China’s Third Plenum: In Deng’s footsteps?

Client Note
December 2013

Background
“Our responsibility is to rally and lead the whole party and all of China’s ethnic groups and continue to emancipate our way of thinking, insist on reform and opening up.”

- Communist Party General Secretary Xi Jinping, 18th Communist Party of China National Congress, 14 November 2013.

The 18th National Congress of the Communist Party of China held its much anticipated Third Plenum between 11-15 November 2013.

The Plenum was billed by most political commentators and market analysts as being as significant and historic as the reforms inaugurated by former Communist Party Chairman Deng Xiaoping between 1978 and 1992.

The reform blueprint known as the 21,500 Chinese character “Decision” was released on 15 November. It is considered by most analysts to be the boldest package of policies seen in decades – exceeding market expectations. It covers 16 areas and 60 individual items, tackling everything from economic to social reforms, indicating the new leaders’ determination to put the country on a new course.

On the economic front, reducing the level of government intervention to let the market play a decisive role in the allocation of resources is a positive theme for financial markets.

Politically, the Third Plenum has marked the emergence of Communist Party General Secretary Xi Jinping as the undisputed leader in the mould of Deng Xiaoping, and away from the more collective leadership format that we have seen in the past two decades. The reform blueprint bears his personal stamp. For example, it was Mr Xi, rather than the head of the executive, Li Keqiang, who introduced the “Decision” document.

The “Decision” – what are the reforms?
In the following, we summarise the major reforms announced in the “Decision” that we believe are most relevant to our clients:

- Deregulation: According to the “Decision” the private sector will be permitted to enter most industries other than those related to national security. For example, in the oil sector, private investors will be likely to be allowed to engage in oil and gas exploration, trading (imports and exports) and pipeline operations.

We consider this to be most important part of the reform program as it may significantly lift China’s growth potential.

To create a more competitive environment, prices of water, oil, natural gas, electricity, transport and telecommunications will be more market-orientated in their determination.

As a result of deregulation, many service sectors (such as financials, telecoms, railways, energy and healthcare) will likely grow significantly faster than previously due to the removal of supply-side restrictions. Therefore, the private sector is projected to be 36% larger by 2020, adding approximately 2% points to average annual real GDP growth over the coming decade.

The reforms also extend to foreign investment, with the plan suggesting that China will lift foreign ownership limits. This will ultimately grant offshore investors greater access to service industries such as financials, education, health care, culture, accounting, logistics, nursery, elderly care, construction design and e-commerce. This appears to confirm China’s increasing interest in establishing bilateral free trade agreements.

- Financial liberalisation: One of the master plan’s positive surprises is the determination of the leadership to accelerate the pace of both interest rate liberalisation and the Renminbi’s (RMB) full convertibility. Interest rate deregulation is expected to be completed within 2-3 years and RMB convertibility in 3-5 years. This would have the overall effect of reducing capital costs. Private banks will also be allowed for the first time.

Other financial reforms include the establishment of: (i) multi-layered capital market; (ii) bank deposit insurance scheme; and (iii) government bond yield curve which better reflects market demand and supply.

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– **Land and hukou reforms:** The government will grant farmers legal titles of land use rights. In turn, farmers can transfer, receive rents and pledge these rights as collateral.

The hukou (household registration) system will be further relaxed and social services enhanced for migrant workers via fiscal reforms. Requirements for access to social welfare and affordable housing will be abolished in small cities and eased in medium-sized cities, in particular.

Restrictions on the sale of rural “construction” land will be lifted. This will increase the mobility of approximately 700m farmers, increasing their incomes, while also accelerating the pace of Chinese urbanisation.

– **Resource pricing:** It is expected that natural gas and water prices will be increased, on-grid power tariffs to become more competitive and refined oil prices to align with global prices following resource pricing reforms.

– **State-Owned Enterprises (SOEs):** the plan emphasised two main pillars for SOEs: (i) encouraging private investment in traditionally state-owned industries; and (ii) improving administrative mechanism of SOEs. The State-owned Assets Supervision and Administration Commission (SASAC) will change its supervision approach from administrative measures to corporate governance as a controlling shareholder.

More specifically, the plan indicated that the SOE dividend payout ratio will be increased to 30% by 2020 in order to recapitalise the national social security system. This will reduce the retained earnings of large SOEs, affecting their ability to expand. Also, the “Decision” includes a provision to transfer SOE shares to the social security fund.

Overall, market participants were a little disappointed with the SOE reforms as it appeared that the leadership wants to retain a still-prominent role for SOEs.

– **Fiscal reform:** the property (holding) tax legislation is expected to accelerate following the “Decision”. This tax is expected to provide a more stable source of local revenue, reduce the reliance of local governments on land sales and will provide incentives to push-up land prices. This would counter concerns over property bubble events.

Other fiscal reforms include the expansion of the Value Added Tax (VAT) to other service sectors, increasing taxes and levies on polluting industries, improving the transparency of government budgets. This would enable the monitoring of local government debt, allowing these governments to issue more debt to finance regional infrastructure projects.

