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What to make of China's Third Party Plenum? **19 November 2013**

Exactly a week ago China closed the Third Plenum of the 18th Central Committee, the most important political meeting since 2003. By talking of a "master plan" President Xi had raised expectations that the upcoming meeting would bear a set of unprecedented broad and deep reforms. The initial Party statement did not reveal much detail and failed to meet expectations. However, in the follow-up statement released on Friday it became clear that President Xi is actually serious about reforms. It still remains to be seen how successful Chinese authorities will be in implementing reforms. After all, the Party Plenum is a conference where Chinese leaders only set out the general principles. But all in all, there are good reasons to believe that the new leadership will be able to push through significant changes that make the Chinese economy more robust in a longer term perspective. This is clearly positive as it reduces the chances of a hard landing further down the road. On the other hand, we still expect Chinese growth to gradually decrease from current levels.

Whereas the initial Plenum communiqué failed to provide clear answers to several questions, the document released last Friday was in fact surprisingly clear and coherent. Although it's still too soon to know for sure, there is a good chance that the latest Party Plenum marks the start of a significant shift in economic policy. The central message from the meeting is that market forces will be allowed to play a much more important role in the economy while direct government intervention will be reduced. This is a very welcome step because at the end of the day much of China's problems including high local debt levels or the discrepancy between investment spending and household consumption can be reduced to poor government policy. Before last meeting and despite the fact that President Xi has already launched a successful anti-corruption campaign, there was still much doubt about whether he would really change course and run against the interests of local government officials and state-owned enterprises (SOE's). After the meeting, it seems that at least a great deal of this scepticism can be dropped. Not only does he explicitly favour a more decisive role for the market, he will also set up two institutions that will closely monitor progress and make sure that conservative (dissident) forces are kept under control. Apart from the explicit pro-market language, the new leadership has also indicated in which areas reforms can be expected. Prices of energy and utilities will be more market-determined and China will also be more open to private firms (including banks and foreign companies). To be clear, SOE's will not be privatized but instead face stricter regulation and more intense competition. Within the financial sector interest rate and capital account liberalisation will continue (although at a gradual pace). Most probably, China will also make fiscal policy more transparent by shifting some responsibility for spending from the local to the central level and allow local governments to issue debt. Furthermore, land reforms should benefit poor rural households and the one-child policy will be relaxed.

The result of the recent Party Plenum is a blueprint and Chinese leaders still have everything to prove. But the fact that the document convincingly maps out the way in the right direction is new and a cause for optimism. If executed successfully, it will help rebalance China's economy away from investment towards consumption and reduce the probability of a hard landing further down the road. That said, we still expect a gradual decrease from the current high growth numbers (7.8% year on year in Q3). Credit growth, arguably the best forward looking indicator for the Chinese economy, seems to have peaked and the rebalancing of the economy over the next decade is set to put further downward pressure on Chinese growth.