

April 2, 2012

The Purge of Bo

(Due to upcoming travel and quarter end activities, the next report will be published April 23rd)

On February 6th, Wang Lijun, the former Chief of Public Security in Chongqing, tried to defect to the U.S. by entering the U.S. Consulate in Chengdu City, which is around 200 miles from the capital of the province. His attempted defection occurred four days after he was relieved of his duties by the Communist Party leader of Chongqing, Bo Xilai. Mr. Wang's decision to flee touched off a major scandal in China; he is said to be the highest official in 40 years to attempt defection. His act led to the ouster of Mr. Bo, who was a rising star in Chinese Communist Party (CPC) circles up until his removal from power,

In this report, we will offer a short biography of Bo including the events that led to his downfall. More importantly, we will move to examine how China is reaching an inflection point in its economic development, and how Bo's fall from grace may be related to divisions within the CPC on the best way to address China's future development. As always, we will conclude with potential market ramifications from this issue.

Bo Xilai

Bo Xilai is the son of Bo Yibo, known as one of the "eight immortals," who were revolutionary leaders during the communist revolution. The father was an important revolutionary period general who served

under Mao Tse-tung. Bo Yibo was also purged during the Cultural Revolution; his son reportedly denounced him during this period. Despite this familial disloyalty, the father was eventually rehabilitated and the son became a rising figure in the CPC. The younger Bo became a deputy party secretary of Jin County in 1984 and held several positions in the Dalian Economic Zone, eventually becoming Vice-Mayor in 1990 and Mayor and Deputy Party Secretary in 1993. He remained in this role until 2000. In 2001, Bo became Commerce Minister and in this role became a member of the Central Committee of the CPC. In 2007, Bo was elevated to the Politburo of the CPC and was made Party Chief of Chongqing. There are reports Bo was unhappy with this move, viewing it as a demotion. His predecessor in this municipality, Wang Yang, was moved to the coastal city of Guangdong, where he became party chief of this vibrant manufacturing and export hub. Chongqing, which is in the interior, was seen by Bo as less important. In his role as Commerce Minister, Bo worked with foreign governments and trade missions; being fluent in English made him popular in international diplomatic circles. It would be similar to a Washington bureaucrat being sent to the Midwest. Making it worse, Wang Yang was considered a major rival, so Bo was losing rank to a contemporary.

However, Bo decided to make the most of his appointment. He began an aggressive crackdown on “organized crime” in Chongqing, arresting numerous business figures who were accused of nefarious activities. In fact, many of these figures were legitimate businessmen; in China, moderate levels of corruption are necessary to conduct business.

Coupled with this crackdown, Bo began a nostalgia campaign, encouraging the recitation of Maoist era proverbs and singing period songs. Unlike the vast majority of CPC leaders, who appear to be rather colorless technocrats, Bo was a media-savvy politician who was intent on boosting his public image.

Although Communism is theoretically built on a basis of equality of outcomes, in practice, lifestyle differences were rather common in China. Deng Xiaoping’s decision to move China to a market economy in 1978 has tended to exacerbate these differences. Business leaders became wealthy and income differences widened. The current real estate crisis in China is a case in point. It appears there is an oversupply of high-end housing and a dearth of affordable housing for the less affluent.

Bo used his “go red” campaign to address the social tensions from widening income differentials. He used Maoist era slogans to boost morale of the less fortunate. In addition to his crackdown on the “criminal element” in Chongqing, which attacked wealthy businessmen, he also began programs to build public housing for the poor. These actions made Bo a popular figure among the common people who have mostly been left behind by the rapid growth in China.

In early February, Wang Lijun, the aforementioned Chief of Public Security for Chongqing, was removed from his position by Bo. Four days later, Wang attempted to defect to the U.S. by entering the American Consulate. Wang stayed in the consulate for more than a day. Although there is no official reason why he tried to enter U.S. custody, numerous media reports suggest the former police chief had uncovered illicit activity that was tied to Bo’s family. Instead of allowing the police chief to proceed against this alleged corruption, Bo fired Wang. According to reports, Wang feared for his life; although he had little hope the U.S. would be willing to risk relations with China by spiriting him out of the country, he was reasonably certain that the scandal of his attempted defection would lead CPC officials in Beijing to put him under arrest. He apparently preferred to be taken to the capital than to be held in the “tender mercies” of local security officials.

In short order, Bo came under great scrutiny. On February 15th, Hu Jintao, the current General Secretary, appointed Guan Haixiang the new head of public security in Chongqing. Guan is a Hu loyalist, meaning that the new police leader would be more inclined to do Hu’s bidding, not Bo’s. On March 14th, Wen Jiabao, the current Chinese Premier (second in power), gave a press conference where he launched into a thinly veiled criticism of Bo; the next day, Bo was removed from his post.

The Struggle for Power

In November, the CPC will hold a once every decade change of leadership. Xi Jinping is expected to become the next General Secretary and Li Keqiang will be the Vice-President. Perhaps more important is that seven of the nine positions in the Politburo Standing Committee (PSC), the most powerful body in China, will be

appointed in the fall. An unusually large number of retirements in the PSC is leading to this large turnover. The only two “safe” seats are Xi Jinping and Li Keqiang.

