Chi on China

FOR WHOLESALE INVESTORS – 3 September 2018

CHANGING CHINA'S INCENTIVE SCHEME IN THE NEW GROWTH MODEL

If you have a rigidly controlled economy, cut off from the rest of the world by infinite protection, nobody has any incentive to increase productivity and to bring new ideas.

Manmohan Singh

SUMMARY

- To change its economic model from growth maximisation, which has created serious problems in corruption, diminishing marginal returns on investment and environmental damages, to balanced and sustainable growth, China needs to change the economic incentive scheme in its system.
- To do that, it is taking an approach that is opposite to what most western countries do by making people, not institutions, pay the price for excessive risk-taking and misconduct. This approach is often criticised by the West as overly heavy-handed.
- But this may be the price China has to pay for correcting the incentive problem inherent in its system. Any success will go a long way to strengthen the structural underpinning of Chinese assets by putting the country on a sustainable growth path with better governance.

I argued earlier[1] that President Xi Jinping was forcefully changing China's political and economic incentives that were in place for over three decades. He started with changing the macroeconomic policy objective from single-mindedly maximising growth to targeting multiple policy goals, including maintaining GDP growth, alleviating poverty, reducing financial risk and protecting the environment.

By replacing the old incentive with a set of complex priorities, President Xi has created a high-pressure political environment to ensure strict compliance of central decrees. Under this framework, people not institutions are being made to pay the price for wrongdoings so that the incentive to take bribe and excessive risk leading to misconduct, policy misstep and financial crisis can be reduced.

[1] See "*Chi on China: Mega Trends of China (6): Evolution of China's Growth Model*", 6 April 2018.

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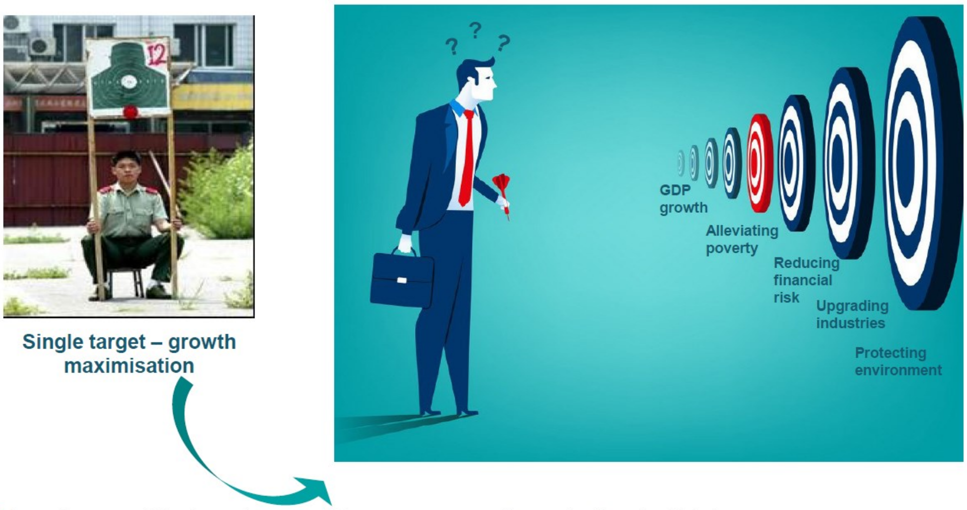
Everything starts with a change in the incentive scheme



- Creating a political environment to ensure compliance by local officials
- Scrapping term limits => no alternative power centres for local officials to appeal to

Source: BNPP AM Asia

PRESIDENT XI IS SERIOUS

Official data shows that China's anti-graft watchdog punished almost 37,000 officials in the 1H 2018 for corruption, fund embezzlement and violating Party frugality rules including the misuse of government-owned vehicles, the awarding of unauthorised bonuses and the exchange of gifts. President Xi has also personally led the 25-member Politburo to investigate the vaccine scandal (first exposed in July 2018) of Changchun Changsheng Bio-technology, which made and sold nearly half a million substandard vaccines for children. At the time of writing, more than 40 cadres, including some ministerial level officials, have been put under disciplinary action.

The purge of individuals for misconduct is most prominently seen in Beijing's approach to de-risk the financial system. It is taking the exact opposite approach to what many Western countries did in the aftermath of the 2008 subprime crisis: people, not the institutions they worked for, have been made to pay for the price of excessive risk-taking and misconduct. The regulatory tightening since 2017 has not led to the collapse of any major financial institutions, but many financial-sector executives have been jailed.

CHANGING THE INCENTIVES…

Naturally, this has raised the question of regulatory forbearance. It is clear that Beijing does not want any major financial failures for the fear of triggering a systemic problem and, most importantly, of losing public confidence in the Communist Party. But this does not mean regulatory forbearance. The Chinese way of correcting the incentive distortion is to threaten the people who run the financial institutions with the failure of their careers rather than threatening them with the failure of the institution they run.

Official data shows that 107 people in the financial sector were banned from the industry or had their professional qualifications cancelled in 1Q 2018, a 360% jump from 1Q 2017. The anti-corruption campaign is a key component of the crackdown on financial risk. The investigation of former China Insurance Regulatory Commission chairman Xiang Junbo in April 2017 signalled the start of the purging process that holds people accountable for their misconduct. So far this year, there have been numerous major prosecutions of financial executives for corruption and illegal activities. Notable examples include:

- In January, the banking regulator of Sichuan province fined the local branch of Pudong Development Bank RMB462 million for hiding non-performing loans; the head of the branch and two deputies were banned from the industry for life.
- In March, Wu Xiaohui, the chairman of private insurance company Anbang, was prosecuted for illegal fundraising and fraud. The firm has since been taken over by regulators.
- In April, the chairman of state-owned China Huarong Asset Management, Lai Xiaomin, was expelled from his job after the government began investigating him.

… THE CHINESE WAY

Instead of closing them down, all of these problem institutions have been kept alive and their creditors have been asked to keep the funding lines open. But the key people who ran these firms have been banned from the financial industry or, more often, faced criminal charges.

Beijing is sending a clear message to the Chinese financial executives that they would not be treated the same way as their Wall Street counterparts were treated after the GFC. Few individuals were then prosecuted and made to pay for malpractice, but the financial institutions and governments had to bear heavy costs.

Experience shows that incentive distortion, which is undeniably prevalent in the Chinese system, lies in the heart of the US subprime crisis[2]. Distorted incentives are also intrinsic to the financial intermediation process and financial innovation, which are evolving rapidly in China.

The West has chosen to deal with the financial mess by making the institutions pay for the mistakes. In China, the financial institutions survive, but the people who led the risky practices are made to pay. The aim is the same – to correct the distorted incentives. Any success of China's heavy-handed approach will go a long way to improve the structural underpinning of Chinese assets by correcting the incentives and building better governance.

Chi Lo
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[2] See "*China after the Subprime Crisis: Opportunities in the New Economic Landscape*", Chi Lo, Palgrave Macmillan 2010.

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