

Too close for comfort

One step forward for China or two steps back?

by Jack Rodman

As year-end approaches, Chinese leaders have announced several measures designed to stimulate a slowing economy, recapitalise the banks and give comfort to depositors that their savings are safe in Chinese banks. In addition, the long-awaited Shanghai-Hong Kong Stock Connect between the Hong Kong and mainland stock exchanges was launched to a somewhat muted reaction. While to some observers it may appear that China is making progress with its stated goal of financial reform (ie. deposit insurance and interest rate liberalisation), to many "old China hands" it looks like China is preparing the public for massive write-offs of nonperforming loans and increasing distress from trusts, wealth management products and local government investment vehicles.



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Since June 2014, the People's Bank of China and other regulatory bodies have pumped more than €230 billion into the banking system to shore up capital adequacy in light of the fastest growth of NPLs since the banks went public a decade ago. In the short run (2015), many of these changes will have only minor (good or bad) implications for the economy. However, China is facing so many "structural reforms" requiring a "generation of change" that it is unlikely we will ever see double-digit growth from the world's second-largest economy.

The following summarises many of the issues that China must overcome in future decades.

Political and policy implications

Uncertainty and concern over the Occupy Central protests in Hong Kong have not calmed investor fears. There does not appear to be much room for either side to back down from their positions

and still save face. Students have lost the 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 highly popular anti-corruption campaign has had a dampening effect on domestic consumption and has caused a delay in several large infrastructure projects, as local officials are wary of approving large expenditures for fear of being accused of taking bribes. The last of the "Big Tigers", Zhou Yongkang (a former Politburo Standing Committee member), will go on trial, and it is hoped that the anti-corruption purge will peak in 2015.

There is concern that the second and third generations of "migrant worker" children could erupt in "social unrest" as they are deprived of human rights (residency, education and access to healthcare). The urbanisation policy is not working, and the hukou system that provides the basis of household registration in China needs major reform. Local governments have no incentives to accept migrants (hukou rights), as they cannot provide social housing (land allocation) or education for migrant children.

Economic implications

China is entering a new era or a "new norm" as a large-scale economy. Rapid economic growth (greater than 10 percent per year) will transition to "medium-to-high" growth, as it is officially being referred to. GDP growth of 6–7 percent is being targeted between now and 2016 as China becomes a member of the "high-income" states. Structural changes in the Chinese economic miracle of the past 20 years will force the economy to transition from high growth to medium-to-high as: the cheap labour supply is exhausted; cheap land is no longer available; and the impact from the introduction of technology abates.

Central government regulators are now focusing on the profit and loss statement instead of focusing solely on the balance sheet. Examination of asset quality is now taking place at all levels within the economy. 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. The property market decline is affecting all sectors of the economy.

The People's Bank of China is aggressively recapitalising the banking system (the top 25 largest lenders) in anticipation of rising NPLs as the economy transitions to medium to high growth and as the China Banking Regulatory Commission and the China Securities Regulatory Commission turn their focus to asset quality on the balance sheet. Chinese banks are trading below book value for the first time since listings back in 2003–2004,



Chinese World Trade Center, Tower 3, Beijing

and bank credit growth is slowing and bank profit margins are declining as banks increase loan loss provisions for an increase in NPLs.

Demographic changes

The percentage of the population over 60 years of age is growing faster than other high-income economies (Japan, South Korea, United States) for a number of reasons including the effects of the one-child policy, a lack of immigration, lower family formations due to the hukou system as well as housing affordability and fertility rates. Recent efforts to relax the one-child policy have not produced the 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.

Government statisticians expected that between 2 million and 3 million couples would “apply” to have an additional child. However, only 270,000 submitted applications. Urbanisation cannot be relied on 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.

Most government economists forecast a shift from the property- and export-led economy of the past 20 years to rebalancing toward domestic consumption, services and higher-quality manufacturing. However, the consensus is that this transition will be extremely difficult and a slow process, due to a number of structural impediments including: low consumer confidence; the lack of a social safety net and pension reforms; ageing demographics (saving more and spending less); and slower family formations and lower fertility rates.

Bumpy and volatile

Steps are being taken to deal with local government debt that is approaching €2.5 trillion by allowing local governments to issue a type of “municipal bond” that is not centrally guaranteed for certain kinds of projects to repay local government debts to banks and investors. Issuance is expected sometime in late 2015, at which time local government debt may reach RMB 24 trillion (€3.2 trillion). Maturities for these instruments are expected to range from five to seven years.

Shadow banking of RMB 12.5 trillion (€1.6 trillion) as of June 2013 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 percent of shadow banking is to property-related businesses as well as to small- and medium-sized enterprises that were not able to access the banking system due to a preference for banks to lend to large state-owned enterprises. The government’s approach to a rise in defaults and NPLs is to use the Big 4 state-owned asset management companies to buy up large-scale systemic bad debts and for the provinces to establish local asset management companies (five pilot programmes are underway) to acquire bad debts in local markets to prevent any systemic risks to local financial institutions and to prevent social unrest due to defaulting debtors.

2015 should see the bottom of the market and stabilisation to the “new norm”. However, the issues enumerated are long term in nature and not subject to a “quick fix” or another economic stimulus plan. Shifting growth rates will be “bumpy” along the way, moderate stimulus specifically focused will be called for, and the markets are expected to be highly volatile through most of 2015, even if all goes well. ♦

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