Although the CPC is often perceived as a monolith, the party does have factions. In broad terms, the two major divisions are between the elitists and the populists. The former tend to support economic liberalization and growth, while the latter are concerned about social and economic stability. However, there are further complications. Political figures within the CPC tend to come from two social groups. The first are the “princelings,” who are blood relatives or have close ties to former leaders. For example, Bo’s father’s role makes him a princeling. These offspring are rather like CPC royalty, typically growing up on the coast or in Beijing, and accustomed to living in the developed areas of China. The second group comes mostly from humble beginnings, with ties to the Chinese Communist Youth League. Leaders from this group often come from the countryside and have risen to power by ruling over interior rural regions.

Most princelings are elitist but some fall into the populist camp. But not all elitists are princelings. Among those jockeying for position in the new PSC are elitists who are not princelings but have ties to either recent leaders or are from the economically developed coastal regions (the Shanghai Gang).

Since 1978, China has deployed a market-based economy with an authoritarian government. The CPC has allowed citizens to become wealthy and develop new businesses. However, the party has not allowed political liberalization to take place. Thus, a citizen can hope to become wealthy but will never vote. Policy decisions have

been consistent on this point. Tiananmen Square did not reverse the trend away from socialism but affirmed the dominance of the CPC. The closing of state-owned firms in 2003 confirmed the bias towards the private sector. For the most part, even though the CPC leadership is somewhat divided, they all tended to agree on developing a market economy with CPC political dominance.

However, the 2008 financial crisis has caused the remaining state-owned enterprises (SOE) to expand relative to the private sector small and medium-sized firms (SME) due to the allocation of credit. The Chinese government decided to aggressively boost growth by increasing investment. This action was designed to offset the loss of exports due to the decline in global growth. Unfortunately, this policy decision has caused the Chinese economy to become increasingly unbalanced.

In general, China has developed by using investment and export promotion policies. This policy required the suppression of consumption; essentially, households subsidize investment by financial repression and exports by policies designed to generate high savings. China severely limits household financial choices, essentially forcing households to put their savings in banks at negative real deposit rates. This allows the banks to lend to companies at favorable rates. At the same time, there is a lack of pension and social security benefits, meaning that households tend to save at high levels for old age.

The Inflection Point

The development model used by China has been adopted by others successfully. Japan, South Korea and Taiwan have all followed this pattern. All three had authoritarian governments that eventually democratized. Japan was only nominally democratic in the

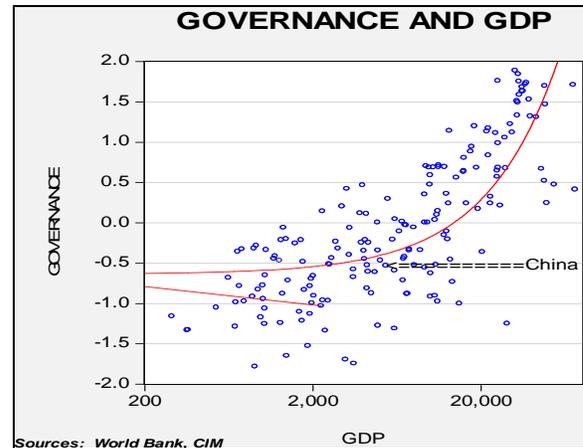
postwar period, as a single party dominated governments for over 50 years.

Recently, the World Bank, in conjunction with Chinese officials, published a report titled “China 2030.” The report clearly indicated that China’s development model has probably reached the end of its useful life. In particular, it noted two key issues. First, wages in China are rising rapidly because the country has reached the “Lewisian Turning Point.” Named after the Nobel Laureate economist Arthur Lewis, it describes the point in a nation’s development where most of the young rural workers have moved to urban areas. China, and others before it, has been able to grow with stable labor costs due to a massive shift of rural workers from the country to manufacturing jobs in the city. These workers tend to be more productive in manufacturing, which means the nation’s labor productivity skyrockets. However, once this pipeline of rural workers dries up, labor costs tend to rise rapidly.

Second, most developing nations are able to grow rapidly because they are able to adopt the latest technologies. For example, a nation industrializing now would probably not even bother with land lines—they would develop their telecommunications system with cell towers right from the start. However, over time, investment levels reach a point where the country has “caught up” with the latest technology and cannot make major gains by merely copying what is available elsewhere.

It is at this point that developing countries fall into the “middle income trap.” Because they can no longer rely on a steady flow of cheap manufacturing labor and adoption of existing technology, to develop further the economy needs to move up the value chain in manufacturing and innovate—to become

their own source of technological development.



