EM Strategy
CHINA: WHAT TO EXPECT FROM THE 3RD PLENUM OF THE CENTRAL COMMITEE

The 3rd Plenum of the Central Committee, lastly held in 2018, used to mark pivotal policy changes in China's strategic priorities over the medium term, with possibly far-reaching consequences on the country's macro backdrop. After having been postponed from April to July, we expect policymakers to focus on structural issues such as the fiscal reform, the improvement of domestic confidence, the rebalancing of consumption, US-China relations and the demographic transition. At this stage, we do not expect major announcements; rather, we believe policymakers should deliver a more directional framework to tackle challenges China already faces. The most relevant near-term ramifications could stem from the Consumption tax reform, which could end up in additional burden on households' consumption. Anyway, we are accustomed to Chinese policymakers to disclose even major policy changes within a very short notice, so we don't rule out further announcements.

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The Central Committee of the CCP is the highest Chinese executive organ, which convenes at least once year in a plenary session, for a total of seven plenums to be held over the five-year term of each Central Committee. In April, the Politburo decided to postpone the 3rd Plenum of the 20th Central Committee (TPoCC) to July. Meanwhile, market expectations grew up, especially considering the economic setback China experienced in recent years.

In fact, third plenums could mark pivotal policy changes in China. In 1978, the TPoCC initiated the "reform and opening-up" transformation; in 1993 the TPoCC solidified the push towards market economy by shuttering SOEs; in 2013, dozens of market-oriented reform measures have been laid out on transforming government roles, rural and urban development and housing policies. The last 3rd Plenum occurred in 2018.

So, what to expect from the 2024 TPoCC? In our view, the focus will be on these issues:

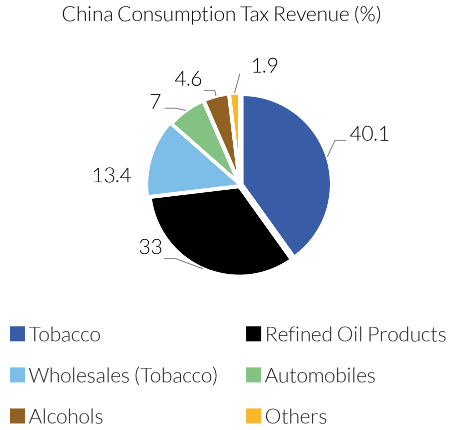
1. Fiscal reform
2. Improvement of domestic confidence
3. Rebalancing of consumption
4. US-China relations
5. Demographic transition

1. Fiscal reform: authorities should decide to increase revenues through higher consumption tax. As early as in 2019, the State Council proposed some key adjustments to the collection of consumption tax, which did not follow through amid the Covid insurgence. Later on, CEWC last year called for a new round of fiscal and tax reforms, and this year's fiscal budget explicitly mentioned a plan of consumption tax reform. Thus, in our view, the fiscal reform would take centerstage in the incoming 3rd Plenum.

Currently, China only applies consumption tax on just 15 products (tobacco, alcohol, refined oil, cars, batteries and luxury goods such as jewelry, watches and yachts, **Figure 1**) and revenues go 100% to central government. Meanwhile, falling land sales (**Figure 2**) increased concern over time on local government debt risk, as local governments finance their spending mainly through land sales.

FIGURE 1.

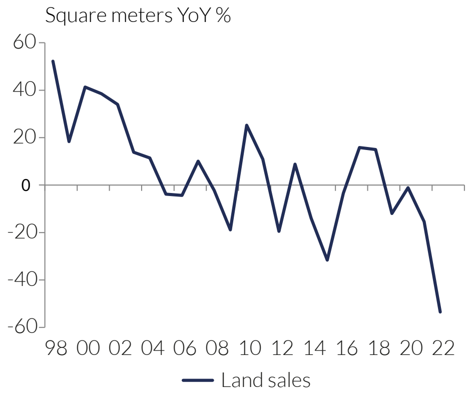
CT has concentrated revenue sources



Source: Haver Analytics, NBS, Anima Research

FIGURE 2.

Land sales shrunk amid housing downturn



Source: Haver Analytics, NBS, Anima Research

Against this backdrop, **Table 1** summarizes our expectations in terms of possible reforms and likely macroeconomic impact.

TABLE 1.

