raised above all other Party officials. Second, it situates Xi to remain for many years the most powerful political actor in China's system. Defining his thought as "Socialism with Chinese Characteristics for a New Era" is an ideological and linguistic device that signifies the commencement of a new era that firmly starts with him and the current socio-economic conditions. His philosophy is now the blueprint for China's current era which will extend until 2049, the target date for China's centenary goal to realize socialist modernization and transform into a fully-developed nation.

Third, it not only elevates his status within the Party above his living predecessors Jiang Zemin and Hu Jintao – it also consigns them to a bygone era. The upper echelons of the CPC are in many ways composed of factional allegiances based on patronage around the highest-level leaders. As such, by effectively ascribing the policies and philosophies of Jiang and Hu as antiquated, he also makes those ideas less relevant. Everyone in the Party must now get in line with Xi's vision. Disagreeing with the paramount leader is tantamount to disagreeing with the Party line and defying its constitution.

The New Era: Making China Great Again

Pivotal to Xi's vision is national strength and a renaissance of the Chinese nation. Just after ascending to the position of Secretary General of the Party in 2012, Xi announced his hallmark 'Chinese Dream', which he has defined as being the 'great rejuvenation of the Chinese nation'. Xi Jinping Thought is therefore essentially his strategy to bring about this rejuvenation by 2049.

Xi presented the Party's Work Report during a lengthy opening address at the Party Congress. During the speech, he offered a bold and assertive vision of China's future, heralding the start of a 'new era' of Chinese prosperity and power where China would move "closer to centre stage". The 'China Model' was also explicitly offered up as a new counter to western-style democracy for countries that want to accelerate their development while maintaining their independence.

Xi also gave a clearer indication of how he envisages a fully-developed socialist nation when outlining his 2035 mid-term goals, a date which falls in the middle of the two centenary goals of becoming a 'moderately well-off society' by 2021 and realizing socialist modernization by 2049.

The pillars of the 2035 goals largely focus on quality of life issues such as rectifying income disparities, alleviating poverty, building a stronger social safety net, increasing housing affordability, improving education access, reducing pollution and improving environmental protection. This emphasis on more societal issues suggests a move by Xi and his team to reduce the government's overriding commitment to economic growth at all costs, while emphasizing more the quality and sustainability of that growth.

Laying out goals this far afield implies that Xi sees himself as having a role to play in seeing them through, particularly the new 2035 goals which are set for a time when he will be 82 years of age. Doing so in the context of heralding the Party's recent achievements, as Xi did extensively in his speech, also suggests that he views the current system, which is characterized by a strong Party and an economy largely influenced by politics, as the right structure to ensure China meets these goals.

Party Central for Foreign Business

The explicit theme running throughout Xi's speech was that the CPC will continue to dominate business and economic outcomes for the foreseeable future as it works toward its goals to build a modern and globally powerful economy. This was unambiguous. "The Party," Xi said, "exercises overall leadership over all areas of endeavour in every part of the country."

In the second term, policy progress will therefore be made in areas that are aligned with Xi's overall political agenda and Party priorities. One of five major noteworthy constitutional amendments made during the Party Congress was the inclusion of Xi's supply side structural reform push, suggesting intensified efforts to draw down unbalanced production overcapacity in heavy industry. For foreign business, the focus on Xi's agenda suggests an increased priority for economic sustainability in areas including environmental protection and avoiding financial risks. But on the downside, this also suggests that Party prerogatives like pushing for innovation, moving up the value-added production chain, and even national security concerns, will be prioritised as well.

The administration is also likely to extend its push to regulate, control, and better access information and data flows given rampant national security concerns in that area. Issues like cybersecurity will remain front-of-mind and appear to be major priorities for Xi and his team. The government will also extend, even double down on, aggressive industrial policy goals that are devised to promote innovation and competitiveness in domestic firms above foreign ones.

In short, we don't expect a sharp shift in economic or business policies in the second term. These initiatives are extensions of priorities that Xi and his team have already focused on over the past five years. This does not mean the CPC is averse to the market playing a bigger role in the economy. Instead our read is that the Party is determined to extend its hybrid model. While the days of central planning are long gone, now is the time of central guiding.

In other words, the Party will have a role to play in setting a framework for every sector of the market, even if different market segments are characterized by varying levels of state involvement and oversight. We see three broad categories for industry that will likely be relevant.

First, the government will maintain a dominant role for state enterprise in key segments of the economy in which Beijing believes it should have an outsized influence. Pillar industries and critical infrastructure sectors such as telecoms, energy, construction and the financial sector, will continue to be dominated by SOEs as these are determined to be crucial for national security and economic control. However, there will be some marginal liberalisation in these sectors. The tangible outcome will be to increase market competition in a way that pressures state industry to improve their competitiveness, without letting private or foreign interests dominate. Private investment will also be encouraged, to an extent, to assist debt deleveraging and the enhancement of corporate governance within these SOEs, with the overarching aim being to further strengthen the position of state enterprises.

