



Global Political Drivers

KEY MAN RISK

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- Globalization has globalized political risk. That is, political risk has broken out of its traditional reservation of EM investing, as the impact of Chinese and wider EM integration into the global division of labour now tears through the political and social fabric of rich countries. Despite boiling cases like Brexit (and Italy always simmering), the elephant in the room of global political risk remains China itself.
- Our cue for revisiting China stability risk is last month's wake-up call from neighbouring Kazakhstan, where the founding ruler stepped back – but not out. Kazakhstan is an extreme example of a personalized regime, with formal institutions mere window dressing. Under Xi Jinping, China is heading fast towards that destination of one-man rule.
- The case of the Nazarbayev succession may have few direct lessons for China, though it may well provide some pointers for Russia. Either way, Kazakhstan illustrates the risks – less a binary question of state breakdown than the possibility of a void left by a departing strongman being filled by destabilizing power struggles, in turn causing economic dislocation.
- Nazarbayev is clearly trying to steer Kazakhstan away from such rocks, but he may not succeed. Kazakhstan anyway matters little in a global perspective. Russia matters a good deal more, and there the succession conundrum has not even been broached. A botched succession in China, by contrast, would be a global risk-off moment – or season.
- Xi has created this problem by ditching the leadership rotation scheme devised by Deng Xiaoping. We are left with the irony that only Xi can mitigate this risk of his own making. Will he prove capable of emulating the way that Deng's paramount authority projected stability beyond the grave? While the moment of truth here may well be years away, the stakes are high enough to justify permanent monitoring.

Global political risk backdrop

Legitimacy goes hand in hand with lower political risk. Political thinkers ever since Aristotle have busied themselves categorizing regimes on a spectrum from democracy to monarchy. Such categories may not always fit well with political risk as seen in an investment perspective – that is, the risk of a country’s political system causing, or failing to contain, social and economic instability. The practical test of risk often boils down to adaptability and flexibility under pressure. Put another way, whenever times of trouble come around (as they always must), a lower-risk political regime will more easily preserve its legitimacy. This rule applies regardless of the source of legitimate rule, be it the “will of the people”, hereditary rights, Marxist-Leninism or whatever. Other things being equal, the more legitimate a government, the more effective will be whatever mix of policies it adopts – from repression to addressing popular grievances – for restoring and buttressing stability.

In countries with entrenched democratic institutions and cultures, political risk is generally lower because, in a crisis, legitimacy can be preserved and replenished by the simple means of holding an election. Since more democracy therefore means lower risk, the above-mentioned problem of real life fitting theory is not so much conceptual, but stems rather from small relative variations. Some advanced democracies might come through periodic trials with flying colours, others less so.

The developed world is struggling with its “left behind”. At present, the great challenge faced by these countries – in Western Europe and North America – is the plight of the large numbers who have lost out from globalization and technology. The protest of these “left behinds” concentrated in the “white working class” has torn through mainstream political parties and establishments. For asset allocation purposes, the delta between low and not-quite-so-low risk is material. The jury is out. Thanks to the present Brexit crisis, UK assets and sterling are relatively cheap. Thanks to the ECB’s recent TLTRO re-boot, BTPs have rallied. It may not take much hindsight for this to seem like a relative mis-pricing.

But China is also an elephant in the room. The Brexit and Eurozone fault lines besetting the UK and Italy will probably take years to be stabilized, let alone repaired. Yet these still seem short-term problems compared to the ‘elephant in the room’ of global political risk – China. This is why we include periodic China stability monitoring in our Global Political Drivers research. When we last looked at this – in December 2017 – the cue was the once-in-every-five-years Chinese Communist Party Congress held the previous October.

Focus on personalized regimes

The highlight of that Congress was what, in institutional terms, amounted to a structural break. According to the top leadership rotation system devised by Deng Xiaoping, this should have been the Congress that revealed the successors-in-waiting to Xi Jinping (and Premier Li Keqiang) five years further down the road (that is, in 2022) – just as Xi and Li themselves emerged as the successors of Hu Jintao and Wen Jiabao at the 2007 Congress. But Xi put a stop to that; and China, even while its Leninist-style Party State remains formally untouched, has since become ever more of a personalized regime – that is, a classic case of one-man rule, in which the nation, the Party and its chief are fused.

