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China Briefing:

Takeaways from the CITIC-CLSA China Summit 2014

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Takeaways Beijing CITIC-CLSA China Macro Summit 2014

Political and Policy Implications

- Ongoing uncertainty and concern over the Occupy Central protests in Hong Kong. There does not appear to be much room for either party to back down from their positions and maintain face. Students are losing support of the average Hong Kong resident as the protests drag on, affecting daily life and negatively impacting local businesses. Uncertainty has not been good for the domestic stock markets.
- The government's anti-corruption campaign has had a dampening effect on domestic consumption and caused a delay in several large infrastructure projects, as local officials are wary to approve large expenditures for fear of being accused of taking bribes.
- The last of the "Big Tigers", Zhou Yongkang, (a Politburo Standing Committee Member) will go on trial and it is hoped that the anti-corruption purge will peak in 2015. There is "wild" support for this campaign amongst the general Chinese public.
- The 4th Plenum focusing on "Rule of Law" is intended to further give credibility and legal standing to the anti-corruption campaign and rule of law as defined by the Party.
- There is concern that growing discontent among offspring of second and third generation "migrant workers" could erupt in "social unrest" as they are deprived of human rights (residency, education and access to healthcare) and adequate economic opportunity.
- China's urbanization policy is not working and the Houkou system needs major reform (revising the unpopular "point system").
- The "next wave" of rural to urban migration has already taken place and the majority of the 200 million migrant workers are already living in major cities where there are employment opportunities.
- Local governments have limited incentives to provide residency status (Houkou) to migrant workers and the education and social services this would require.

Economic Implications

- China has entered a new era or a "New Norm" as a large-scale economy. Rapid economic growth (greater than 10% per annum) has transitioned to "Medium to High Speed" growth as it is officially being referred to by the State Council Development Research Center. Structural changes in the Chinese economy, including the nearing exhaustion of cheap labor supply, cheap land, and the waning impact of technology as China has largely closed the productive technology gap, are driving this transition to slower growth. China is targeting 6-7% GDP growth per year between now and 2020, when China is anticipated to join the "high income" countries.

- Liu Shijin Vice President of the Development and Research Center of the State Council reported on a study of post WWII economies that reach a per capita income of $11,000 (PPP-Madison index). Upon reaching this target, all countries experienced a 50% drop in economic growth (South Korea, Japan, Germany, Taiwan, Singapore and Hong Kong) and China will reach this per capita income level in 2015-2016. The phenomenon is widely regarded as the “Middle Income Trap”, and it is something China would certainly hope to avoid
- Central government (CSRC) is now focusing on the Profit and Loss (P&L) statement instead of focusing solely on the Balance Sheet (growth of assets). Examination of asset quality is now taking place at the Central, Provincial and Local government levels as well as within SOE’s and the banking (financial) system, including local government debts and shadow banking. Only household debt looks relatively healthy.
- The consensus from all parties (government and industry experts) is that the property market has seen its best days and will not return to pre-global financial crisis levels of growth or appreciation. A Texas A&M study has validated that the vacancy rate in unoccupied residential units (apartments) exceeds 49 million units or 20% of supply in Tier 1 and Tier 2 cities and 22-25% of supply in Tier 3 and Tier 4 cities. Absorption of the oversupply will occur much faster in Tier 1 and Tier 2 cities where there are greater employment opportunities and owners desire to “move-up” in housing size and quality.
- The property market decline is affecting all sectors of the economy and is having a particularly pronounced dampening effect on steel (rebar prices are down 15.8% YTD) cement (prices have dropped 9% YTD) and manufacturers of heavy equipment (who are reporting sales and profit declines of 40-60% YTD).
- People’s Bank of China (PBoC) is aggressively recapitalizing the banking system (top 25 largest lenders) in anticipation of rising nonperforming loans (NPLs) as the economy transitions and as the China Banking and Regulatory Commission and CSRC turn their focus to balance sheet health.
- Chinese banks are trading below book value for the first time since their listings back in 2003-2004. Bank credit growth is slowing and bank profits margins are declining as banks increase loan loss provisions for an increase in NPLs.
- All economists and speakers discussed the shift from the property and export led economy of the past 20 years toward an economy driven by domestic consumption, services and higher quality manufacturing. However, the consensus is that this transition will be an extremely difficult and a slow process due to a number of structural impediments, including:
    - Low consumer confidence
    - Lack of a social safety net and pension reforms
    - Aging demographics (saving more and spending less)
    - Delayed interest rate liberalization and deposit insurance
    - Slower family formations and fertility rates

Demographic Changes

- The percentage of the Chinese population over 60 years of age high compared to other emerging markets and is growing faster than high-income economies such as Japan, Korea, and the United States. This is due to multiple factors, including the effects of the one child policy, a lack of immigration, lower family formations due to the Houkou system as well as housing affordability and fertility rates.
- Recent efforts to relax the one child policy have not produced desired results and further reforms are expected. Based on the latest efforts to relax the one child policy it was expected that 11 million people would qualify to have an additional child. The government statisticians expected that between 2-3 million couples would "apply" to have an additional child. However, only 270,000 submitted applications.
- Urbanization cannot be relied upon to spur economic growth as most of the 200 million migrants that are targeted are already "out of the countryside" and living/working in the cities.
- The aforementioned Texas A&M study reported that 89% of urban residents own at least one or more homes and that 96.7% of the rural population own their own home as of August 2014. Therefore, it is highly unlikely that new demand will be able to absorb the oversupply of existing housing nor will residential property development return the lofty levels seen over the past 20 years.

