FOR WHOLESALE INVESTORS ONLY – 7 January 2022

Chi on China

WHEN STRUCTURAL OBJECTIVES CLASH WITH CYCLICAL FORCES

If knowledge and foresight are too penetrating and deep, unify them with ease and sincerity.

Xun Kuang

SUMMARY

- China's trade war with the US and the Covid-19 crisis have aggravated the downturn in growth. This has caused the structural rebalancing objectives that President Xi Jinping has strived to implement since 2013 to clash with cyclical forces that are crying for an economic bailout.
- As growth momentum slowing to below Beijing's tolerance limits, the authorities have shifted to a pro-growth policy from painful economic restructuring. This means that the worst of the regulatory tightening campaign might also be over.
- While policy rescue can prop up GDP growth in the short-term, the bigger question is whether Beijing is returning to its old habit of policy bailouts and sweeping the structural distortions under the carpet. Evidence seems to suggest that China is still sticking with its structural reform gun.

Arguably, President Xi Jinping has followed an economics textbook model of constrained maximisation when he changed the macro-policy objective function from maximising the quantity of growth to improving the quality of growth, subject to the constraints of structural reform and debt-reduction. This change, in our view, represents a revolutionary change in the political and economic incentives that had governed the country for over four decades. The forceful change has created a new economic model based on the strategic usage of markets under state guidance[1].

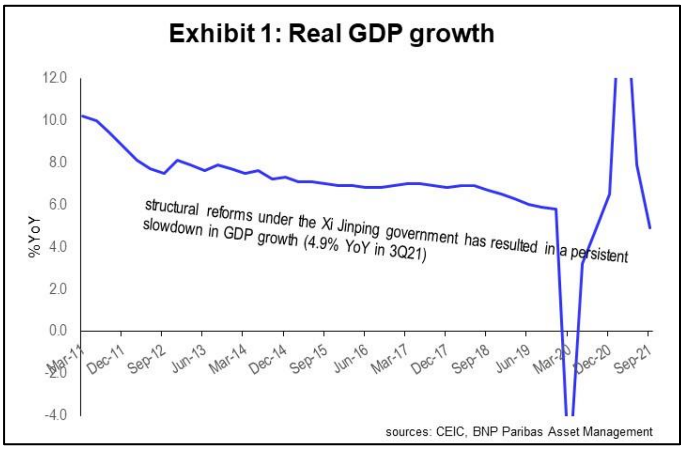
Structural rebalancing and deleveraging have made progress since 2013[2]. These efforts were intensified in 2017 but only to be shelved a year later due to the mounting growth stress from the Sino-US trade war and Covid-19 health

[1] See "*Chi on China: Mega Trends of China (6) – Evolution of China's Growth Model*", 6 April 2018.
[2] See "*Chi on China: China's Deleveraging Strategy and Evidence*", 22 November 2017,

crisis. However, Beijing has not given up. Confronting the economic tough times, it has continued to push through regulatory reforms since 2020, focusing on attacking moral hazard, supervisory loopholes and monopoly power in the internet and other tech sectors[3].

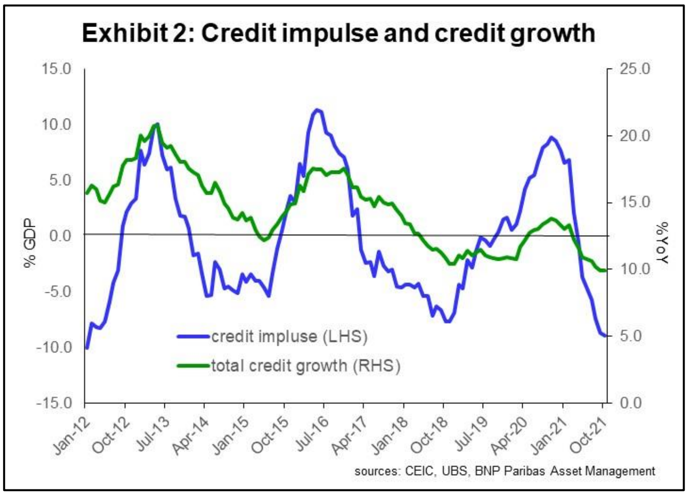
GROWTH SLOWS TOO MUCH…

Persistent reforms under a conservative macroeconomic policy have taken their toll on growth: this has slowed over the years (Exhibit 1). Beijing's aggressive regulatory tightening campaign and its 'zero-Covid policy' since late 2020 have added to the policy uncertainty, hurt public confidence and 'animal spirits' and reduced GDP growth to only 4.9% YoY in Q3 2021.