The current case of Kazakhstan illustrates the risks of one-man systems. Our cue this time for re-visiting this source of increased long-term political risk in China is last month’s resignation

of Nursultan Nazarbayev, the founder president of Kazakhstan, after a 28-year-long 'reign'. The Kazakh experience of handing over monarchical power may have few, if any, lessons for how things may play out in China whenever Xi reaches the end of the line. More likely, it will offer some suggestive pointers about the outlook for the globally significant case of Russia when it comes to the power handover from Vladimir Putin (more on that below). Either way, this Kazakh power transfer is useful above all for highlighting the type of risks involved.

Handovers carry risks – some more prosaic than others. These risks are not limited to the binary question of whether countries where power has become so personally concentrated prove able to negotiate the exit of such dominant sole rulers without some new 'time of troubles' (in the worst case, power struggles spilling over into civil conflict). A less apocalyptic and more plausible risk is simply that the end of a personal reign triggers chronic destabilization causing policymaking distraction and drift, leading in turn to economic uncertainty and underperformance.

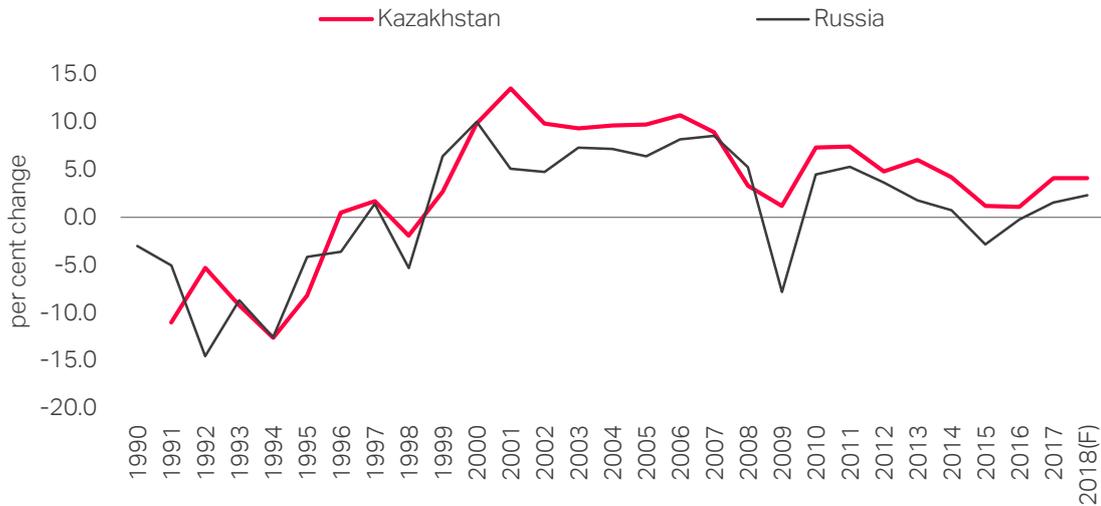
Ill-prepared successions can fail to reconcile different interests. To return to the point about legitimacy that we started with: the main problem for countries is not that the successor to a dominant personal ruler would be illegitimate. In Kazakhstan and Russia, legitimacy is formally based on public assent delivered through a plebiscite (aka 'presidential elections'). As for China, the CCP's power monopoly provides the foundation for whoever might emerge as Xi's successor. So even if any of these countries' strongmen were to disappear suddenly by an 'act of God', the state systems would 'know what to do'. But an ill-prepared succession might fail to supply the pivotal function of supreme arbiter between rival elite clans and interests.

Successful successions?

As it happens, this lesser kind of risk has long been our view of the worst case in Kazakhstan. That is, the case where Nazarbayev died without having put in place workable arrangements for the succession. We doubt even then that the Kazakh state system would break down, as the elite stakeholders have a paramount interest in avoiding that outcome despite all their internal rivalries and disagreements. However, for as long as it took for a new strongman to emerge, most investors – perhaps all except those with the longest horizons – might prefer to keep their powder dry. This advice is only relevant to specialized investors in the case of Kazakhstan – a country which, with less than 2% of world oil production, is marginal in a global perspective. It goes without saying that were the same advice to apply in China's case, no investors could afford to ignore it.

As things stand in Kazakhstan, Nazarbayev's resignation on 20 March is only the first stage in the power transition, which will remain a work in progress at least until the end of the year, if not December 2020 (the latest legal date for the next presidential election). For now at least, Nazarbayev has made a start by positioning himself as supreme leader, under whose wing his chosen successor can grow into the role. Unlike Deng in the post-Mao period, Nazarbayev holds not only the title of "National Leader" for life, but also a formal office: Chairman of the National Security Council, a formerly consultative body which was upgraded last year by constitutional amendment to become a formal institution of state power. This example may well be copied in Russia before the end of Putin's present – and last – presidential term in 2024. It would provide Putin with a secure berth from which to mentor, arbitrate and discipline as need be.

