

## Special Report

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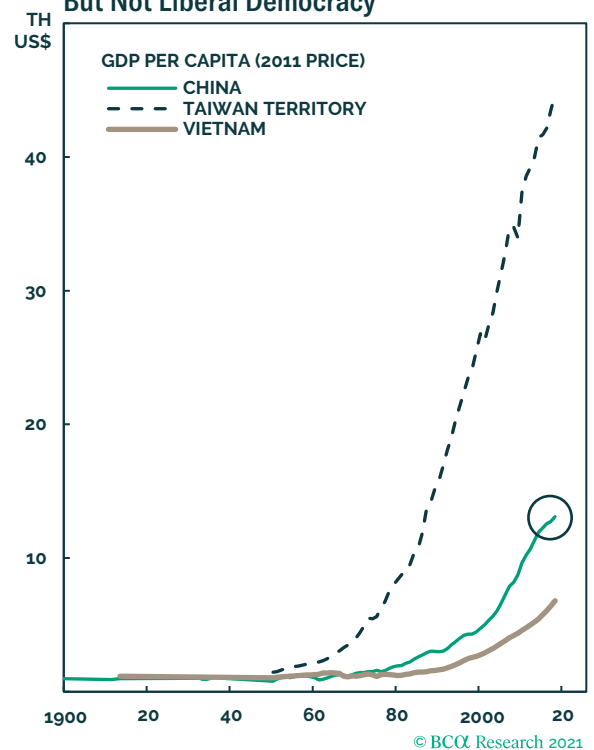
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June 18, 2021

## China's Communist Party Turns 100: So What?

- China's Communist Party has overcome a range of challenges over the past 100 years, performed especially well over the past 42 years, but the macro and geopolitical outlook is darkening.
- The "East Asian miracle" phase of Chinese growth has ended. Potential GDP growth is slowing and it will be harder for Beijing to maintain financial and sociopolitical stability.
- The Communist Party has shifted the basis of its legitimacy from rapid growth to quality of life and nationalist foreign policy. The latter, however, will undermine the former by stirring up foreign protectionism.
- In the near term, global investors should favor developed market equities over China/EM equities. But they should favor China and Hong Kong stocks over Taiwanese stocks given significant geopolitical risk over the Taiwan Strait.
- Structurally, favor the US dollar and euro over the renminbi.

CHART 1  
China Outperformed Communism  
But Not Liberal Democracy



SOURCE: MADDISON PROJECT DATABASE, VERSION 2020. BOLT, JUTTA AND JAN LUITEN VAN ZANDEN (2020), "MADDISON STYLE ESTIMATES OF THE EVOLUTION OF THE WORLD ECONOMY. A NEW 2020 UPDATE".

China's Communist Party turns 100 years old in July. Single-party states are not an impediment to national wealth – but communist ideology is.

Ten years ago, in the lead up to the Communist Party's 90th anniversary, I wrote a report called "China and the End of the Deng Dynasty," referring to Deng Xiaoping, the Chinese Communist Party's great pro-market reformer.<sup>1</sup> The argument rested on three points: the end of the export-manufacturing economic model, an increasingly assertive foreign policy, and the revival of Maoist nationalism. After ten years the report holds up reasonably well but it did not venture to forecast what precisely would come next.

In reality it is the rule of the Communist Party, and not the leader of any one man, that fits into China's history of dynastic cycles. As the party celebrates a hundred years since its founding on July 23, 1921, it is necessary to pause and reflect on what the party has achieved over the past century and what the current Xi Jinping era implies for the country's next 100 years.

### Single-Party Rule Can Bring Economic Success. Communism Cannot.

Regime type does not preclude wealth. Countries can prosper regardless of whether they are ruled by one person, one party, or many parties. The richest countries in the world grew rich over centuries in which their governments evolved from monarchy to democracy and sometimes back again. Even today several of the

world's wealthy democracies are better described as republics or oligarchies.

The rule of one person, or autocracy, is not necessarily bad for economic growth. For every Kim Il Sung of North Korea there is a Lee Kuan Yew of Singapore. But authority based on a single person often expires with that person and rarely survives his grandchild. In China, Chairman Mao Zedong's death occasioned a power struggle. Deng Xiaoping's attempts to step down led to popular unrest that threatened the Communist Party's rule on two separate occasions in the 1980s.

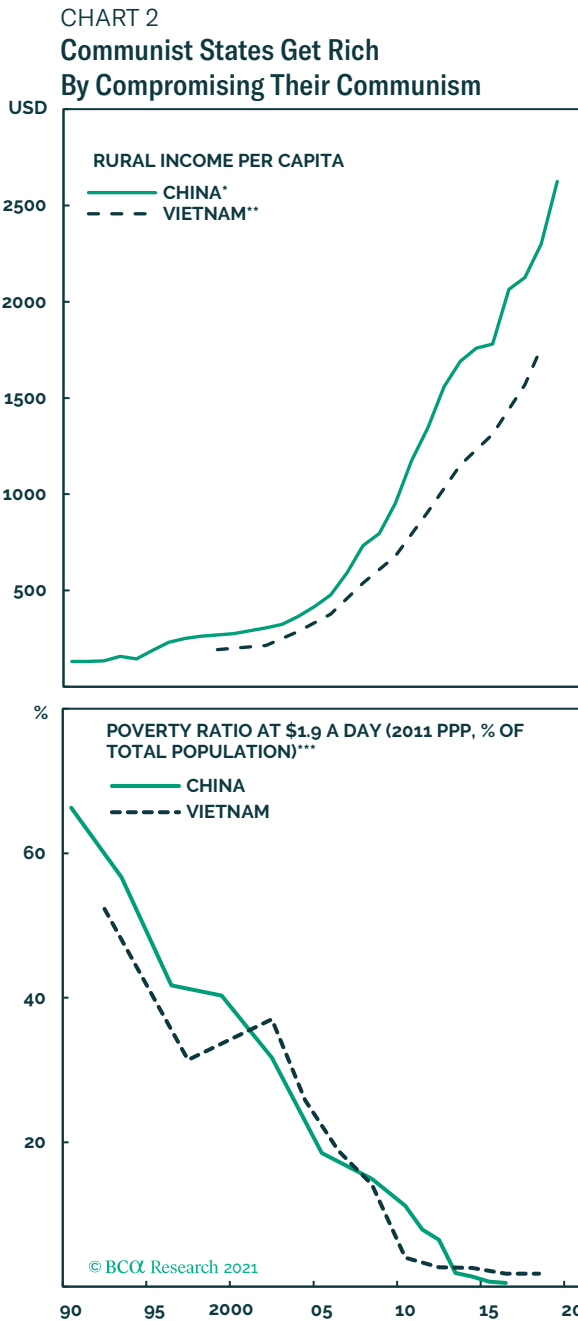
The rule of a single party is thought to be more sustainable. Japan and Singapore are effectively single-party states and the wealthiest countries in Asia. They are democracies with leadership rotation and a popular voice in national affairs. And yet South Korea's boom times occurred under single-party military rule. The same goes for the renegade province of Taiwan. Only around the time these two reached about \$11,000-\$14,000 GDP per capita did they evolve into multi-party democracies – though their wealth grew rapidly in the wake of that transition.