– **Social security reform:** the government has proposed the amalgamation of the civil servant and enterprise pension schemes. Shares from SOEs will also be transferred to the pension system to prepare a plan for increasing retirement ages.

The health system was also a focus of the “Decision”. The promotion of private hospitals, reform of public hospitals and health insurance reform are the key proposals put forward at this stage.

– **Municipal bond market:** according to the “Decision”, the Chinese leadership are expected to permit local governments to issue municipal bonds independently and gradually replace the current financing mechanisms of local government financing vehicles (LGFVs). Consequently, they will be required to publish their balance sheets in order to obtain credit ratings.

– **One-child policy relaxed:** as widely expected by market participants, there is a pledge within the “Decision” to relax China’s decades-old one-child policy. Couples will be permitted to have two children if either the husband or wife is a single child.

While market participants may be a little disappointed that the policy still has some restrictions in place, this overall reform should boost consumption in the short-term. Births are expected to grow by 10% to 1.6m pa from 2014-16. Assuming 25% of child bearing women (totalling 79m) choose to have a second child, this would amount to around 9.5m babies in total born as a result of this policy.

The reform is expected to benefit baby-related products such as infant formula, clothing and nappies, in particular.

**Economic impact of the “Decision”**

Overall, the reforms announced in the “Decision”, combined with the cyclical recovery, will drive China’s economic growth path in the medium-term.

The announcement of these transformational reforms is likely to contribute positively to Chinese growth. While the leadership is delicately rebalancing the economy to a more domestic consumption-led growth path, with growth of around 7%-7.5% pa, most market economists have estimated that if the reforms are successfully implemented at a reasonable pace, growth could increase by around 0.5% pa.

**Furthermore, it appears that financial markets may be underestimating the pace of these reforms and the ability of the state to implement them.**

**Response from Chinese equity markets**

Chinese equity markets have responded positively so far. Market participants were initially disappointed by the brief communique released on 12 November, but the more detailed “Decision” released a few days later boosted market sentiment.

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2 Ibid.
As shown in the following chart, Chinese shares, as represented by the MSCI China Index rose by 8% between 15-18 November.

Exhibit 1: MSCI China Index

![Graph showing MSCI China Index]

Source: Bloomberg as at 21 November 2013.

In terms of the outlook, given that these reforms are expected to boost economic growth and the sustainability of China’s long-term growth path, this could equate to a positive equity market re-rating.

Some equity market analysts have forecasted 20%-25% upside to the MSCI China Index over the next 12 months, with final 2013 GDP growth of around 7.6% pa, implying earnings per share (EPS) growth of around 12% next year.\(^3\)

From a sectoral perspective, China’s banks, railways, environmental and developers are expected to be the biggest beneficiaries of the “Decision”. Conversely, oil and telecommunications companies are considered those most adversely impacted by deregulation reforms, in particular.

**Resources investors have reason to applaud**

There is quite a lot for global resources’ investors to like about China’s new policy direction.

Accelerating urbanisation, with multiple positive knock-on effects for energy, minerals and metals, and soft commodities consumption, will flow from reforms to the hukou household registration system. Likewise, greater emphasis on environmental protection will be a tailwind for energy from gas, nuclear power and renewables.

**Expect greater electricity consumption**

There are many set views about China. One is that its drive for economic growth, powered by coal-fired energy, has come at a significant environmental cost. Many Chinese citizens as well as the government share this opinion. At times, the authorities have reacted with short-term mitigation measures, such as shutting down some factories (and limiting auto usage).

Deeper analysis and trends paint a more complex picture of China’s power industry than well-worn stereotypes about its coal-dependence.

A recent study\(^4\) argues that China will add more electricity generating capacity from renewable sources by 2035 than the United States, Europe and Japan combined. Hydro power and wind power will be the two main sources of China’s renewably sourced electricity, with solar photovoltaic cells coming in a distant third.

Natural gas and liquid natural gas can also be expected to become a bigger part of China’s energy mix. Coal, by contrast, which currently provides around 70% of China’s power needs, will gradually become a less dominant energy source.

Nuclear energy remains controversial in China as it does elsewhere. Nevertheless, the new leadership team’s commitment to rebalancing economic and environmental considerations should be positive for nuclear power and uranium demand.

China is working towards significantly increasing its nuclear-generated electricity capacity. Plans to install 50 gigawatts of nuclear power by 2015 will now take longer to achieve as extra care is being exercised on the heels of the Fukushima accident in Japan. When achieved, around 12% of all globally generated nuclear electricity will be in China.

Few uranium mines have been developed in recent years. This may lead to thinking that a meaningful rise in Chinese demand could trigger higher prices. Caution, though, is required on the uranium pricing front.

The United States’ fast-growing shale gas industry is being portrayed by some as an economic game-changer. Optimists foresee a steady rise in America’s energy self-sufficiency, an improving current account balance and cheap energy to fire a manufacturing renaissance.

China’s potential shale resources are even greater. However, the development of unconventional oil and gas has lagged in China and past production targets have gone unmet. Shale energy remains uneconomic in China with current technology. China’s shale resources are deeper and more difficult to access requiring more fracturing of rock to release trapped gas.

