China

By Christian Nolting,
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China: is economic reform working?

China will host the G-20 summit for the first time this September and will want to make a good impression on the rest of the world. One likely focus is a push to further enhance the liberalization of global trade and investment rules. But, closer to home, how is China's own economy faring?

On the face of it, China appears to be putting a lot of effort into effectively managing its much-discussed transition towards a consumption-driven economy. Real GDP growth reached 6.7% in Q2, underpinned by strong consumption. Buoyant consumption, according to the GDP data, might be seen as one by-product of a more resilient labor market, raising hopes of higher wages and steady economic growth.

Other data is less encouraging. Some measures of economic imbalance have been worsening. One particularly obvious – and therefore much-discussed – ratio is between debt and GDP. Debt was equivalent to 150% of GDP in 2008; by the end of 2015 this ratio had risen to over 250%. The non-performing loan ratio is now at its highest level since 2009 (World Bank data based on China Banking Regulatory Commission rules). Recent import data also suggests that Chinese demand may not be as buoyant as the GDP data suggests: imports were down 8.4% year on year in June, compared to a 4.8% fall in exports.

The truth is that, for all its good intentions, China might not escape its recent past. In 2009 – after the start of the global financial crisis – it embarked on a major stimulus program. In subsequent years it launched other stimulus programs. As the effects of such stimulus packages wear off, Chinese firms – perhaps burdened by higher leverage as well as lower demand – might suffer cashflow problems and find it tough to service existing debts. But, despite this, bank lending continues: bank credit growth is running at over 25% per year at the moment. Lending and activity levels appear rather out of synch.

Another problem is that – in this half-liberalized environment – economic actors are seeking new ways to negotiate existing rules and structures. In recent years, for example, as banks have not been able to finance the property sector to the extent they would like due to capital constraints, they started to do it off balance sheet by using Special Purpose Vehicle (SPVs) or non-bank finance companies. As a result leverage has gone up sharply and while the overall rate of house price inflation looks acceptable, regional year on year increases of over 60% are obviously too high.

The topic of state owned enterprises (SOE) is strongly tied to the debt issue. Between 1997 and 2000 the Chinese government was able to lay off 30 to 40 million SOE employees without large amounts of compensation as the market opportunities for them to get other jobs were huge. The subsequent 6-7 years of boom also helped to resolve related deflation and Nonperforming Loan (NPL) problems. However, nowadays the SOE problem is more concentrated on certain sectors (particularly steel and coal) and geographies (the northeast "rustbelt") and is more difficult to fix. The government has already located 345 "zombie" SOEs (firms which continue to operate but are effectively insolvent) which should be closed but the regional governments do not want to close SOEs as regional GDP could suffer. Meanwhile, SOEs take a large and

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increasing share of bank credit. A comprehensive plan to deal with this debt overhang – as already talked about by the International Monetary Fund (IMF) – would assist a steady deleveraging process. This plan could include a faster writing-down of bad debt, thereby promoting corporate restructuring and hardening the budget constraint for inefficient SOEs. It would eliminate implicit government guarantees and improve corporate governance frameworks, particularly for SOEs and state owned banks. Defaults by nonviable firms would need to be carefully phased in and clearly communicated to help facilitate better pricing of credit risks in domestic financial markets. (It should be noted that four Chinese asset management companies have been in existence since the late 1990s, tasked with dealing with bad loans at the state owned banks.) Another deleveraging method could be debt replacement via equity, but the woeful state of the stock market may make this problematic.

Finally the government could use fiscal policy to prop up growth, in effect transferring debt from corporate balance sheets to its own. That makes sense, in that official public debt is low, at less than 50% of GDP, while state owned companies are the biggest debtor. As before, direct bailouts would give state firms little reason to improve their operations.

Another heavily discussed topic is the controlled depreciation of the Chinese Yuan (CNY). Given the recent commitment not to engage in a currency devaluation campaign, we believe that a one-off CNY devaluation is highly unlikely. The recent decision to open the on-shore bond market for a wide range of international investors should help contain capital outflows: with better, though still not encouraging, foreign reserve numbers, CNY has been less subject to speculative selling in recent months. The inclusion of the currency into the IMF SDR basket, as of October 2016, accompanied by greater financial market flexibility and liberalization, would create an apparatus that will allow a further shallow but gradual depreciation of the CNY against the USD (achieved via a managed float against an official basket of currencies).

So we believe the conclusion must be that Chinese reform is still very much a “work in progress” and is likely to remain so for several years. In the interim it might be wise not to set your hopes too high: for example, the capital efficiency index (incremental capital-output-ratio) has declined last three years, suggesting that reforms have not yet managed to improve the overall efficiency of the economy. But we believe, eventually, they will. China has achieved some success in social reforms over the last decade, with the introduction of a nationwide pension system and increased health care coverage. Anti-corruption and military reforms are also positives. And while corporate debt levels are high, personal and government debt are not.

We believe that China could succeed with its reforms, but that further bumps are likely along the way. For this reason we would remain selective over the medium-term on Chinese equity and fixed income investment, particularly given continuing sectoral risks. Longer-term, while these markets would be bumpy we believe they will offer significant opportunities, meaning that selective purchases, perhaps on dips, could offer the possibility of longer-term gains.

Glossary

Bailout – A situation in which a business, individual or government offers money to a failing business in order to prevent the consequences that arise from a business's downfall

CNY – The abbreviation for the China Yuan Renminbi

Emerging markets – Economies with fairly efficient and liquid markets, but less developed than developed markets

Foreign direct investment – A controlling investment by a firm in a firm in another country

GDP – Gross domestic product, a measure of an economy‘s output

IMF (International Monetary Fund) – An international organization created for the purpose of standardizing global financial relations and exchange rates

IMF basket – Consists of particular currencies that differ in weight

Leverage – The amount of debt used to finance a firm's assets

NPL (Nonperforming Loan) – The sum of borrowed money upon which the debtor has not made his scheduled payments for at least 90 days

Portfolio inflows – Flows into and out of investable assets, usually shorter-term in nature

Q – Quarter

Real GDP – An inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year, expressed in base-year prices

SPV (Special Purpose Vehicle) – Usually a subsidiary company with an asset/liability structure and legal status that makes its obligations secure even if the parent company goes bankrupt

Stimulus – Consists of attempts by governments or government agencies to financially stimulate an economy

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