China and soon Vietnam will test whether non-democratic, single-party rule can persist beyond the middle-income economic status that brought about democratic transition in Taiwan (**Chart 1**). Vietnam and Taiwan are the closest communist and non-communist governing systems, respectively, to mainland China.

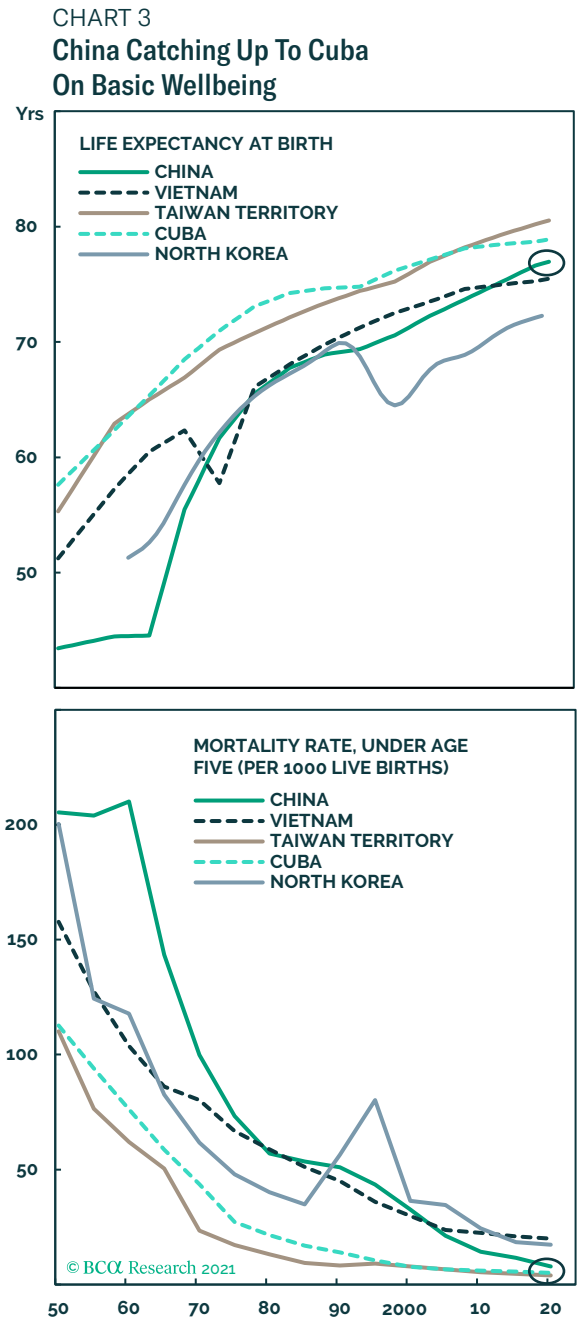
Insofar as China and Vietnam succeed at catching up with Taiwan it will be for reasons other than Marxist-Leninist ideology. Most communist systems have failed. At the height of international communism

<sup>1</sup> The report concluded, "the emerging trends suggest a likely break from Deng's position toward heavier state intervention in the economy, more contentious relationships with neighbors, and a Party that rules primarily through ideology and social control." Co-written with Jennifer Richmond, "China and the End of the Deng Dynasty," *Stratfor*, April 19, 2011, [worldview.stratfor.com](http://worldview.stratfor.com).

China and Vietnam not only survived the fall of the Soviet Union but unleashed market forces and prospered.



\* DISPOSABLE INCOME. SOURCE: NBS.  
 \*\* SHOWN AS 12 TIMES MONTHLY INCOME. SOURCE: GENERAL STATISTICS OFFICE OF VIETNAM.  
 \*\*\* SOURCE: WORLD BANK.



SOURCE: UN WORLD POPULATION PROSPECTS (2019) & WORLD BANK DATABASE.

in the twentieth century there were 44 states ruled by communist parties; today there are five. China and Vietnam are the rare examples of communist states that not only survived the Soviet Union's fall but

also unleashed market forces and prospered (**Chart 2**). North Korea survived in squalor; Cuba's experience is mixed. States that close off their economies do not have a good record of generating wealth.

Since China's reform and opening up in 1979, the Communist Party has avoided many errors and drastically increased China's global wealth and power.

TABLE 1  
China's Global Rise After 'Reform And Opening Up'

	CHINA AS A % OF GLOBAL	
	1980	2020 OR LATEST AVAILABLE
NOMINAL GDP*	1.7	16.3
NOMINAL GDP PER CAPITA*	7.7	89.4
TOTAL CAPITAL STOCK**	3.6	15.1
EXPORTS***	1.0	15.2
MILITARY SPENDING****	1.7	14.0

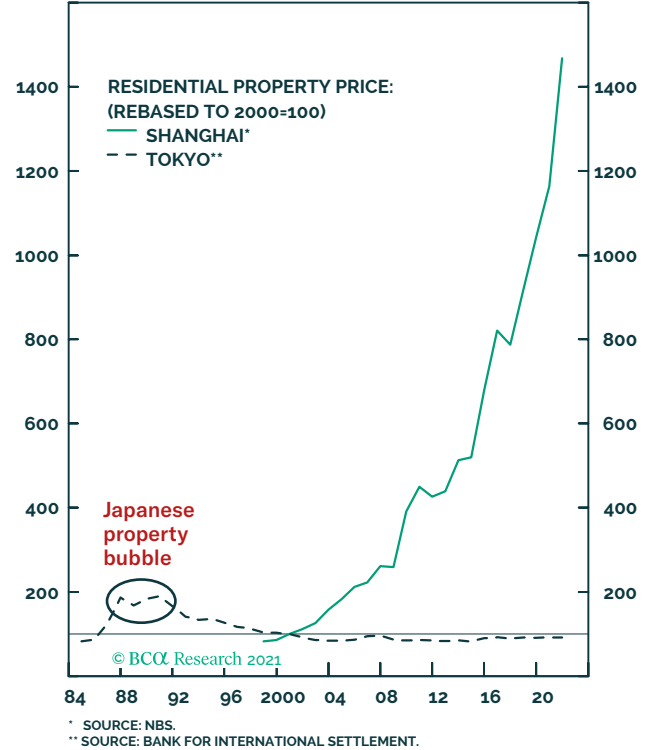
\* SHOWN AS 1980 AND 2019 DATA. SOURCE: WORLD BANK.  
 \*\* SHOWN AS 1980 AND 2019 DATA IN 2017 CONSTANT USD. SOURCE: UNIVERSITY OF GRONINGEN; UNIVERSITY OF CALIFORNIA, DAVIS.  
 \*\*\* SHOWN AS 1980 AND 2020 DATA. SOURCE: IMF DOT.  
 \*\*\*\* SHOWN AS 1989 AND 2019 DATA. SOURCE: WORLD BANK.