While shale may be falling short of its promise in China, for now at least, the country is on-track to become a higher per capita energy consumer. Greater urbanisation and entry of millions more into the ranks of the middle class will result in higher purchases of consumer goods ranging from cars to air conditioners, washing machines and refrigerators.

Current relatively low levels of per capita usage underline how far China has to go before it can get near developed-country status. Estimates suggest that China is consuming around one-quarter of the electricity of the United States on a per-

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\(^3\) Ma, Jun (2013): “Beneficiaries of reforms post 3rd Plenum”, 18 November 2013.

\(^4\) International Energy Agency World Energy Outlook
head basis. Urbanisation will do much to narrow the gap, in time.

During a comparable period of economic development neighbouring countries including Japan and South Korea consumed similarly low levels of energy, but the picture changed as both countries climbed the urbanisation and income ladders (Exhibit 2). China is heading along a similar path.

Exhibit 2: China’s per capita energy consumption to rise

Betting against China is risky

The truism about raw materials investing is to be long where China is short and short where China is long. On this basis, the long-term outlook for iron ore and copper is encouraging. China is short of quality iron ore and has few copper assets. Both are indispensable to urbanisation.

China is expected to produce around 770 million tonnes of steel this year, lift production to about 830 million in 2014 and plateau production near the 1 billion tonne mark by the end of this decade. This is a good scenario for Rio Tinto, BHP Billiton and Brazil’s Vale as the three own the majority of the world’s high-quality/low cost iron ore assets.

Rather than being able to ride a pricing breakout as was the case several years ago, winning iron ore producers will be those able to respond to the steady climb in volume growth. Moreover, as is the case with uranium, a note of caution is required on iron ore profits and pricing. Current iron ore margins are already the largest in the resources sector.

China’s place in the commodity volume growth dynamic is well-known, but warrants repeating. In 2006, China’s GDP grew by US$450 billion, while it grew by US$900 billion in 2012. An economy of this size growing at around 7% per annum will be a massive consumer of iron ore as well as other commodities it lacks.

A gradual fall-off in available sources of low cost supply for copper underpins our optimism for the long-term copper price. About a decade ago the average grade of copper was around 0.9%. Today it is around 0.7%. Said another way, much more ore needs to be moved to extract commercial quantities of copper. This is likely to keep copper prices higher than many observers currently expect (Exhibit 3).

Exhibit 3: Copper is getting harder to find

China-watchers are constantly on the lookout for signs that its decades-long growth cycle is at risk. They are still waiting. Betting against China is risky. For hard commodity investors, and especially those with a basically favourable view of iron ore and copper, China’s deepening urbanisation continues to be a historically positive development.

New food consumption patterns to consolidate

Urbanisation generally brings about a higher income to new residents and consequently affects both levels of food consumption as well as triggering new tastes. Announced reforms to the hukou household registration system will consolidate trends.

When a rural resident moves to a city, they make the transition from growing food to food buying. The consumption of food grains tends to remain relatively stable while that of other foods including animal protein products tends to increase, especially as incomes rise (Exhibit 4). For example, depending on whether the city is small, medium or large, the consumption of animal products by new urban residents in China will increase in the range of 4.2 to 7.2 kilograms (kg), and that of aquatic products, 1.5 to 1.7 kg.\(^5\)

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Exhibit 4: Higher living standards leads to greater protein consumption

At first glance, the magnitude of increase in meat consumption may not seem great, but the process leading to the production of animal protein reveals something deeper. Meat/protein-rich foods are grain-intensive. On average, 2 kg of grain is needed to produce 1 kg of chicken, 4 kg to produce 1 kg of pork and a whopping 7 kg to produce 1 kg of beef. What this translates to is that total grain consumption will rise as meat becomes a bigger part of the Chinese diet.

China’s rising meat consumption has begun to impact global trade patterns as its domestic grain and meat production capacity has been unable to keep pace with demand. Greater imports of corn, soybeans, pork, chicken and beef have been making up the shortfall.

Patterns in dairy products’ consumption have been intriguing in recent years. Total consumption of dairy products increased significantly during the past ten years. However, the percentage increase in dairy consumption was much greater in rural areas; the consumption of dairy products increased threefold from 2000-2010 in rural areas. The corresponding increase in urban areas was 67% but with a much larger absolute increase (7 kg compared with less than 4 kg in rural areas).

Fresh milk consumption dropped in both rural and urban areas in the past few years. Consumers’ concerns regarding domestic milk quality and food safety are behind this fall. Safety-related apprehension has led to rising demand for overseas sourced ultra-high temperature (UHT) long-life milk. As well, Chinese parents have displayed a preference for foreign produced baby milk formula products after multiple contamination incidents with locally made formula. This is creating growing opportunities for dairy related companies in Europe, New Zealand and North America.

China’s pivotal influence

Investing in resources requires a perspective going back over several decades rather than just the past 10 years or so. The industry was subdued for large parts of the 1980s and 1990s as there was an absence of large countries in a rapid phase of industrialisation.

That changed in the early 2000s with China’s emergence. The Third Plenum’s economic roadmap confirms that China will continue to remain pivotal to energy, minerals, metals and agricultural markets.

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