FOR PROFESSIONAL INVESTORS – 9 January 2019

Chi on China

MEGA TRENDS OF CHINA (7): EVOLUTION OF ECONOMIC MANAGEMENT POLICY (I) – CONTROL VERSUS MARKET FORCES

Control your own destiny or someone else will.

Jack Welch

SUMMARY

- The difference between the current policy easing (started in July 2018) and the previous easing cycles indicates that China's economic policy had evolved towards a commitment to structural reform policy even at the expense of growth.
- Productivity growth is expected to improve under this "new normal" policy direction. But the market remains sceptical about Beijing's willingness to make structural changes, as many of the new policy initiatives still look at odds with market-determined resource allocation.
- The real question, in my view, is whether market forces will work to improve China's system, as conventional wisdom has assumed. What if the market fails?

In the past easing cycles (2008-2009, 2011-2012, 2014-2015), Beijing used the same bailout tool kit which contained subsidies for corporate investment, measures for boosting the property market, subsidies for household spending on durable goods and instructions for the PBoC to pump liquidity and cut interest rates significantly, for the commercial banks to engage in a lending frenzy, and for the SOEs and local governments to borrow and invest in infrastructure. The purpose was to boost growth quantity.

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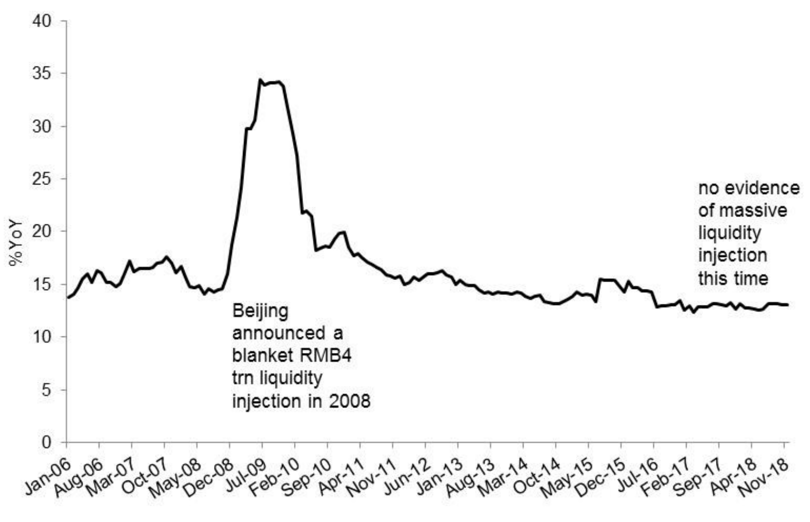
In this easing cycle, which started in July 2018, China has only used selective stimulus in the fiscal, monetary and regulatory fronts. This tactic is also designed to restore private-sector confidence[1]. Hawkish policy messages that insist on no wholesale reflation have often accompanied the targeted easing measures. This new easing approach shows Beijing's commitment to prioritising growth quality over quantity via structural reforms and debt-reduction. Table 1 summarises the policy difference between this and past easing cycles; massive liquidity injection is history (Chart 1).

Table 1: Easing measures - then and now

In the past easing cycles	This cycle (Jul.2018 to now)
Massive liquidity injection by the PBoC	Limited & selective liquidity injection by the PBoC
Significant interest rate and RRR cuts	Limited & selective RRR cuts
Commercial bank lending frenzy	Some increrase in commercial bank lending
Local government investment	No
Infrastructure investment	Some selective infrastructure investment
Property investment	No
Corporate investment subsidies	No
Consumer spending subsidies	No

source: BNPP AM (Asia)

Chart 1: Chinese bank loan growth



sources: CEIC, BNPP AM (Asia)

WHY THE CHANGE IN THE EASING TACTICS?