Closed economies lack competition and investment, struggle with stagflation, and often succumb to corruption and political strife. Openness seems to be a more diagnostic variable than government type or ideology, given the prosperity of democratic Japan and non-democratic China.

Has the CPC performed better than other communist regimes? Arguably. It performs better than Vietnam but worse than Cuba on critical measures like infant mortality rates and life expectancy. Has it performed better than comparable non-communist regimes? Not really, though it is fast approaching Taiwan in all of these measures (**Chart 3**).

What can be said for certain is that, since China's 1979 reform and opening up, the CPC has avoided many errors and catastrophes. It survived the 1980s, 1990s, and 2000s without succumbing to international isolation, internal divisions, or economic crisis. It has drastically increased its share of global power (**Table 1**). Contrast this

CHART 4  
China To Keep Struggling With Financial Instability



global ascent with the litany of mistakes and crises in the US since the year 2000.

The CPC also managed the past decade relatively well despite the Chinese financial turmoil of 2015-16, the US trade war of 2018-19, and the COVID-19 pandemic. However, these events hint at greater challenges to come. China's transition to a consumer-oriented economy has hardly begun. The struggle to manage systemic financial risk is intensifying today at risk to growth and stability (**Chart 4**). The trade war is simmering despite the Phase One trade deal and the change of party in the White House. And it is too soon to draw conclusions about the impact of the global pandemic, though China suppressed the virus more rapidly than other countries and led the world into recovery.

There are two significant domestic risks on the horizon: import substitution and “cult of personality.”

Judging by the points above, there are two significant risks on the horizon. First, the CPC’s revival of neo-Maoist ideology, particularly the new economic mantra of self-reliance and “dual circulation” (import substitution), poses the risk of closing the economy and undermining productivity.<sup>2</sup>

Second, China’s sliding back into the rule of a single person – after the “consensus rule” that prevailed after Deng Xiaoping – increases the risk of unpredictable decision-making and a succession crisis whenever General Secretary Xi Jinping steps down. The party’s internal logic holds that China’s economic and geopolitical challenges are so enormous as to require a strongman leader at the helm of a single-party and centralized state. But because of the traditional problems with one-man rule, there is no guarantee that the country will remain as stable as it has been over the past 42 years.

## Slowing Growth Drives Clash With Foreign Powers

Every major East Asian economy has enjoyed a “miracle” phase of growth – and every one of them has seen this phase come to an end. Now it is China’s turn. The country’s potential GDP growth is slowing as the population peaks, the labor force shrinks, wages rise, and companies outsource production to cheaper neighbors (Charts 5A & 5B). The Communist Party is attempting to reverse the collapse in the fertility

rate by shifting from its historic “one Child policy,” which sharply reduced births. It shifted to a two-child policy in 2016 and a three-child policy in 2021 but the results have not been encouraging over the past five years.

In the best case China’s growth will follow the trajectory of Taiwan and South Korea, which implies at most a 6% yearly growth rate over the next decade (Chart 6). This is not too slow but it will induce financial instability as well as hardship for overly indebted households, firms, and local governments.

The Communist Party’s legitimacy was not originally based on rapid economic growth but it came to be seen that way over the roaring decades of the 1980s through the 2000s. Thus when the Great Recession struck the party had to shift the party’s base of legitimacy. The new focus became quality of life, as marked by the Xi administration’s ongoing initiatives to cut back on corruption, pollution, poverty, credit excesses, and industrial overcapacity while increasing spending on health, education, and society (Chart 7).

The party’s efforts to improve standards of living and consumer safety also coincided with an increase in propaganda, censorship, and repression to foreclose political dissent. The country falls far short in global governance indicators (Chart 8).

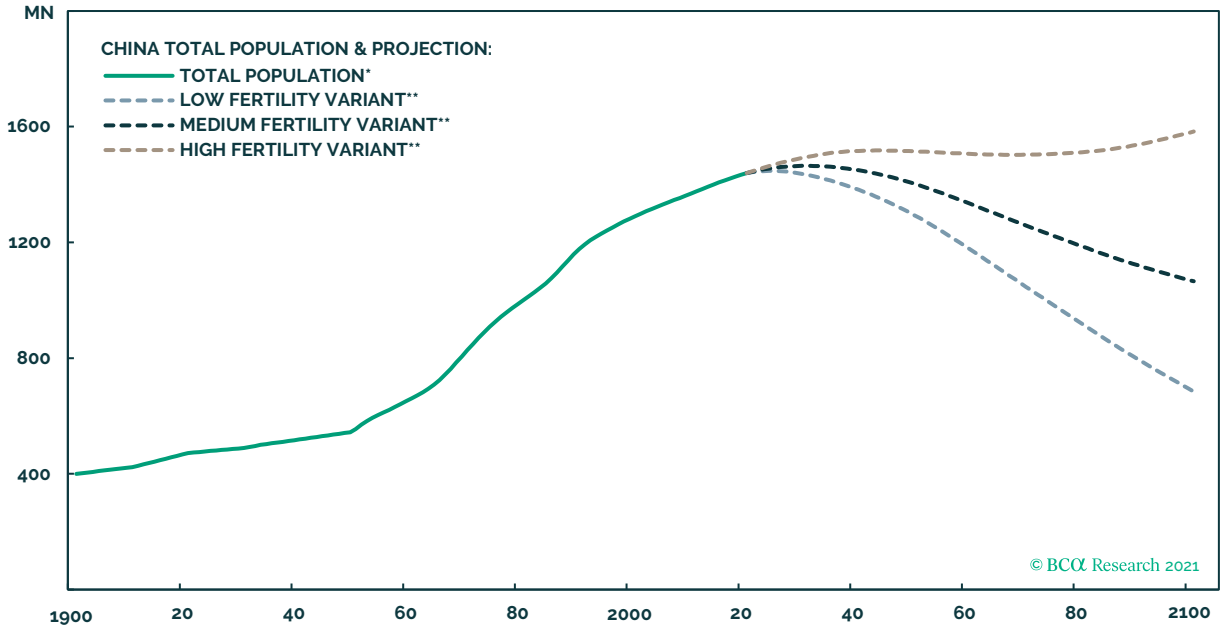
A second major new source of party legitimacy is nationalist foreign policy.