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Second, the government will extend industrial policy programmes aimed at the development of globally-leading domestic players in strategic sectors aligned with the Party's innovation goals. The target areas identified by the state are already clear and aligned with existing policies, such as the Internet Plus strategy and the Made in China 2025 plan. They include industries that the state has itself identified as future global growth areas, like high-tech manufacturing, robotics, environmental technologies, new energy vehicles, next generation IT, semiconductors, biopharmaceuticals, and aviation technology, amongst others. This will mean continued regulatory risks to foreign firms in these sectors. The government will not close these sectors to foreign

investment, but they will continue to prioritize domestic industry and China's innovative capacity above openness to foreign players. We expect to continue to witness the provision of robust government spending and preferential market access treatment to Chinese enterprises in many of these sectors, as the country uses its own massive marketplace as a springboard to develop domestic players than can compete globally.

Finally, the government will still allow an important role for the market in a number of sectors. Even the revised Party Charter approved this week called for allowing market forces to play a decisive role in the allocation of resources. Following from this, we expect to see continued efforts to increase market forces in the services sector as well as in industries that can promote productivity, help meet industry goals, or satisfy the societal objectives Xi outlined in his 2035 agenda. After all, China's private sector has been a massive growth engine for the country for decades. And it has already created massive technology giants that are driving new investments and technological advancements in the country, like Baidu, Alibaba, and Tencent – albeit from a sector that was significantly protected from foreign competition. While Beijing may seek to increase its influence in private firms, it will not claw back the free market entirely. Other sectors where the government might look to inject more private competition include healthcare, environmental protection and education, although the jury is still partially out on significant market opening to foreign business in these sectors.

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Another positive is that Xi expressed commitment in his Work Report to providing national treatment for foreign firms and moving towards a nationwide negative list for foreign investment. Foreign investors have been largely frustrated with the slow pace of new openings over the past five years. But the next few may present an opportunity to achieve long-desired breakthroughs in a number of sectors. This is particularly the case as the government understands the need to attract further foreign investment to offset likely capital outflows over the coming years.

Go Out, Go West

Another question surrounding the 19th Party Congress is what will happen with Chinese outbound investment. Chinese firms flooded external markets with investments in the early years of Xi's first term, only to be curtailed amidst a growing focus on capital flight and systemic risk in 2017. Capital controls were not directly addressed in the 19th Party Congress. But our overall view is that the theme of Party empowerment over key economic and business decisions will also become more formalised in this area.

China's regulators will likely push for a greater say over where and how China's financial resources are deployed moving forward, even for private capital. Key regulators like the State Administration of Foreign Exchange, the National Development Reform Commission and the Ministry of Commerce have all made clear that they will continue to rein in what they see as 'irrational investments' into areas like sports clubs, real estate, and entertainment, and will instead try to funnel capital into preferred areas.

Investments supportive to the Belt and Road Initiative as well as investments that serve to boost access to technology and R&D – particularly in areas that can support the development of those sectors earmarked by the state as strategically important – will be encouraged. However, the government will step up its scrutiny of all outbound investments, even in these encouraged areas.

While the country's capital controls will certainly be loosened going into to 2018, the government will only grant outward remittance of foreign currency if it regards outbound investments as beneficial. A number of criteria will be used when weighing up the benefits of such investments. Regulators want companies to make investments aligned with their core business and to provide sophisticated analyses showing likely returns on their investments. The government will also want to be convinced that all Chinese companies making overseas investments are in a healthy financial position to do so and will not be taking on risky levels of debt-financed leverage to fund such transactions.

This targeted approach towards outbound M&A is likely to increase government-to-government tensions with the West. Chinese firms are set to continue rising up the value chain, which will put them into increasing direct competition with western industry. As such, a renewed push from Chinese businesses to acquire western technologies and firms in these industries will further pique governments in developed nations, particularly as China looks set to maintain market access barriers to foreign firms and continue to offer favourable conditions to domestic enterprises.

We are already witnessing rising resentment against Chinese investment in the West, which is leading to increasing calls for reciprocity from politicians and businesses in both the EU and the US. The European Commission, for example, has this year tabled a proposed regulation to establish a framework for screening foreign investments into the bloc, which was the result of pressure from the governments of Germany,

France and Italy to develop a system that can help counteract investment asymmetries with China. The US, meanwhile is considering reforms to its Committee on Foreign Investment in the United States (CFIUS) that could result in even closer scrutiny of Chinese deals.

Chinese firms are thus set to experience greater levels of scrutiny, particularly state-owned companies and those investing in more sensitive, high technology sectors. This will mean that Chinese businesses will need to win trust with foreign governments and stakeholders when targeting acquisitions in the West. To do so they will need to better communicate their rationales and provide greater transparency into their businesses and motivations.

Conclusion

We have now entered the third chapter of modern China, and it is Xi's chapter to write. The constitutional amendments he has secured and the power he has amassed within the CPC ranks ensure that he will be regarded as the primary political force for the foreseeable future, even if he steps down from office in 2022.

From a business perspective, Xi's consolidation of power at the 19th Party Congress is a sign of strength that may position him to more easily deliver his longer-term strategies and economic reforms during his second term. But we offer a note of caution. This likely suggests a strengthened role for the state in promoting domestic businesses and overseeing the economy wherever it touches upon the Party's broader interests.

> Chinese firms investing in the West are almost certainly set to experience greater levels of scrutiny themselves, particularly state-owned companies and those investing in more sensitive, high technology sectors.

In our view the message from the 19th Party Congress was unambiguous on these points. Xi and his administration clearly see potential daunting obstacles and impediments to China's future progress, and are eager to address outstanding problems ranging from financial systemic risk to pollution and income inequality. But the leadership also perceives the solutions to these problems as best found via the government, policy, and political control.

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