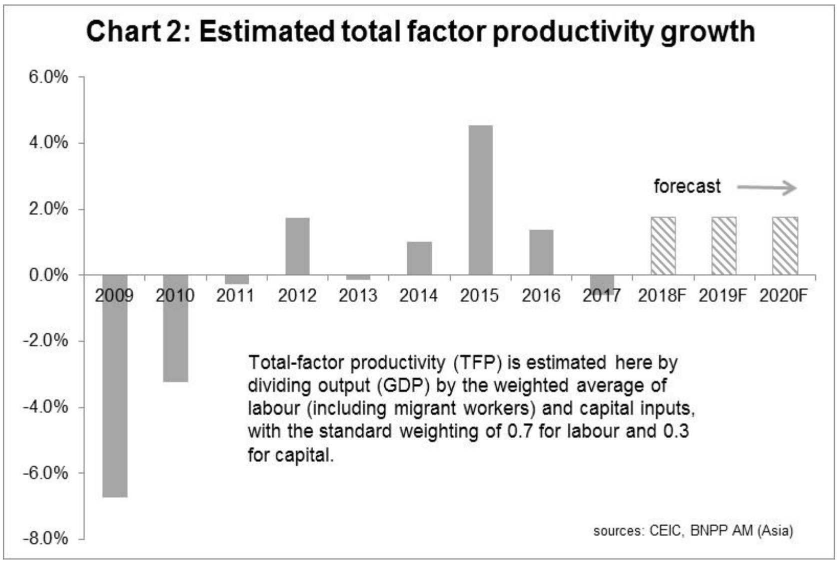
1. A significant change in Beijing's policy objective, with the Xi administration prioritising growth quality and financial stability through reduction in excess capacity and debt growth maximisation[2].

[1] See "*Chi Time: What's New in China's 2019 Outlook?"* 18 December 2018.
[2] See "*Chi on China: China's Deleveraging Strategy and Evidence*", 22 November 2017,
"*Chi on China: China's Deleveraging Strategy and Evidence (II) – Rising Credit Spread*", 30 May 2018,
"*Chi on China: The Beginning of the End of Excess Capacity*", 24 August 2016,
"*Chi on China: The Conundrum of China's Excess Capacity*", 14 September 2016.

2. There are constraints on policy easing. One big difference between the backdrop of this and the past cycles is that in this cycle the economy has a lot of debt, the renminbi has weakened and the current account surplus has dropped to around 1% of GDP, while in the previous easing cycles China had much less debt, a strong renminbi and a large current account surplus.

PRODUCTIVITY TO RISE MODESTLY

Under this "new normal" policy direction, which aims at keeping GDP growth at a moderate (6.0% - 7.0%) range and implementing structural reforms and paring debt, China's total factor productivity (TFP)[3] growth is expected to recover from the decline in the previous years (Chart 2).

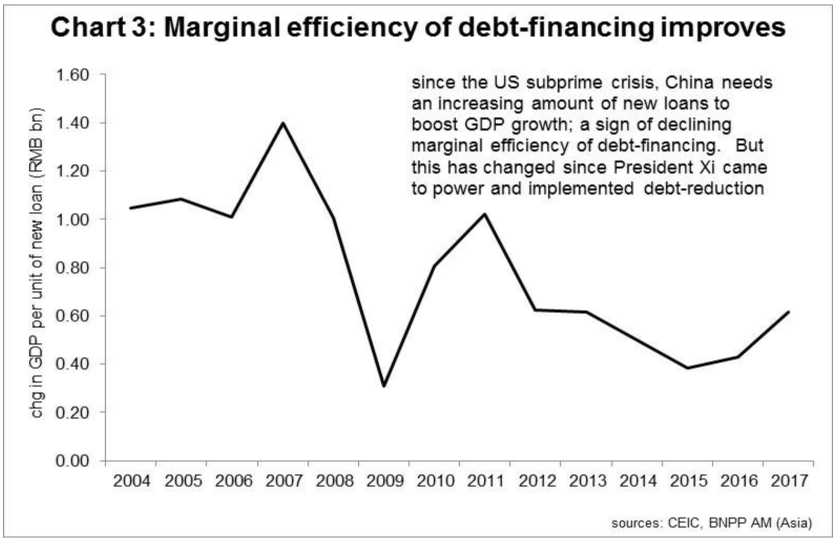


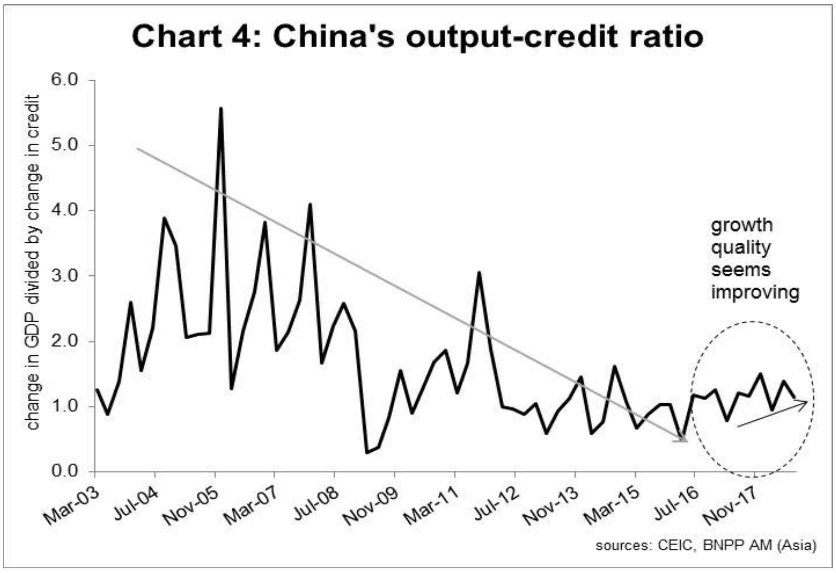
Previous debt-fueled excess investment in upstream industries[4], property and infrastructure led to sluggish or decline in productivity growth. President Xi's new normal policy has shown some initial success, with improving marginal efficiency of debt-financing (Chart 3) leading to an improvement in growth quality as seen in the rise in the output-credit ratio (Chart 4).