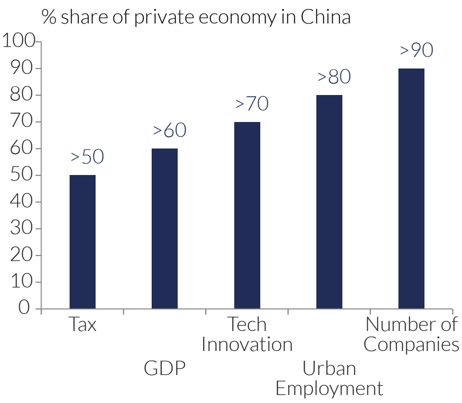
Consumption tax reform should be a focal point of the 3rd Plenum

What to expect from the Consumption tax reform	Possible macro impact
Tax revenues to be gradually shifted from the central government to local governments, as the local-central split ratio should rise from 0/100 to 50/50, as per the current 50/50 sharing of VAT.	Adding around CNY 1 trl to local government revenues, up to 10% of their budgetary revenues, based on 2023 data.
Broaden the scope to more consumption products and raise their tax rate, especially for polluting products.	This could be positive for a rebalance from supply to demand in the medium term, as local governments should have more incentives to improve consumption, tourism infrastructure and services instead of pure production.
Shifting the taxation point from production/ imports to wholesale/retail.	This could end up in higher end-user prices, which, although not concerning from an inflation point of view given the current deflationary environment, should not be conducive for a consumer sentiment rebound in the short-term.

2. . Improvement of domestic confidence: authorities will try to take companies' confidence back. Given China's rising ambition on global tech and innovation, restoring high level of confidence —primarily among domestic actors— will be crucial. In fact, private companies are essential to China's economy (**Figures 3**, **4**). As a starting point, we expect some actions on equal treatment between private companies and SOEs and equal access to credit. Furthermore, we expect more reassurance on property rights protection, but we continue to believe it will take time to bring private business confidence fully back.

FIGURE 3.

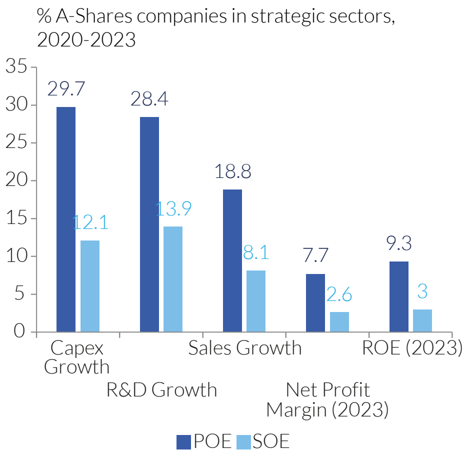
China can't do without the private sector…



Source: Haver Analytics, NBS, Anima Research

FIGURE 4.

…especially for strategic sectors

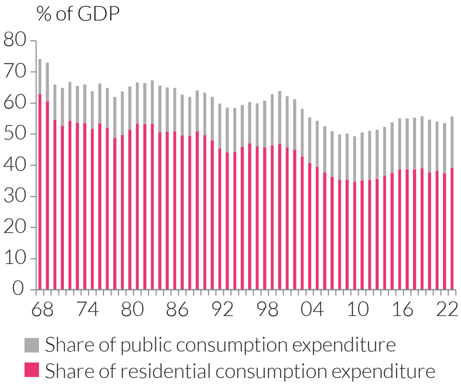


Source: Haver Analytics, NBS, Anima Research

3. Rebalancing of consumption: we do not expect fresh stimulus on housing stabilization. There is urgent need for a rebalancing of domestic demand as consumption's share in the economy has almost stalled (**Figure 5**). Nonetheless, we don't expect detailed plans to stimulate households' consumption at this stage; we think authorities will prefer more general pledges to keep family income growth in line with nominal GDP growth, while some fiscal resources could be reallocated to the welfare to strengthen the social safety net, which could translate into a marginally higher propensity to consume in the near term. Furthermore, we continue not to expect policymakers to unveil any major stimulus on the housing sector: as long as the recovery of the housing sector is not achieved in full, we won't expect consumers to spend more, as real estate remains the largest share of households' wealth (**Figure 6**).

FIGURE 5.

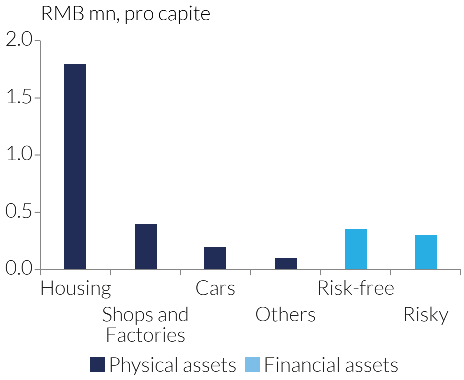
Consumption's share of GDP shrunk



Source: Haver Analytics, NBS, Anima Research

FIGURE 6.

