China: reform agenda of the Third Plenum eyed as growth stabilizes

Growth stabilization has allowed the Chinese government to refocus on structural reforms to contain risks and achieve a more balanced and sustainable growth path.

We expect the Third Plenum* to unveil a far-reaching reform roadmap, covering areas such as financial, fiscal/tax, land, resource pricing and administration reforms, among others with a focus on areas that have broader consensus. However, announcement of detailed measures or a timetable is unlikely.

Financial markets will likely assume a lower growth trajectory and need to meet higher hurdles for policy easing in the near term, despite the support from improved corporate profits.

In the medium term, effective implementation of reforms could raise China’s productivity growth and put the economy back on a sustainable path, creating stock market re-rating potential and long-term investment opportunities in sectors and stocks that potentially benefit from economic reforms.

7.5% growth target for 2013 within reach

The government’s growth-stabilization policies – from tax cuts to investment in certain sectors such as infrastructure, public housing and environment protection, among others, as well as better external demand and the lagged effect of strong credit growth in the first quarter (Q1,) helped propel a rebound in China’s economic growth in Q3. Gross domestic product (GDP) growth picked up to 7.8% year-over-year (yoy) in Q3 from 7.5% in Q2 and after a 7.7% advance in Q1. Sequential growth (quarter-over-quarter, seasonally adjusted) accelerated to 9.1% annualized in Q3 from 7.8% in Q2 and 6.1% in Q1. China’s economy grew 7.7% in the first three quarters and it looks on track to meet or slightly exceed its growth target of 7.5% for this year.

Recent readings of manufacturing and non-manufacturing purchasing managers indices (PMIs) continued to point to stable and solid business activities in the near term. Retail sales, such as catering services maintained solid momentum and passenger car sales picked up. The solid September import data, including the broad-based pickup in commodity imports, hints at ongoing recovery in the domestic economy. Railway cargo traffic stayed strong in September.

However, a wide range of other macro indicators showed signs of the recovery losing some momentum toward end-Q3. Growth in industrial production, urban fixed asset investment, electricity consumption and power production for September slowed both on an annual and sequential basis seasonally adjusted (s.a.), following two months of acceleration.

The 0.3% yoy contraction of September exports on top of an unfavorable base effect surprised the market to the downside. The over-invoicing in late 2012 and early this year make it difficult to analyze the export trend but, overall, the data points to a bumpy and fragile external demand recovery.

Policy re-focus on containing risks and reforms

The rebound in Q3 growth and cyclical growth stabilization have taken some near-term pressure off the government, but the growth pattern and model – driven still by investment and growth in heavy industries and state owned enterprises (SOEs) on the back of the government’s “mini fiscal stimulus” and high credit growth – may not be sustainable and are seeing increasing vulnerabilities of the economy. Debt has risen rapidly, balance sheets in parts of the corporate sector have weakened, investment has become less productive, and local government finances are strained. Accelerating reforms is critical for containing risks, achieving more balanced and sustainable growth, and transitioning the economy to a more consumption-based, inclusive, innovative and environmentally-friendly growth path.

President Xi Jinping and Premier Li Keqiang have pledged to carry out structural reforms even though they may lead to slower growth. The forthcoming Third Plenum of the 18th Central Committee of the Communist Party of China (CPC) during November 9-12 is seen as a springboard for significant changes and a key test of the new leaders’ commitment to structural reforms. The CPC has a tradition of proposing key economic and social reform agenda in the Third Plenum (recurring usually every five years). It was the Third Plenum of 1978 when the then leaders decided to implement the “reform and opening up” strategy, which ended decades of seclusion. The Third Plenum of 1993 endorsed the socialist market economy, paving the way for China’s economic take-off in the subsequent two decades.

Selected real activity indicators

![Source: CEIC. Data as of September 2013.](image-url)
The Third Plenum of 2003 was a disappointment with reform momentum ebbing over the following years, but a favorable global environment allowed China to prosper without structural reforms in the past decade. However, economic imbalances are far wider and global environment is worse today, and the pressure to reform is greater for China.