State Owned Entity (SOE) Reform

- The consensus is that SOE reform will be a long, tough road with many obstacles along the way.
- Local governments rely on profits from SOEs, especially in monopolistic businesses, to provide essential fiscal services. This source of revenue will increase in importance, as local governments must be weaned off of land sales to generate fiscal revenues.
- The ownership structure of large SOEs has not evolved nor have Boards of Directors, Corporate Governance and the role of Independent Non-Executive Directors. State regulators of large SOEs often lack 100% control.
- SASAC the Central regulatory authority over SOEs wants more power and control over SOE affairs but it is not seen as competent and its oversight is being resisted at the local government and company level.
- Many SOEs are losing money and the ones that are profitable are required to support the weak SOEs to maintain employment and social stability, especially at the local level.
- There is huge excess production capacity in the SOEs. Labor quality and productivity of the top SOEs in the Fortune 500 lag their competitors in virtually every measure.

- Employee shareholder schemes in China, meant to give workers a "share of the profits", have generally ended in failure.

Retail and Logistics Business in China

- The anti-corruption campaign is taking its toll on the sale of high-end and luxury goods as well as fancy dining. One company reported holding its annual dinner in its canteen instead of at a hotel.
- Automobile sales are likely to peak in 2015, as China will approach 400 autos for every 1000 persons. The ratio in the US is 800 autos per 1000 persons.
- The Alibaba effect and its distribution channels are not well understood and is placing a damper on traditional bricks and mortar retail expansion.
- Small to light manufactured products such as iPhone accessories are bypassing warehouses and going directly from the manufacturer to the consumer by "special handlers" that are using excess capacity in air cargo to offer 48 hour door to door delivery to end consumers anywhere in the world.

Hong Kong Shanghai Mutual Market Access

- Executives of both exchanges are awaiting final approvals before announcing an "implementation" plan. Testing has been underway for some time.
- To-date the scheme has been beneficial to both exchanges.
- The State Administration of Taxation (SAT) in China has not issued authoritative taxing guidelines, which is holding up final approval and creating greater uncertainty as to how profits and losses on trading will be treated. SAT is more than ten years behind schedule on announcing tax guidelines for the establishment of REITS in China, so many institutional investors are cautious as to the timing of implementation.
- There are strict limitations on how much capital can flow across the border and the initial stocks to be traded will be limited to mostly blue chips in an effort to protect investors.

Summary and Conclusion

- Senior Government Officials were quite candid and open in their remarks. The program was VIP audience and no media was allowed to attend.
- The speakers demonstrated a good understanding of the issues facing China as its economy transitions from fast growth to medium to high growth.
- Steps are being taken to deal with local government debts, currently approaching $3 trillion dollars, by allowing local governments to issue "municipal bonds" (not centrally guaranteed) for certain types of projects to repay local government debts to banks

and investors. Issuance is expected to begin in late 2015 at which time local government debt may reach $4 trillion (24 trillion RMB). Maturities for these instruments are expected to range from 5-7 years. My guess is that they will generally be sold “interbank”.

- The size of the Shadow Banking as of June 2013 is 12.5 trillion RMB ($2 trillion), and is of major concern as the asset quality is suspect and likely to deteriorate as the economy slows and the property market is not allowed to return to the lofty levels of the past decade. As much as 40-50% of shadow banking is to property related businesses as well as SME (small and medium enterprises) that were not able to access the banking system due to a preference for banks to loan to large SOEs. The governments’ approach to a rise in defaults and NPLs is to use the Big 4 State Owned Asset Management Companies (AMCs) to buy up large scale systemic bad debts and for the Provinces to establish local AMCs (5 pilot programs are underway) to acquire bad debts in local markets to prevent any systemic risks to local financial institutions and any ensuing social unrest.
- Expected rising NPL levels in the banking system are being addressed by recapitalizing banks and banks issuing preferred shares to shore-up their capital base to meet international standards.
- SOE reform will be a long and slow process.
- 2015 should see the bottom of the market and stabilization to the “new norm”. However, the challenges enumerated above (structural economic slowdown, SOE reform, Houkou reform, financial reform, demographics, etc.) are difficult to address, long-term in nature and not subject to a “quick fix” or another large-scale blanket economic stimulus plan.
- Shifting growth rates will be “bumpy” along the way; targeted moderate stimulus may be called for; the consensus forecast expects market volatility to remain high through most of 2015.