Throughout this economic cycle, China has pursued a cautious monetary policy that only aims at preventing liquidity from contracting but not increasing injection. This is seen in the decline in the credit impulse that measures the amount of new credit flowing into the financial system (Exhibit 2). Declining land sales revenues, shrinking shadow banking activities (which reflect continuous efforts on financial de-risking) and local governments cutting implicit debt[4] (i.e. off balance sheet borrowing via special purpose vehicles) have also contributed to a drop in investment funding.

"*Chi on China: China's Deleveraging Strategy and Evidence (II): Rising Credit Spread*", 30 May 2018,
"*Chi on China: Structural Rebalancing – Part I The External Sector*", 3 July 2013,
"*Chi on China: Structural Rebalancing – Part II The Domestic Sector*", 16 July 2013,
"*Chi on China: Progress on China's Structural Rebalancing and Reverse Migration*", 8 November 2017.
[3] See "Chi Time: Financial Reform – Reducing Moral Hazard in China's Fintech Platforms", 25 November 2020,
"*Chi on China: Regulatory Tightening Explained: A Strategic Policy Shift and the Outlook for China's Private Sector*", 15 September 2021,
"*Chi Time: China's Financial Discipline and market Pains*", 14 April 2021,
"*Chi Time: China's Regulatory Tightening Pains and Gains*", 12 May 2021.
[4] Beijing issued a directive in August 2021 instructing the local governments to reduce their implicit debts and banning them from raising funds via the corporate bond market and providing guarantees for corporate bond issuances. See "*China Looks to be Defusing Government's Hidden Debt Bomb*", Bloomberg News, August 18, 2021.
Note: All tables are as at January 2022, unless otherwise stated



… PROMPTING A POLICY SHIFT

A tight macroeconomic policy bias was supposed to facilitate Beijing's structural reform initiatives. However, it has pushed growth to below the authorities' comfort zone of 5% to 6%. Aggressive regulatory reform measures since late 2020 have sapped private-sector incentives and aggravated the economic fragility. Beijing finally gave in to the economic stress and announced a policy shift to a pro-growth stance last December, shelving temporarily its deleveraging and structural reform initiatives.

The policy shift will likely push China's growth cycle into a moderate upswing this year. Structural policies such as common prosperity and reduction in carbon emissions are likely to be implemented far less aggressively than in 2020 and 2021. Beijing has also reportedly handed out RMB1.46 trillion in special local government bond quota. That is at least 40% of the estimated total. The funds raised are to be deployed in early 2022 to boost aggregate demand[5].

The People's Bank of China (PBoC) will facilitate the growth protection efforts with further monetary easing, especially for strategic and green development sectors that are high on Beijing's priority agenda. Local governments will lean towards pro-growth policies in 2022 when having to choose between stabilising growth and containing debt levels as the former is now a political priority.

TURNAROUND INDICATORS

With further easing and more special bond issuance on the cards, credit growth should turn up in early 2022. The PBoC has already cut the reserve requirement ratios for banks twice by a total of 100bp since July 2021. Together with selective cuts in the rates on its lending facilities, including the mid-term lending facility (MLF) and the loan prime rate (LPR), monetary policy has started to stabilise the credit impulse and aggregate credit growth.

In policy statements in December 2021, the Central Economic Work Conference said clearly that stabilising GDP growth would be the top priority for 2022. Policymakers are channelling liquidity to priority investments in developing the green economy, climate control, reducing carbon emissions, new energy, high tech and high value-added manufacturing.

The sharp slowdown in the property sector (Exhibit 3) due to policy tightening has resulted in rising defaults, raising market risk aversion and aggravating credit default risk. The initial pace of the correction was aggressive and disruptive.

[5] "*China Issues Advance Local Bond Quota to Support Slowing Economy*", Reuters, December 16, 2021 https://www.reuters.com/markets/rates-bonds/china-issues-advance-local-bond-quota-support-slowing-economy-2021-12-16/
and "*China Front-loads 2022 Special Bond Quota to Sustain Growth*", XinhuaNet, December 28, 2021 http://www.news.cn/english/2021-12/22/c_1310388443.htm

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However, assertive and quick policy reactions by the authorities have helped avert a systemic crisis, showing that Beijing has both the skills and tools to contain any crisis.