China adopted a “more assertive” foreign and trade policy in the mid-2000s as its import dependencies ballooned. It helped that the US was distracted with wars of

<sup>2</sup> The Xi administration’s new concept of “dual circulation” entails that state policy will encourage the domestic economy whereas the international economy will play a secondary role. This is a reversal of the outward and trade-oriented economic model under Deng Xiaoping. See “Xi: China’s economy has potential to maintain long-term stable development,” November 4, 2020, news.cgtn.com.

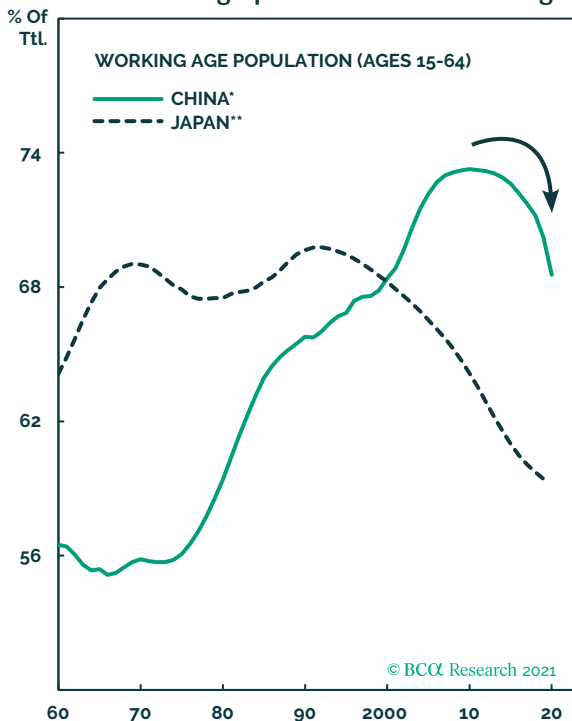
China's shrinking labor force subtracts from potential growth, which in turn motivates assertive foreign policy.

CHART 5A  
China's Demographic Decline Accelerating



\* SOURCE: MADDISON PROJECT DATABASE. BOLT, JUTTA AND JAN LUITEN VAN ZANDEN (2020), "MADDISON STYLE ESTIMATES OF THE EVOLUTION OF THE WORLD ECONOMY. A NEW 2020 UPDATE."  
\*\* SOURCE: UN WORLD POPULATION PROSPECTS (2019) PROJECTION.

CHART 5B  
China's Demographic Decline Accelerating



\* SOURCE: CHINA NATIONAL BUREAU OF STATISTICS.  
\*\* SOURCE: WORLD BANK.

choice and financial crises. After the Great Recession the CPC's foreign policy nationalism became a tool of generating domestic popular support amid slower economic growth. This was apparent in the clashes with Japan and other countries in the East and South China Seas in the early 2010s, in territorial disputes with India throughout the past decade, in political spats with Norway and most recently Australia, and in military showdowns over the Korean peninsula (2015-16) and today the Taiwan Strait (Chart 9).

If China were primarily focused on foreign policy and global strategy then it would not provoke multiple neighbors on opposite sides of its territory at the same time. This is a good way to motivate the formation of

Assertive foreign policy threatens quality of life by provoking protectionism and sanctions on trade and investment.

CHART 6  
China's Growth Rates Will Converge With Taiwan, South Korea

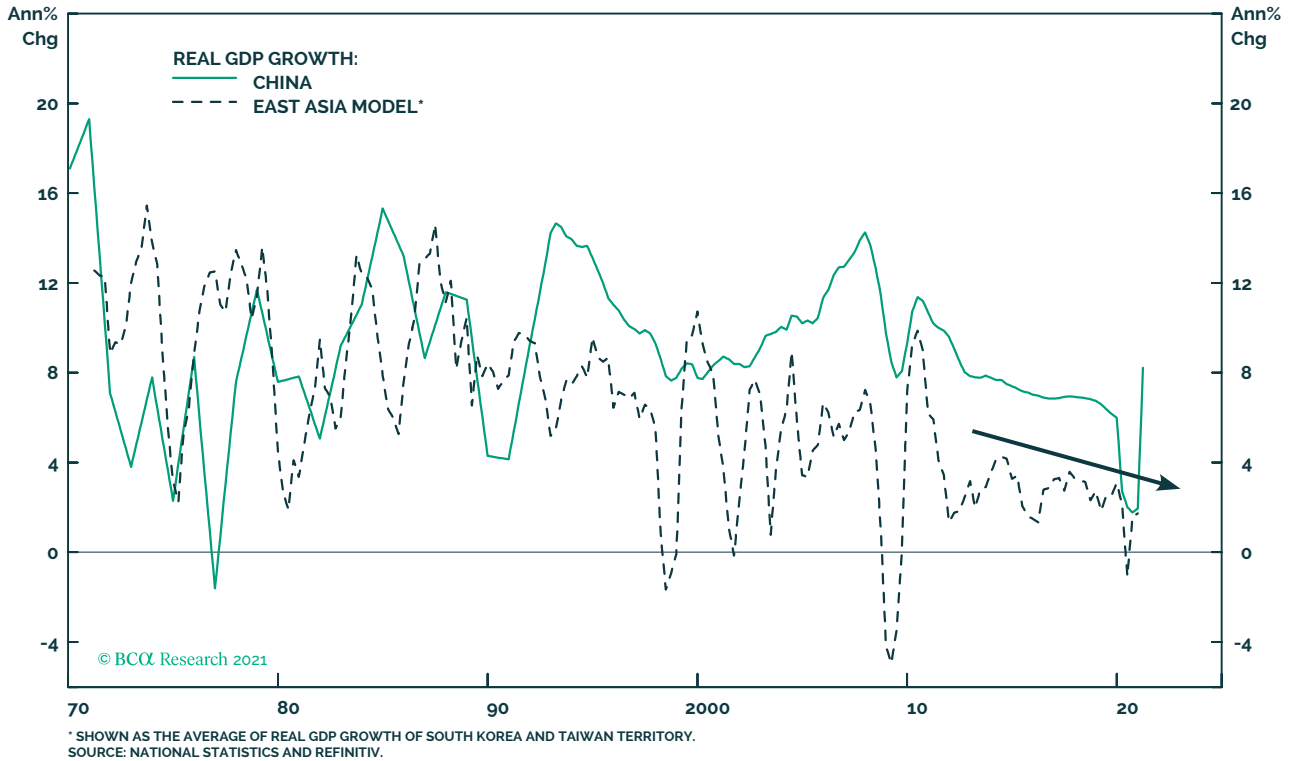
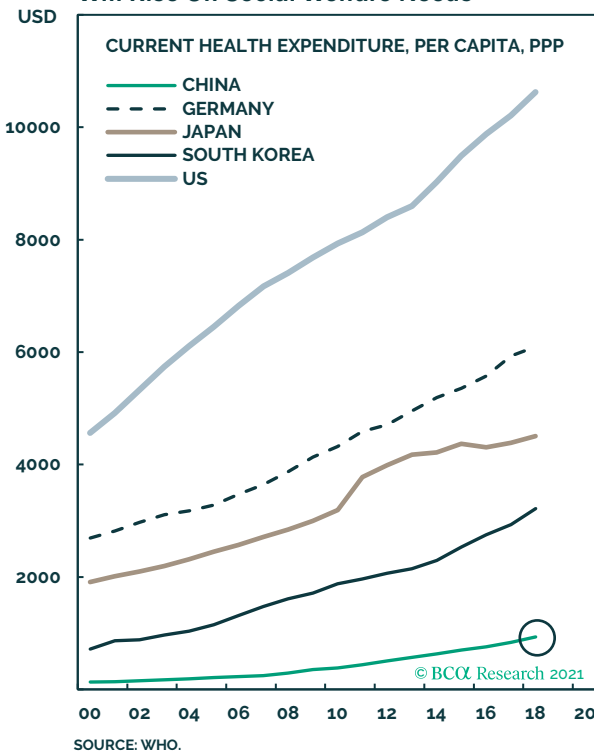