Kazakhstan and Russia: real GDP growth



Source: World Bank, TS Lombard

Such ploys may reduce succession risks, but do not eliminate them. In all these countries, rising living standards lie at the heart of the social contract underlying stable power. Slowing growth in Russia and Kazakhstan (see chart above) tilts the balance of the public mood, generally fearful of instability, towards desire for change – that is, new leaders and new hope. The lack of predictable rotation of the top political leadership frustrates such natural feelings.

This uncertainty persists in Kazakhstan. Nazarbayev has been replaced as president by the head of the Senate *ex officio* – Khasym-Zhomart Tokayev, a veteran diplomat – until the end of the present presidential term. Meanwhile, Tokayev has been replaced by Nazarbayev’s elder daughter Dariga. It remains to be seen whether this is an insurance policy against future attacks on the family or the beginnings of a full-fledged dynastic succession plan (as seen in Azerbaijan). The latter scenario might prove destabilizing for Kazakhstan.

As for Russia, Putin’s intentions remain a closed book. A more immediate risk driver than the contents of that book (perhaps still unwritten in Putin’s own mind) may be the timing of its publication. In other words, the longer Putin sticks to his usual style of playing his cards close to his chest, the more damaging will be the effects of the positioning battles between the main interest groups. Recent prosecutions of senior officials seem ominous in this perspective. If this trend were to intensify, the investment climate would suffer. Our base case for now is that Putin will start to reveal his hand on the succession at the time of the next scheduled parliamentary (State Duma) election in September 2021.

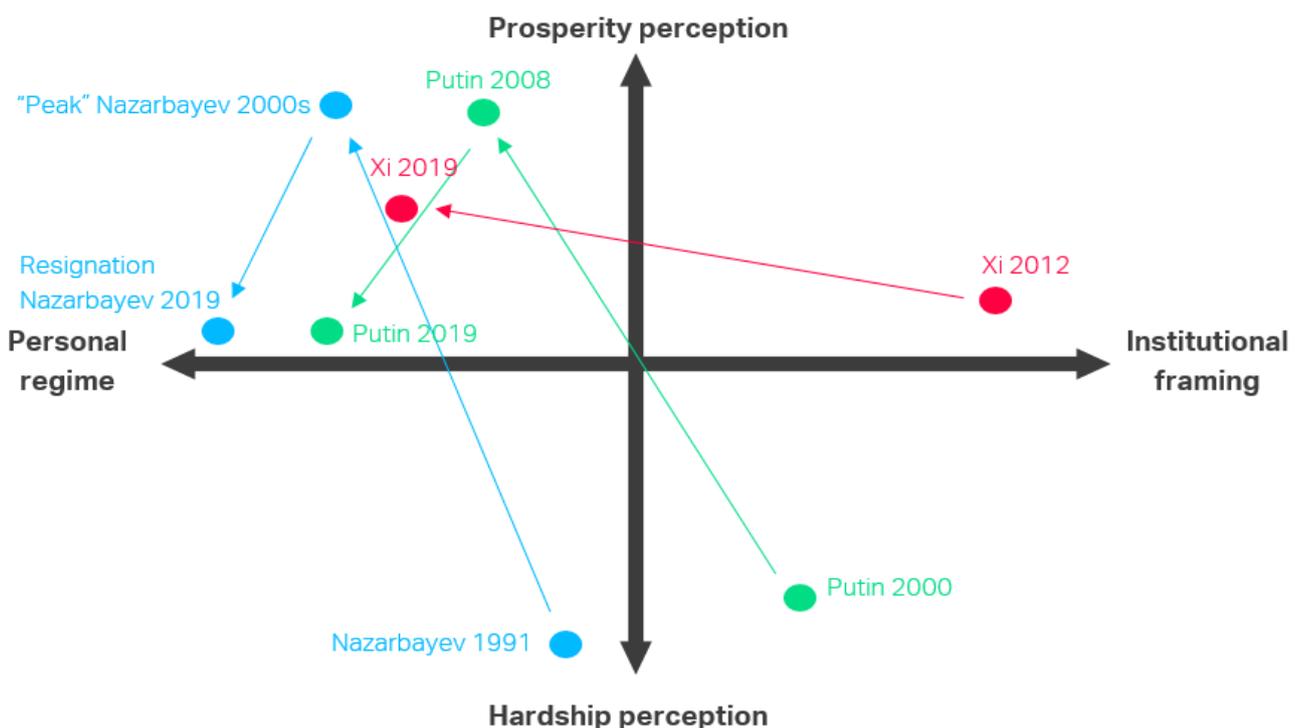
How will Xi leave?