Housing is the pillar of households' wealth



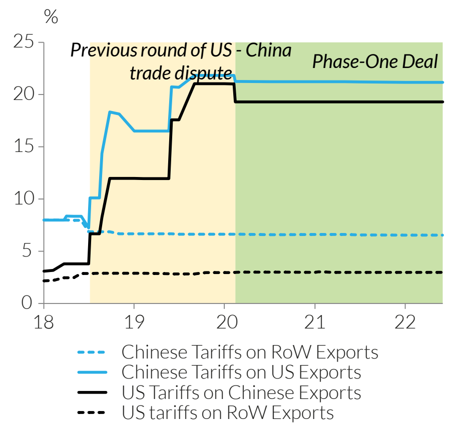
Source: Haver Analytics, NBS, Anima Research

4. US-China relations: we expect political tensions to rise, especially if Trumps wins. Political tensions between China and the US have been structurally on the rise in the last decade. We expect greater emphasis to be addressed to security and stability in this 3rd Plenum, while publicly reiterating the reassuring message that "development is the first priority". In reality, we think national security issues will represent a much larger part of Xi's hidden agenda, as more intense US-China confrontation looms ahead.

In particular, we think that US rhetoric on potential tariffs is likely to rump up heading into US elections. A potential 60% universal tariff on Chinese goods (as Trump promised) would squeeze all Chinese exports out of the US markets; on the other hand, a more realistic 15% increase in average tariffs (similar to the 2018-19 round, **Figure 7**) would reduce China's export by around 9% and GDP by more than 1% next year. Given China's lower GDP potential vis à vis the pre-COVID period, chances are an actual 15% tariffs increase would ignite a tit-for-that tariff retaliation by China, not excluding targeting US companies operating in China. Furthermore, more US tariffs on Chinese imports might backfire through an increase of US domestic inflation risks (**Figure 8**).

FIGURE 7.

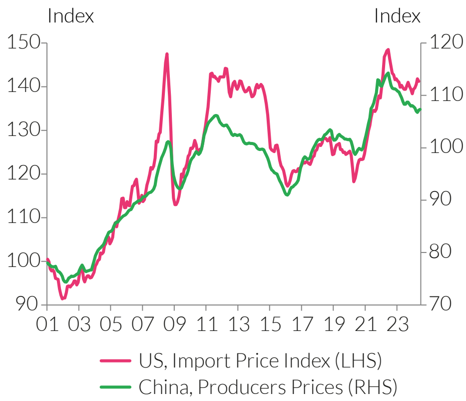
HH's consumption slowed sequentially



Source: Haver Analytics, NBS, Anima Research

FIGURE 8.

PPI deflation still spilling into CPI...

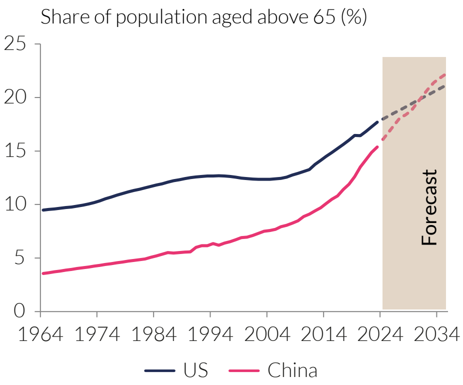


Source: Haver Analytics, NBS, Anima Research

5. Demographic transition: time to start hedging against aging population, as China gets old. China's old age population share (>65) is now high at 14.9% and set to move higher (**Figure 9**), while the fertility rate ranks among the lowest in the world (**Figure 10**). Furthermore, pension deficit is set to widen, as the retirement of Chinese baby boomers in the next decade could pose a challenge to the pension system, even with higher retirement age: pension schemes already rely on fiscal subsidies. We expect the 3rd Plenum to try to arrest the fertility decline, advancing concrete measures,such as more government spending /subsidies to lower parenting costs or more family-friendly labour regulations, which at the margin could have a positive impact on domestic demand.

FIGURE 9.

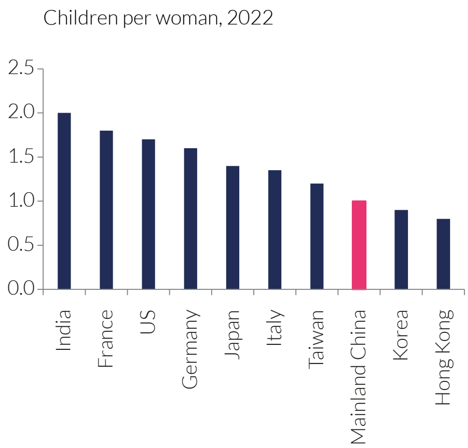
China demography set to deteriorate



Source: Haver Analytics, United Nations, NBS, Anima Researc

FIGURE 10.

Fertility rate ranks among the lowest



Source: Haver Analytics, NBS, Anima Research