Third Plenum of 18th CPC Central Committee

We expect the meeting to unveil a roadmap for economic and social reforms over next 5-10 years, but there will not be specific or concrete measures or a timetable. The main themes are likely to improve the market system, reduce government intervention in business, deepen economic openness, and reduce social inequality. The launch of the Shanghai Free-Trade Zone (FTZ) could be the third round of opening-up initiatives, following the establishment of Shenzhen Special Economic Zone in 1980 and China’s entry to the World Trade Organization (WTO) in 2001. The focus of the Shanghai FTZ is the opening-up to foreign capital, especially in the service sector. The existing “approval” system for foreign investment will be replaced by the “negative list” system that does not require approval beforehand, and foreign investors will obtain pre-entry national treatment in the FTZ. The Shanghai FTZ will serve as a testing ground for China’s multilateral trade negotiations such as the Trans-Pacific Partnership (TPP) in the future.

In the near term, we believe policy priority will likely be to rein in broader credit growth, address the risk of local government debt, and prevent further buildup of risks in the financial sector. Thus, financial and fiscal/tax reforms could be major focuses of the meeting in addressing the financial and debt risks. Interest rate liberalization and Chinese Yuan (CNY) internationalization will remain the key directions of financial reform to remove price distortion in the financial market and improve the efficiency of capital allocation within the country and across the border. The People’s Bank of China (PBoC) has removed the lending rate floor in July and introduced a new benchmark lending rate in October in another step toward letting markets set the cost of funds. The next step is to liberalize deposit rates, which will likely take a few years to complete. The deposit rate reform is likely to start with allowing banks to issue certificates of deposits on the interbank market, followed by the introduction of a deposit insurance scheme. The government may announce a timetable for capital account convertibility on the condition that risk is under control, but the actual progress is expected to be gradual and tightly managed.

Fiscal and tax reform is key to address the concern about fiscal sustainability amid rising local government financing vehicle (LGFV) debt and dependence of local government revenues on property/land sales. Tax reform will likely be aimed at aligning and reallocating spending and revenues of central and local governments. Central government could take back some key public services spending from the local governments, such as social security and compulsory education, etc. Reform of the tax system will likely include the value-added tax and property tax while new taxes (e.g. environment protection tax and resource tax) could be introduced. Proposals for more sustainable local government finances may include the creation of new and sustainable fundraising mechanism for local governments e.g. local governments issuing bonds.

Issues related to urbanization will also be mentioned, mainly the rural land rights and household registration system (“hukou”). The objective of the land reform is to increase the transferability of land and protect the interest of farmers. However, it will likely face resistance from local governments given that land sales revenue is a major source of their finances. Although the Third Plenum may announce some guidelines to give more rights to farmers’ collective land holdings and general principle of more flexible rural land transaction, etc., it will unlikely propose any sweeping package of land reforms. There will likely just be some very general statement about the hukou reform. That said, the party leaders could announce the start of rural-land-reform pilot in selected regions and increase the number of regions to launch a pilot scheme of integrating urban and rural hukou system in small towns and small cities.

Another area that will likely face strong resistance from interest groups is the reform of SOEs and monopolistic industries which is key to generate higher productivity to support China’s long-term growth potential. However, SOE reform will unlikely be a major focus of the Third Plenum and we do not expect any major upheaval to SOEs. That said, we do expect a reiteration of the desire to ease entry barriers for private investors and allow private capital to invest in several state-dominated sectors such as railway, utility, medical and telecom industries.

We expect new leaders will also lay out reform strategies in other key areas such as administrative reform (to cut red tape and approval authority of the government); resource pricing reform (toward more market-based price setting mechanism); policies to promote economic rebalancing and sustainable growth (e.g. strengthening of the social security system and innovation & green development); and demographic policy (e.g. signal of a move on mild relaxation of the one-child policy).

Investment implications

Market expectation is running high about the reform agenda to be unveiled in the Third Plenum, providing the potential for disappointment. If the top party leaders can articulate a clear and comprehensive vision for reform strategies, it may boost market confidence in the short term as it could lead to the perception of a consensus being reached. However, it remains to be seen how effective the government will be in implementing the reforms.

We believe improved profit growth momentum, cyclical growth stabilization and the current low valuations should lend some support to the Chinese stock market in the near term. However, investors will likely be gripped by a bumpy road ahead for China’s and global economic recovery, higher inflation (though inflation is unlikely to be a threat in the near term) and higher hurdle for policy easing. Structural reforms may inevitably result in lower near-term growth trajectory. De-leveraging and reduction in production capacity in several heavy industries may help cap investment growth of traditional sectors dominated by local governments and SOEs.