The general conclusion so far must be that the outlook for risk stemming from personalized regimes depends to a considerable extent on the personal choices of the strongman. This perspective is summed up in our graphic below, which also takes us back to the central case of China. We find that the China case reinforces our conclusion from looking at Kazakhstan and Russia.

Having expanded the Party's reach, Xi has no wish to see a designated successor becoming the focus of attention at its summit. The top Chinese political body, the Politburo Standing Committee named at the 2017 Congress, contains no one who could step easily into Xi's shoes. Prime Minister Li Keqiang, who ranks second in the official Party hierarchy, has suffered from steadily diminishing authority since he lost out to Xi in appointments to the Politburo in 2007 and the weakening of the government's role has reinforced this. Other Standing Committee members lack a power base of their own; most owe their positions to their loyalty to the leader. The influence of Xi's predecessors, who supported or acquiesced in his ascension, has been curtailed.

At 65, Xi can expect to continue to dominate China or another decade or more. Chen Yixin, Secretary-General of the Party's Political and Legal Commission and a close Xi associate, stressed in a speech a week ago that political security was a constant concern, underlining the need to "prevent economic and financial risks from becoming political and social risks". The anti-corruption campaign is broadening to include going after "political deviation" according to its extra-legal enforcement organization, the Party Discipline Commission. Those found guilty of corruption are increasingly accused of "disloyalty" alongside pecuniary crimes. Meanwhile, the Party Commission and the National Supervisory Commission, which monitors officials, have defined their "most fundamental mission" as not only protecting the CCP Central Committee but also – as reported by Xinhua news agency – safeguarding "Xi's status at the core".

The personal power problem in authoritarian systems



Succession strains look like a bigger risk than opposition. Despite recurrent speculation about opposition generated by Xi's power accumulation, the leadership displays no substantive sign of weakness, and its principal flaw is more likely to stem from internal strains, among which the failure to offer the prospect of a smooth handover to a new generation of leaders may loom large.

This would not be a new phenomenon. The People's Republic has known only one completely seamless transfer of power in its seventy-year history – that to Xi, himself. Deng Xiaoping recognised the threat to Party unity posed by the in-fighting after Mao Zedong's death in 1976 – even if he, himself, fought a lengthy battle to displace the last of the Great Helmsman's chosen successors, Hua Guofeng. So he tried to set up an institutionalised succession process, including a limit of two five-year terms for the top leadership and the designation of a successor at the five-year stage. Holding no formal Party or State positions himself, Deng counted on his political and military clout and his historic stature to enforce his will, ruling through others from not so far behind the scenes – though his initial reformist choices to lead the Party, notably Zhao Ziyang, were overthrown by a mixture of conservative pressure and their own misjudgements.

2007 was the only proper handover of power in modern Chinese history. After the convulsions of the 1989 protests against Party rule and the crushing of the demonstrators in Tiananmen Square, Deng settled on the secondary figure of the Shanghai political boss, Jiang Zemin, as General Secretary of the Party. But he also promoted a young Party bureaucrat, Hu Jintao, as Jiang's successor. Such was the Paramount Leader's authority that Hu duly took over the Party leadership in 2002 - when Deng had been dead for five years. But Jiang was still able to stage a rear guard action to retain the Chair of the Military Commission and obtain Standing Committee posts for associates from his Shanghai Faction.

It was only at the 2007 Congress that the Deng succession system took full shape when Xi Jinping was placed one rung ahead of Li Keqiang among newcomers to the Standing Committee, moving on five years later to assume the General Secretary-ship, the Chairmanship of the Military Commission and the State Presidency after Hu Jintao stepped down from all three at the end of his ten-year term.

The key question is whether Xi will end up emulating Deng (the optimistic case) or, like Mao, bequeath a debilitating power struggle – with the big difference compared to the post-Mao period being that any such power struggles at the pinnacle of the Chinese regime would cause shock waves in the global economy and geopolitics.

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