CHART 7  
China's Fiscal Burdens Will Rise On Social Welfare Needs

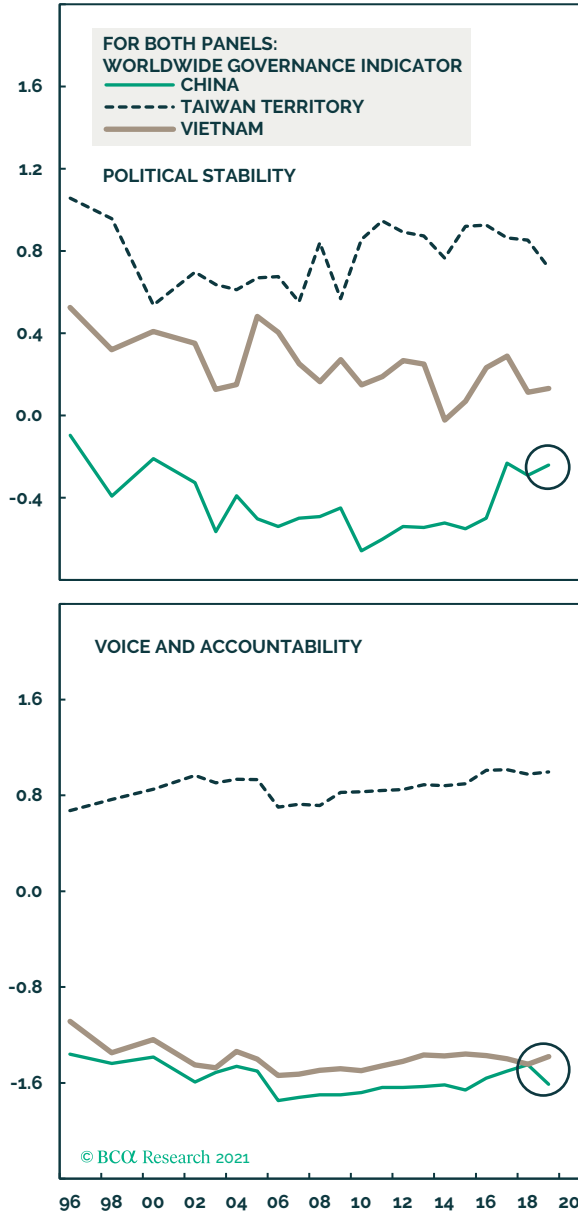


a global balance-of-power coalition that can constrain China in the coming years. But China's outward assertiveness is not driven primarily by foreign policy considerations. It is driven by the secular economic slowdown at home and the need to use nationalism to drum up domestic support. This is why China seems indifferent to offending multiple countries at once (like India and Australia) as well as more distant trade partners whom it "should be" courting rather than offending (like Europe).

Such assertive foreign policy threatens to undermine quality of life, namely by provoking international protectionism and sanctions on trade and investment. The US is galvanizing a coalition of democracies to

China has fallen short in worldwide governance indicators.

CHART 8  
China Lags In Governance, Rule Of Law



SOURCE: DANIEL KAUFMANN, AART KRAAY AND MASSIMO MASTRUZZI (2010). "THE WORLDWIDE GOVERNANCE INDICATORS: A SUMMARY OF METHODOLOGY, DATA AND ANALYTICAL ISSUES". WORLD BANK POLICY RESEARCH WORKING PAPER NO. 5430  
HTTP://PAPERS.SSRN.COM/SOL3/PAPERS.CFM?ABST

put pressure on China over its trade practices and human rights. The Asian allies are mostly in step with the US because they fear China's growing clout. The European states do not have as much to fear from China's military but they do fear China's state-backed industry and technological rise.

Europe's elites also worry about anti-establishment political movements just like American elites and therefore are trying to win back the hearts and minds of the working class through a more proactive use of fiscal and industrial policy. This entails a more assertive trade policy. China has so far not adapted to the potential for a unified front among the democracies, other than through rhetoric. Thus the international horizon is darkening even as China's growth rates shift downward.

### China's Geopolitical Outlook Is Dimming

China's government has overcome a range of challenges and crises. The country takes an ever larger role in global trade despite its falling share of global population because of its productivity and competitiveness. The drop in China's outward direct investment is tied to the global pandemic and may not mark a top, given that the country will still run substantial current account surpluses for the foreseeable future and will need to recycle these into natural resources and foreign production (Chart 10). However, the limited adoption of the renminbi as a reserve currency in the face of this formidable commercial power reveals the world's reservations about Beijing's ability to maintain macroeconomic stability, good governance, and peaceful foreign relations.