There appears to be no catalyst for a sustained market rebound until there is some conviction that the government has put the economy back on a sustainable growth path. Reform-driven re-rating potential is likely to take time to be realized. However, successful reforms could raise productivity growth, helping to sustain China’s relatively high growth (say 6-8%) in the medium-term in the face of slower investment growth and unsupportive demographic trends, as well as promote more inclusive growth. Although some sectors or existing listed companies could have inherent difficulties adapting to the transition, we continue to see opportunities for long-term investors in sectors and stocks that potentially benefit from economic rebalancing and reforms.

Renee Chen
Macro & Investment Strategist
HSBC Global Asset Management
*Third Plenum: First Plenum introduces the new leadership, the Second Plenum tends to be personnel- and Party construction-focused, while the third one is usually seen as the first plenary session at which the new leadership has basically consolidated power and can introduce a broader economic and political blueprint. Source: http://www.businessinsider.com/qa-what-is-chinas-3rd-plenum-2013-11

Important Information:

The contents of this document may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose. All non-authorized reproduction or use of this document will be the responsibility of the user and may lead to legal proceedings. The material contained in this document is for general information purposes only and does not constitute advice or a recommendation to buy or sell investments. Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors. We do not undertake any obligation to update the forward-looking statements contained herein, or to update the reasons why actual results could differ from those projected in the forward-looking statements. This document has no contractual value and is not by any means intended as a solicitation, nor a recommendation for the purchase or sale of any financial instrument in any jurisdiction in which such an offer is not lawful. The views and opinions expressed herein are those of HSBC Global Asset Management Macro & Investment Strategy Unit at the time of preparation, and are subject to change at any time. These views may not necessarily indicate current portfolios’ composition. Individual portfolios managed by HSBC Global Asset Management primarily reflect individual clients’ objectives, risk preferences, time horizon, and market liquidity.

The value of investments and the income from them can go down as well as up and investors may not get back the amount originally invested. Past performance contained in this document is not a reliable indicator of future performance while any forecasts, projections and simulations contained herein should not be relied upon as an indication of future results. Where overseas investments are held the rate of currency exchange may cause the value of such investments to go down as well as up. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging-market countries are greater than the risks generally associated with foreign investments. Fixed income investments are subject to credit and interest rate risks. Investments in high-yield securities (commonly referred to as “junk bonds”) are often considered speculative investments and have significantly higher credit risk than investment-grade securities. For complete risks considerations, please carefully review the products’ offering document(s).

There are important differences in how the strategy is carried out in each investment vehicle. Investors should carefully consider the investment objectives, risks and fees of the strategy carefully before investing. There are important differences in how the strategy is carried out in each investment vehicle. Investors should carefully consider the investment objectives, risks and fees of the strategy carefully before investing. A separately managed account may not be suitable for all investors and a minimum asset level is required. Please refer to the Form ADV Part 2A for important information about the investment manager.

Investors should consider the investment objectives, risks, charges, and expenses of the investment company carefully before investing. The prospectus contains this and other important information about the investment company. To obtain more information, please visit www.emfunds.us.hsbc.com or call (888-936-4722). Investors should read the prospectus carefully before investing or sending money.

We accept no responsibility for the accuracy and/or completeness of any third party information obtained from sources we believe to be reliable but which have not been independently verified.

HSBC Global Asset Management is the brand name for the asset management business of HSBC Group. The above communication is distributed by HSBC Global Asset Management (USA) which is regulated by the Securities and Exchange Commission;

HSBC Global Asset Management (USA) Inc. serves as the investment adviser to the HSBC Funds. Foreside Distribution Services, L.P., member FINRA, is the distributor of the HSBC Funds and is not affiliated with the Adviser. HSBC Securities (USA) Inc., member NYSE, FINRA, SIPC is a sub-distributor of the HSBC Funds. Affiliates of HSBC Global Asset Management (USA) Inc. receive fees for providing various services to the funds.

Investment products are offered by HSBC Securities (USA) Inc. (HSI), member NYSE/FINRA/SIPC. HSI is an affiliate of HSBC Bank USA, N.A. Investment products: Are not a deposit or other obligation of the bank or any of its affiliates; Not FDIC insured or insured by any federal government agency of the United States; Not guaranteed by the bank or any of its affiliates; and are subject to investment risk, including possible loss of principal invested.

All decisions regarding the tax implications of your investment(s) should be made in connection with your independent tax advisor.