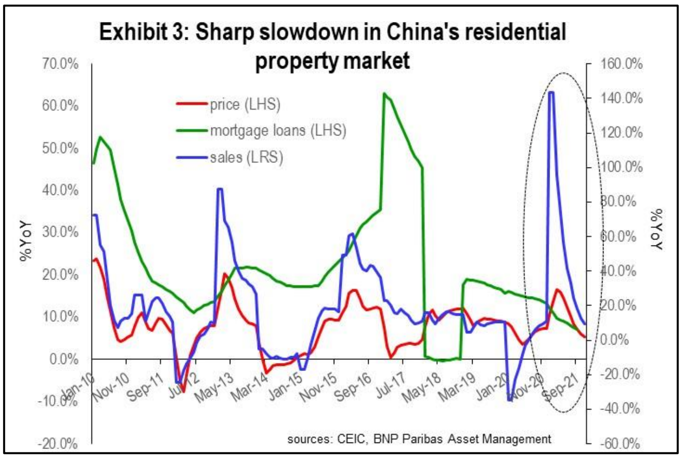

Exhibit 3: Sharp slowdown in China's residential property market

The authorities have taken further action to prevent any credit seizure from arising by urging banks to increase development loans and lifting onshore bonds and restrictions on issuing asset-backed securities. Local governments in hard-hit cities have eased restrictions on access by developers to presales proceeds, which are a crucial funding source.

Furthermore, China's banking system should be strong enough to deal with an increase in delinquencies in the property and construction sectors[6]. The International Monetary Fund has estimated that Chinese banks had an average tier-1 capital ratio of 12% in 1Q 2021 (the latest data available).

All this suggests that the system has a large financial cushion for potential shocks, making the risk of a property market crash pulling the rug from under the economy manageable.

Under the renewed pro-growth efforts, Beijing is expected to loosen its aggressive targets to reduce energy intensity and consumption. This relaxation should ease any constraints on growth. It has already shown flexibility by lifting the restrictions on coal production when energy shortages disrupted production and supply chains and hurt GDP growth in late 2021 (Exhibit 4).

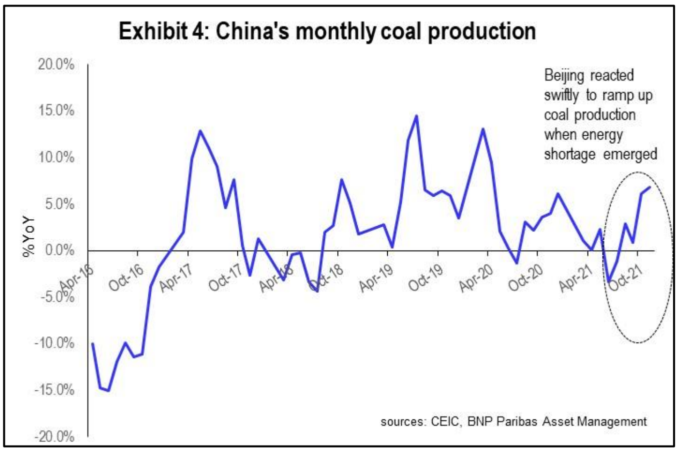

Exhibit 4: China's monthly coal production

[6] See '*Chi Time: Credit Events in China (II) – Will the Property Market Come Crumbling Down*?" 22 October 2021.

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China has also shifted its policy on de-carbonisation to an ‘investment before retrenchment’ framework from the earlier ‘de-carbonisation by brute force’ approach. So going forward, the carbon-reduction campaign will ramp up investment in alternative energy sources first before moving away from traditional energy sources, notably coal, to minimise any energy shortages.

MAJOR SHORT-TERM RISKS

The two major risks to China’s growth are fading export growth and mutation of the coronavirus.

China’s robust export growth since mid-2020 has been a direct result of its ‘zero Covid policy’ (ZCP). This has allowed China’s production to normalise quickly to cater for global demand at a time when production in the rest of the world was hamstrung.[7] When production and consumption is normalised in the rest of the world, Chinese exports growth will likely weaken, translating into weaker GDP growth, *ceteris paribus*.

Omicron and any other evolving virus strains with greater transmissibility suggest that China’s ZCP will remain in place for longer. If China has to step up its containment measures, including selective shutdowns and border closures, consumption and the services sector (which accounts for over 50% of GDP) will face severe disruption. Meanwhile, it is unclear by how much another Covid outbreak in developed markets would boost the consumption of stay-at-home goods from China. Such demand may have been largely satiated by now.

REFORM RESOLVE – THE EVIDENCE

However, China’s policy shift has raised a crucial question about its resolve to stick with structural reforms under stress. Evidence shows that it has risen to the challenge of pushing through needed changes even during tough times, while experience shows that Beijing has the policy skills and tools to contain potential crisis.