Proxy battles and proxy wars are a real risk in China's periphery in the coming years and decades.

CHART 9  
Proxy Wars A Real Risk In China's Periphery

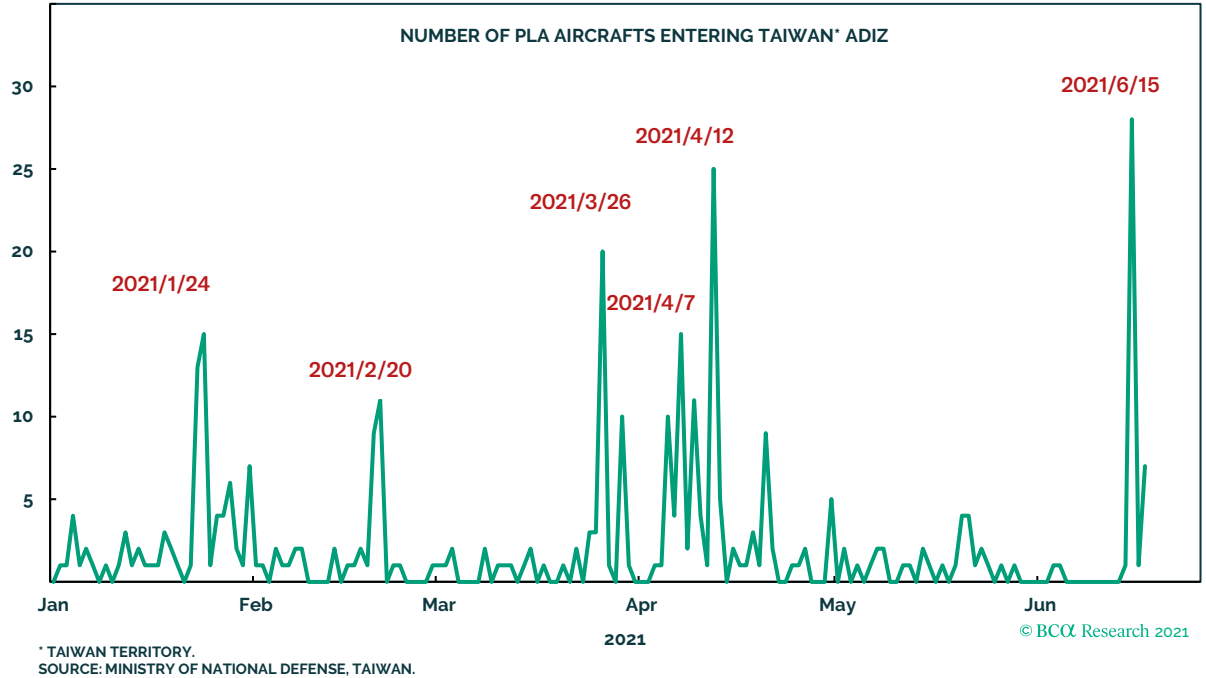
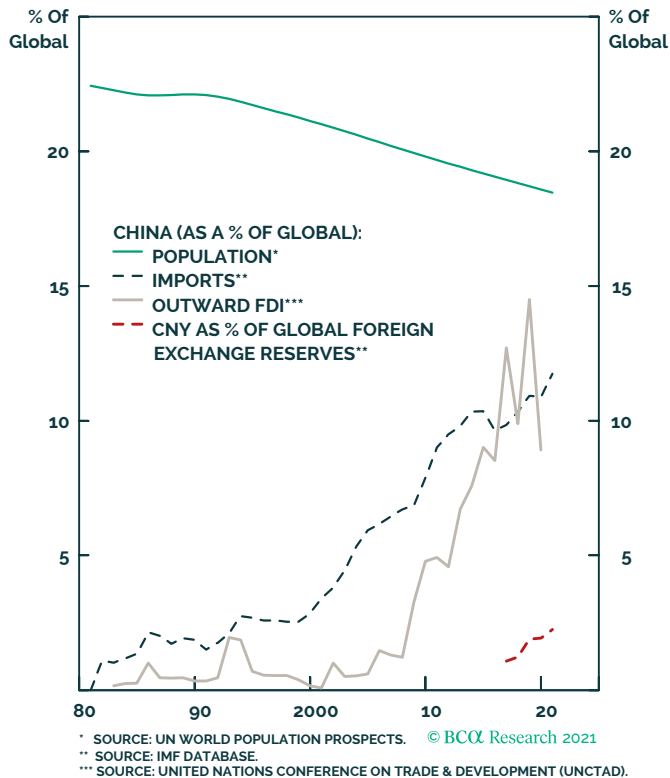


CHART 10  
China's Global Status



China is not in a position to alter the course of national policy dramatically prior to the Communist Party's twentieth national congress in 2022. The Xi administration is focused on normalizing monetary and fiscal policy and heading off any sociopolitical disturbances prior to that critical event, in which General Secretary Xi Jinping, who was originally slated to step down at this time according to the old rules, may be anointed the overarching "chairman" position that Mao Zedong once held. The seventh generation of Chinese leaders will be promoted at this five-year rotation of the Central Committee and will further consolidate the Xi administration's grip. It will also cement the party's rotation back to leaders who have ideological educations, as opposed to the norm in the 1990s and early

China's structural rise in policy uncertainty will prevent a stable and predictable investment environment.

2000s of promoting leaders with technocratic skills and scientific educations.<sup>3</sup>