This chart captures China’s problem. The left axis is the average of the World Bank’s governance measures. These measures include indexes that measure the degree of citizen input, political stability, the effectiveness of government, the quality of regulation, the rule of law and the degree of corruption. The higher the reading, the better governance in a nation. We use a 15-year average of those indexes. The bottom axis, which uses logarithmic scaling, is the past five-year average of per capita GDP. The data series covers 180 countries. The plotted regression line indicates that a country can expand its per capita GDP rapidly with weak governance until it reaches around \$6,000, close to China’s current level. From that point forward, most nations that develop into high-income nations also enjoy dramatic improvements in governance. (We do note the cluster of high-income nations with a governance reading of +0.5—those are low population oil exporters).

China needs to improve governance to move up the income scale. However, this governance improvement will almost certainly require major reforms in how the CPC operates. In observing the

development of other countries, this probably means some form of democratization. However, it may not necessarily work that way. Instead, the CPC may simply become more transparent and inclusive. The CPC may allow democracy at the local level but not at the national level. The CPC may remain the single governing party but move towards rule of law.

When leaders are facing the potential for a major governing crisis, there is great fear of losing control over events. Bo's "go red" campaign suggests a harkening back to the "old religion" as a way to keep the party in control. For CPC leaders looking to liberalize the political system to foster the next stage of growth, this return to communist slogans looks too much like another Cultural Revolution. Until Bo was appointed to Chongqing, he supported economic growth and the rise of the private sector. His policies in Chongqing could reflect a turn in his thinking or may have been a cynical ploy to gain support from CPC conservatives for the purpose of gaining national standing. In other words, the posturing of being more Maoist may have been a way to gain credibility on both sides of the political spectrum. In any case, the direction he was heading was clearly seen as dangerous and thus, when the defection scandal broke, the CPC leadership moved quickly to remove him from power.

There have been rumors that Bo and some of his supporters were planning a coup to ensure that Xi Jinping would not take power. For example, there have been news reports of military mobilization in some areas but none of these reports have been confirmed by reliable sources. It would not be a surprise to see allies of Bo come under suspicion. But it is unlikely a coup was underway. Instead, it is likely that the coup rumors were planted by the CPC to further

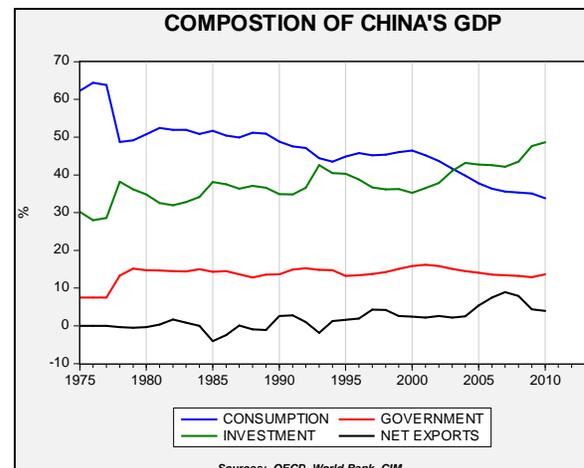
justify their arrest of Bo, who remains popular among the poor of Chongqing.

Ramifications

The CPC works very hard to project an image of stability and unity. This doesn't mean that divisions don't exist—they do, but they rarely spill out for public viewing. In fact, the last major public event when policymakers were clearly divided was the Tiananmen Square tragedy. Since then, the CPC has presented a united front.

It appears the decisions facing the CPC are significant enough to rent this veil of consensus. Liberalizers within the CPC want to increase democratization, opt for the rule of law and weaken corruption. More conservative members of the CPC leadership, especially most of the princelings who would have the most to lose in liberalization, generally oppose moving too quickly to open the economy and political system.

Here is another way of examining the challenge China faces.



This chart shows the composition of China's GDP. Note that before the 1978 liberalization, consumption was over 50% of China's GDP. Since liberalization, investment has steadily grown from 30% to

nearly 50% of China's GDP. Exports rose as well, from around zero to nearly 9% in 2007. Growth in these two sectors came at the expense of consumption, which represents about 34% of GDP.

In 2008, in response to the financial crisis, China decided to spur growth through massive investment spending. Investment was lifted because the country could no longer rely on exports to boost growth, given the state of the global economy. Although the increase in investment spending was successful in boosting growth, it did so at the expense of efficiency. Most of the investment spending occurred at the SOEs, which tend to be less efficient. It appears China has increased capacity in the least efficient part of its economy. The money borrowed to boost this investment was probably ill spent, meaning that bad debts will rise in the future.

China has purposely structured its policies to suppress consumption in order to boost investment and exports. These policies include financial repression, which keeps deposit rates consistently below the rate of

inflation, and not creating a social safety net to discourage saving. China is reaching the point where suppressing consumption is becoming counterproductive. However, changing this policy will almost certainly provoke demand for political changes as well.

With China at the crossroads, it's highly likely that policy will become muddled and political unrest will rise. For the past two decades, China has tended to conduct policy with great certainty and verve; if that stops, the economy is vulnerable to unexpected weakness. If China's economy stumbles, commodity and equity prices will come under pressure. Unfortunately, if China tries to boost growth through increasing investment and exports, it will simply be "kicking the can down the road," a familiar theme throughout the world. Thus, the possibility that China could become a threat to global growth is rising.

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