In particular, while developed countries may provide a bailout when systemic crisis seems imminent, the Chinese authorities intervene regularly in the capital markets and tolerate few risks to financial stability. This means the monetary authorities know how to manage homegrown financial stress and are adept in containing financial contagion, preventing financial seizure and providing selective rescue.

The resolve to implement painful changes in tough times dates back to the late 1990s and early 2000s. At the time, former Premier Zhu Rongji sold off and closed more than 60 000 inefficient state-owned enterprises, leading to more than 40 million job losses,[8] after the 1997-98 Asian Financial Crisis hit the economy. President Xi Jinping restarted the structural reforms after he took over in 2013, focusing on macro-financial de-risking, debt and excess capacity reduction and high-tech and green economic development.

These efforts have continued, despite negative shocks from the Sino-US trade war and the Covid-19 pandemic. Since launching its financial de-risking campaign in 2017 by reining in the shadow bank market[9] that wiped out Ponzi schemes such as the P2P lending[10], Beijing has retreated from implicit guarantees. This has resulted in rising defaults and bankruptcies, notably of property giant Evergrande and state-owned Huarong Asset Management in 2020 and the three banks that failed in 2019[11]. This was followed in late 2020 by the regulatory crackdown on moral hazard and the supervisory loopholes in the internet and other tech sectors.

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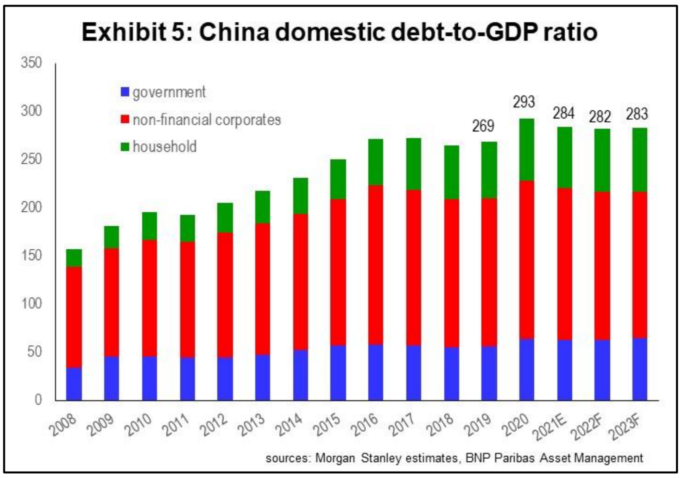
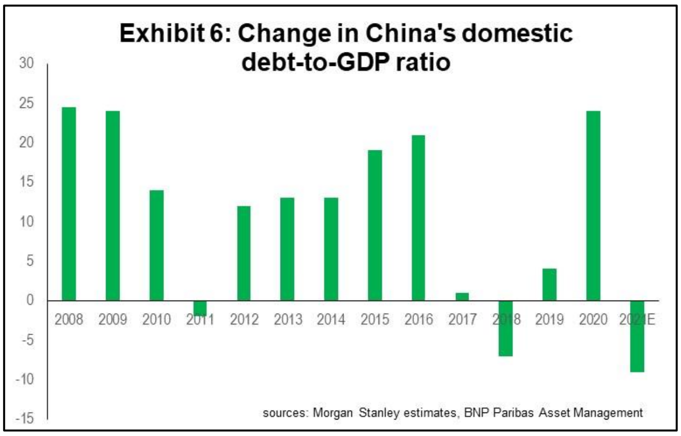
[7] See “*Chi Time: China’s Zero-Covid Policy – Timing, Benefits, Costs and Impact*”, 24 November 2021.
[8] See “*Demystifying China’s Mega Trends: the Driving Forces that Will Shake Up China and the World*”, Emerald Publishing 2017, pp. 99 – 102.
[9] See “*Chi on China: China’s Deleveraging Strategy and Evidence (II): Rising Credit Spread*”, 30 May 2018.
[10] See “*Chi Time: China’s P2P Crisis – Financial Innovation Backfires*”, 27 August 2018.
[11] See “*Chi on China: China’s Bank Failures – A Turning Point for the System*”, 28 August 2019.

Deleveraging efforts have also continued despite the Covid-19 crisis, with sell-side analysts estimating that China's debt ratio had fallen to 284% of GDP in 2021 from 293% in 2020 (Exhibit 5). Indeed, the debt-to-GDP ratio dropped during the trade war and Covid-19 (Exhibit 6), reflecting its persistent financial de-risking and reforms through tough times.





All this argues that China deserves the benefit of the doubt: it will stick with its structural reform even in bad times. Beijing does not want to return to the old debt-financed growth model.

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