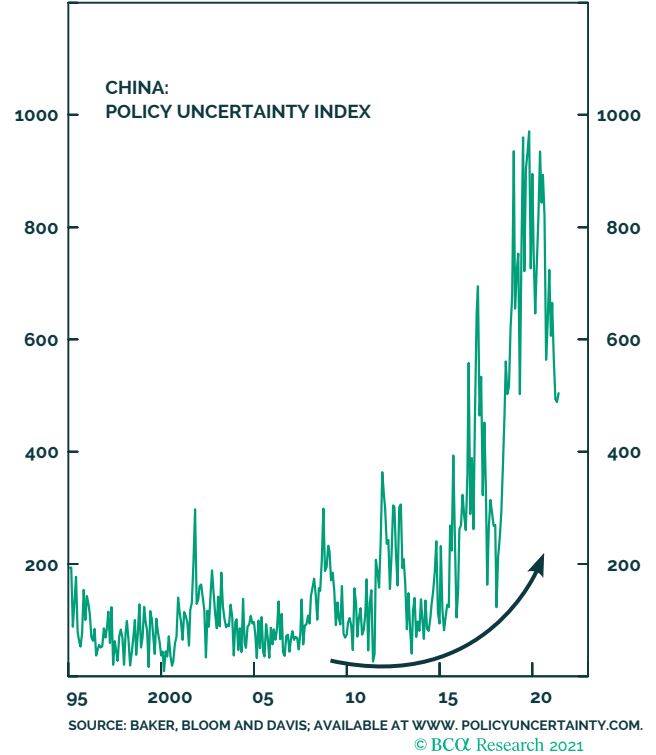
This does not mean that President Xi will refuse to hold a summit with US President Biden in the coming months nor does it mean that US-China strategic and economic dialogue will remain defunct. But it does mean that Beijing is unlikely to make any major course correction until after the 2022 reshuffle – and even then a course correction is unlikely. China has taken its current path because the Communist Party fears the sociopolitical consequences of relinquishing economic control just as potential growth slows. The new ruling philosophy holds that the Soviet Union fell because of Mikhail Gorbachev's *glasnost* and *perestroika*, not because openness and restructuring came too late.

Moreover it is far from clear that the US, Europe, and other democratic allies will apply such significant and sustained pressure as to force China to change its overall strategy. America is still internally divided and its foreign policy incoherent; the EU remains reactive and risk-averse. China has a well-established set of strategic goals for 2035 and 2049, the 100th anniversary of the People's Republic, and the broad outlines will not be abandoned.

The implication is that tensions with the US and China's Asian neighbors will persist. Rising policy uncertainty is a secular trend that will pick back up sooner rather than later (**Chart 11**), to the detriment of a stable and predictable investment environment.

<sup>3</sup> See Willy Wo-Lap Lam, "China's Seventh-Generation Leadership Emerges onto the Stage," Jamestown Foundation, China Brief 19:7, April 9, 2019, Jamestown.org.

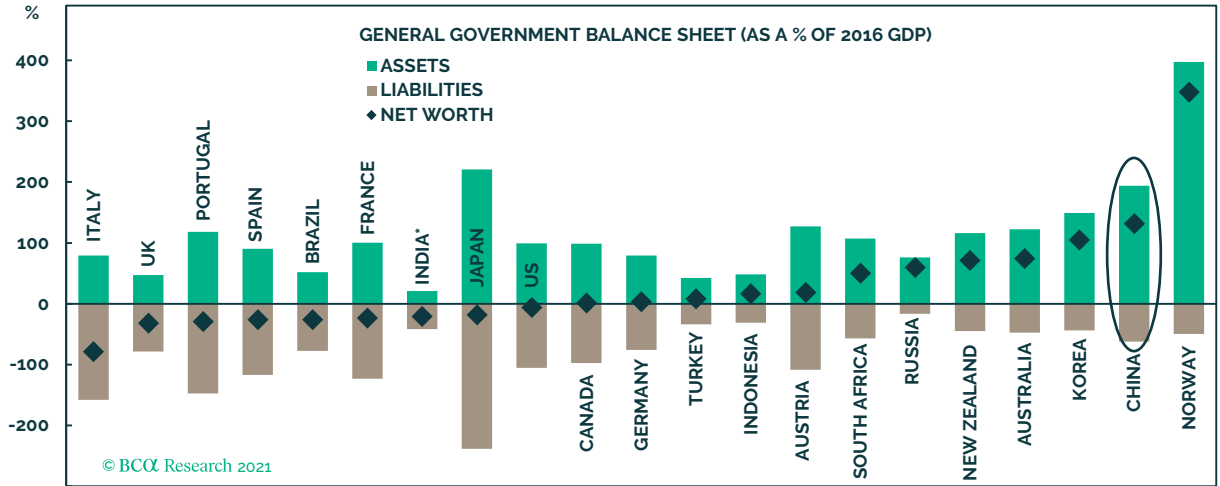
CHART 11  
China's Policy Uncertainty:  
A Structural Uptrend



Monetary and fiscal dovishness and a continued debt buildup are the obvious and necessary solutions to China's combination of falling growth potential, rising social liabilities, the need to maintain the rapid military buildup in the face of geopolitical challenges. Sovereign countries can amass vast debts if they own their own debt and keep nominal growth above average bond yields. China's government has a very favorable balance sheet when national assets are taken into consideration as well as liabilities, according to the IMF (**Chart 12**). On the other hand, China's government is having to assume a lot of hidden liabilities from inefficient state-owned companies and local governments. **In the short run there are major systemic financial risks even though in the long run Beijing will be able**

China's government will face financial instability in the short and medium run as hidden liabilities are recognized and added to the public balance sheet.

CHART 12  
Chinese Government's Net Worth High But Hidden Liabilities Pose Risks



\* CENTRAL GOVERNMENT DATA.  
NOTE: IN ALL PANELS, THE DATA EXCLUDE LAND AND NATURAL RESOURCES ASSETS AND PENSION LIABILITIES.  
SOURCE: IMF FISCAL MONITOR, FALL 2018.