To maintain the domestic supply-chain competitiveness, attract FDI and address the developed world's criticisms on its trade/investment practices, Beijing has embarked on cutting taxes and loosening foreign ownership restrictions, and pledged to improve IP protection regulations and increase penalty on property rights violation.

[3] Total-factor productivity (TFP) is the amount of output produced by the combined inputs of labour and capital. It is estimated here by dividing output (GDP) by the weighted average of labour (including migrant workers) and capital inputs, with the standard weighting of 0.7 for labour and 0.3 for capital.

[4] The closer to the production source a firm is, the further upstream it is said to be. Conversely, the closer to end user a firm is, the further downstream it is said to be. Raw material extraction and production are elements of the supply chain considered to be upstream. More generally, firms/industries whose activities affect the producer prices are upstream economic entities. So the primary producers, wholesalers can be grouped as upstream sectors.





SCEPTICISM ABOUT BEIJING'S MARKET-REFORM MOTIVES

However, many players remain unconvinced about Beijing's willingness to let market forces play a bigger role in the system. Indeed, many of the new policy initiatives seem to be in conflict with market-driven resource allocation. Notably, the CBIRC's proposal in November 2018 to set a "1-2-5" target for bank lending to the private sector[5] has raised serious concern about Chinese banks being asked to take on "national service" to support growth at the expense of their profitability.

The regulators have also asked banks to lend at lower interest rate than normal corporate loan interest rate to small and micro-enterprises since July 2018[6]. The market estimates that these initiatives could add RMB1 to 2

[5] The new CBIRC "1-2-5" lending target proposes that private-sector loans should account for at least 1/3 of new corporate loans at large banks, 2/3 at medium and small banks and 50% at all banks in three years starting from the date of implementation.

[6] It was reported that banks had lent to small private businesses at an average interest of 6.23% since July 2018, which was 70 bps lower than the normal corporate loan interest rate. Some bank analysts estimated that Chinese banks would need to lend at 7.0% or above to break even or make a profit.

trn of bad loans to the banking system in three years and that the lower lending interest rate to small businesses was generally unprofitable for banks.

While these new policies aim at changing banks' behaviour of not lending to the private sector, the more crucial question is whether banks' aversion to private-sector lending is a market decision of capital allocation or is it a result of market failure? It is both, in my view.

Lending to the SOEs is less risky due to Beijing's implicit guarantee policy, until recently. Private businesses have no implicit guarantee and are smaller and, thus, riskier. So the banks seem to be making a rational, market-determined, choice. However, the private sector has consistently outperformed the SOEs in their financial returns, and many of China's most successful businesses are private companies. But banks have denied lending to them, so they have to rely on expensive venture-capital or even shadow financing.

This phenomenon reveals the irony that the supposedly market-driven banks have persistently failed to pick winners. It also suggests market failure in the Chinese banking system and argues for policy intervention to correct the situation. Of course, China needs structural reforms to correct the distorted incentives in its capital allocation process. But these will take time and are harder to implement in the short-term. Meanwhile, Beijing has embraced debt-reduction, which has hurt the private businesses more than the SOEs.

All this is not to deny the healthy dose of scepticism on Beijing's market liberalisation motive, which is indeed a conundrum that the Communist Party has to resolve[7]. This puzzle, in my view, roots from the fact that the Communist Party's ideology of control clashes with the economic reform spirit of market freedom. The point is that the new monetary policy and regulatory initiatives to force banks to lend more to the private sector are, arguably, stop-gap measures to reduce the negative externality of the deleveraging policy.

As Keynes argued, when the market failed the government had to step in. In the next instalment on this topic, I shall explore the change in China's incentives to make changes. Stay tuned.

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[7] See "*Chi on China: A Binary Choice for China's New Leaders*", 5 March 2013.

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