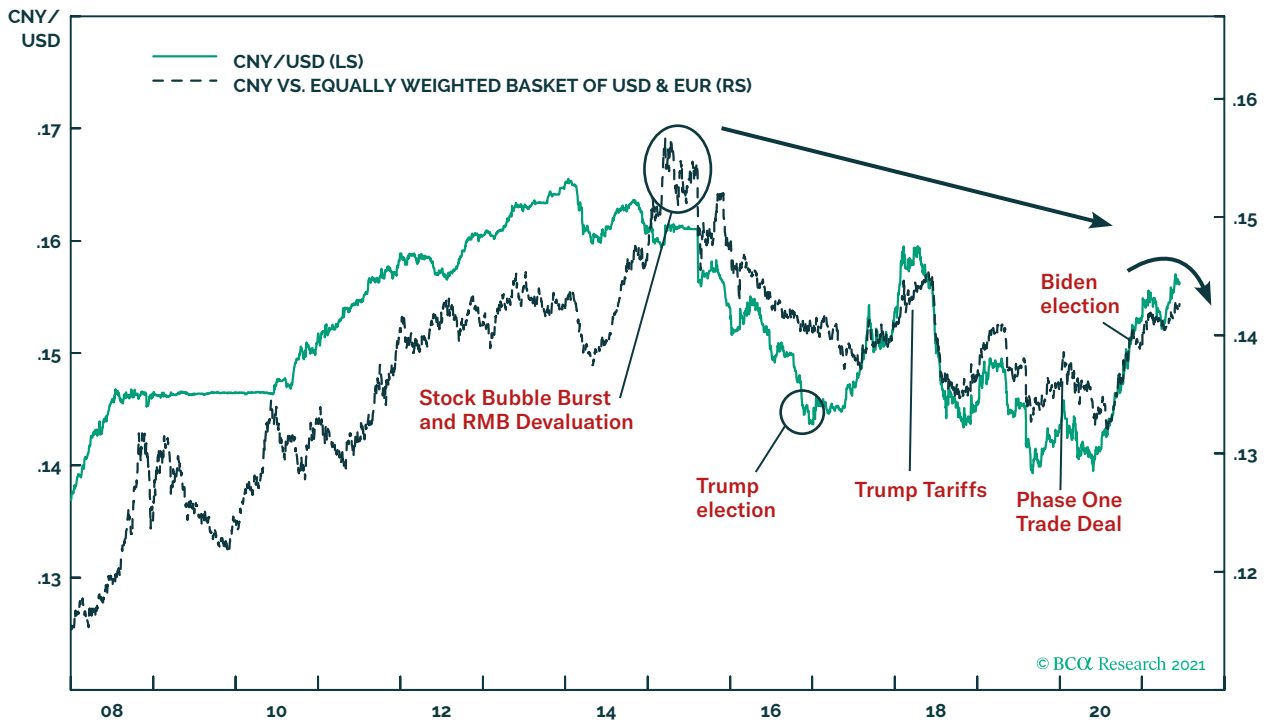
to increase its borrowing and bail out failing entities in order to maintain stability, just like Japan, the US, and Europe have had to do. The question for China is whether the social and political system will be able to handle major crises as well as the US and Europe have done, which is not that well.

### Investment Takeaways

- The rule of a single party is not a bar to economic success – but the rule of a single person is a liability due to the problem of succession. Marxism-Leninism is terrible for productivity unless it is compromised to allow for markets to operate, as in China and Vietnam. States that close their economies to the outside world usually atrophy.
- There is no compelling evidence that China's Communist Party has performed better than a non-communist alternative would have done, given the province of Taiwan's superior performance on most economic indicators.
- Since 1979, the Communist Party has avoided catastrophic errors. It has capitalized on domestic economic potential and a favorable international environment. Now, in the 2020s, both of these factors are changing for the worse.
- China's "miracle" phase of growth has expired, as it did for other East Asian states before it.
- The maturation of the economy and slowdown of potential GDP have forced the Communist Party to shift the base of its political legitimacy to something other than rapid income growth: namely, quality of life and nationalist foreign policy.
- An aggressive foreign policy works against quality of life by provoking protectionism from foreign powers, particularly the United States, which is capable of leading a coalition of states to pressure China.
- The Communist Party's policy trajectory is unlikely to change much through the twentieth national party congress in 2022. After

Structurally, global investors should favor the euro and US dollar over the renminbi.

CHART 13  
Prefer The Dollar And Euro To The Renminbi



that, a major course correction to improve relations with the West is conceivable, though we would not bet on it.

- Between 2021 and China's 2035 and 2049 milestones, the Communist Party must navigate between rising socioeconomic pressures at home and rising geopolitical pressures abroad.
- An economic or political breakdown at home, or a total breakdown in relations with the US, could lead to proxy wars in China's periphery, including but not limited to the Taiwan Strait.
- For now, global investors should favor the euro and US dollar over the renminbi (**Chart 13**).
- Mainland investors should favor government bonds relative to stocks. Chinese

stocks hit a major peak earlier this year and the government's seizure of control over the tech sector is taking a toll.

- Investors should prefer developed market equities relative to Chinese equities until China's current phase of policy tightening ends and there is at least a temporary improvement in relations with the United States. But investors should also prefer Chinese and Hong Kong stocks relative to Taiwanese due to the high risk of a diplomatic crisis and the tail risk of a war.

**Matt Gertken**

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Open Trades & Positions

Open Tactical Recommendations

TRADES	INCEPTION LEVEL	INITIATION DATE	CLOSED LEVEL	CLOSED DATE	RETURN	COMMENTS
<b>Fixed Income</b>						
Long Italian 10-Year BTPS / Short German 10-Year Bunds	100	Feb 5/21			0.01%	
<b>Equities</b>						
Long India Consumer Discretionary Equities	719.625	June 4/21			-0.64%	
Short India Banks Equities	2292.965	June 4/21			2.13%	
Long Italian / Short Spanish Equities	0.701	Feb 5/21			0.07%	
<b>Currencies</b>						
LONG GBP/CZK	29.585	Jun 11/21			0.47%	
Long CAD/RUB	60.67	Apr 16/21			-2.44%	
Long JPY/KRW	10.424	Mar 12/21			-1.52%	
Long JPY/USD	0.0092	May 24/19			-1.26%	

NOTE: RETURN AS OF JUNE 17, 2021.

Open Trades & Positions

Open Strategic Recommendations

TRADES	INCEPTION LEVEL	INITIATION DATE	CLOSED LEVEL	CLOSED DATE	RETURN	COMMENTS
<b>Fixed Income</b>						
Long China 10-Year Government Bonds	1.87	Jan 22/21			0.81%	For domestic or main-land-dedicated investors.
<b>Commodities</b>						
Long Gold	1495.65	Dec 6/19			27.48%	
<b>Equities</b>						
Long Mexico Equities / EM Equities	3.833	Jun 11/21			-2.02%	
Long FTSE 100 / DM EX-US Equities	3.054	May 7/21			-1.82%	
Long ISE Cyber Security Index	649.48	Mar 12/21			4.66%	
Long Global Aerospace & Defense Equities	474.17	Mar 12/21			7.79%	
Long BCA Rare Earth Basket	11.20	Feb 26/21			-5.60%	
Long Global Value / Global Growth Equities	0.524	Feb 26/21			2.85%	
Long DM Europe / EM Europe Equities	6.083	Feb 26/21			-2.44%	
Long European Industrials / Global Industrials Sector	0.932	Dec 10/20			4.64%	
Long Global Aerospace & Defense / Broad Market	0.7118	Nov 27/20			0.02%	
Long Korea / Short Taiwan Equities	0.8077	Mar 27/20			-2.63%	
<b>Currencies</b>						
Short TWD / USD	0.036	Jun 11/21			0.42%	
Short CNY / Equal-Weighted Basket Of Euro And USD	0.143	Jun 11/21			0.01%	
Short EM Strongman / EM Currency Index EX-PHP, TRY, BRL	0.487	Feb 26/21			-0.22%	

NOTE: RETURN AS OF JUNE 17, 2021.

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