

Diagnosing Chinese Economy

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Storyline

1. Current state of Chinese economy

- Two speed economy
- Fast growing “New economy”
- Tackling the corporate debt problem is most urgent

2. The aftermath of investment bubble

- Deteriorating balance sheet and Increasing NPL
- Economy rebounded in the 1st half, why was it not a good news?

3. The prospect of Chinese economy (short/mid term)

- Regarding debt-driven stimulus, learn Japan’s lesson
- The ultimate risk of Chinese economy is the financial sustainability
- China's demography

4. Currency and capital flow

- RMB : further liberalization unlikely for the time being
- What is the problem? “excess debt” or “excess savings”?

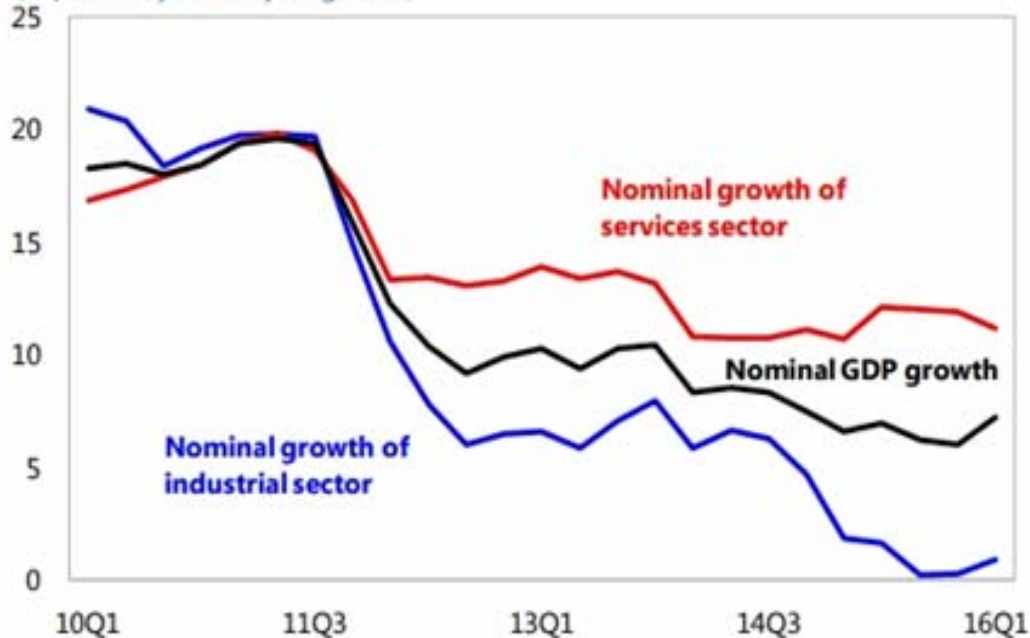
5. Other issue

- One Belt One Road, AIIB, FTA
- MY reading of Xi Jinping’s politics

“Two speed economy”: fast growing service sector and deteriorating manufacturing sector

Two-speed Economy

(In percent, year-on-year growth)



Wide Regional Growth Disparity

(In percent, year-on-year growth, 2015)



Source: 2016 IMF Article IV Consultation Report on China

IMF also argues that overcapacity sectors/regions are already experiencing ‘Hard landing’.

How the **IMF** views Chinese economy?

Article IV consultation report (12th Aug.)

① **Rebalancing progressed**

From industry to services, from investment to consumption

② **Some of key reforms also progressed**

Exchange rate/interest rate mechanism, new budget law etc.

③ **Tackling the corporate debt problem: most urgent**

Harden budget constraints (especially on SOEs) , recognize and allocate losses, restructure/liquidate weak Zombie firms

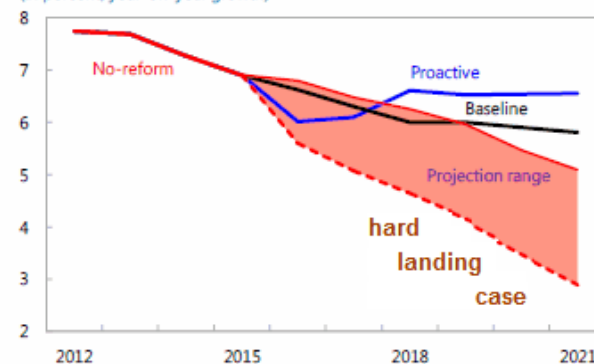
④ **Guarding against financial risks: very urgent**

To boost bank buffers, recognize losses to rein in risks in shadow banks

⑤ **Moderately slowing down the economic growth: important**

Current growth target (6.5% or higher) is unrealistically high

GDP Growth: Illustrative Scenarios
(in percent, year-on-year growth)



source: IMF 2016 Article IV consultation report

Not all is unhopeful in Chinese economy: “New economy” is growing fast



Tmall: a subsidiary of Alibaba World's largest retailer with annualGMV \$485 billion



Alipay : a subsidiary of Alibaba One of the largest Fintec srvice provoder



DIDI (滴滴打车) a Uber like Chinese Company

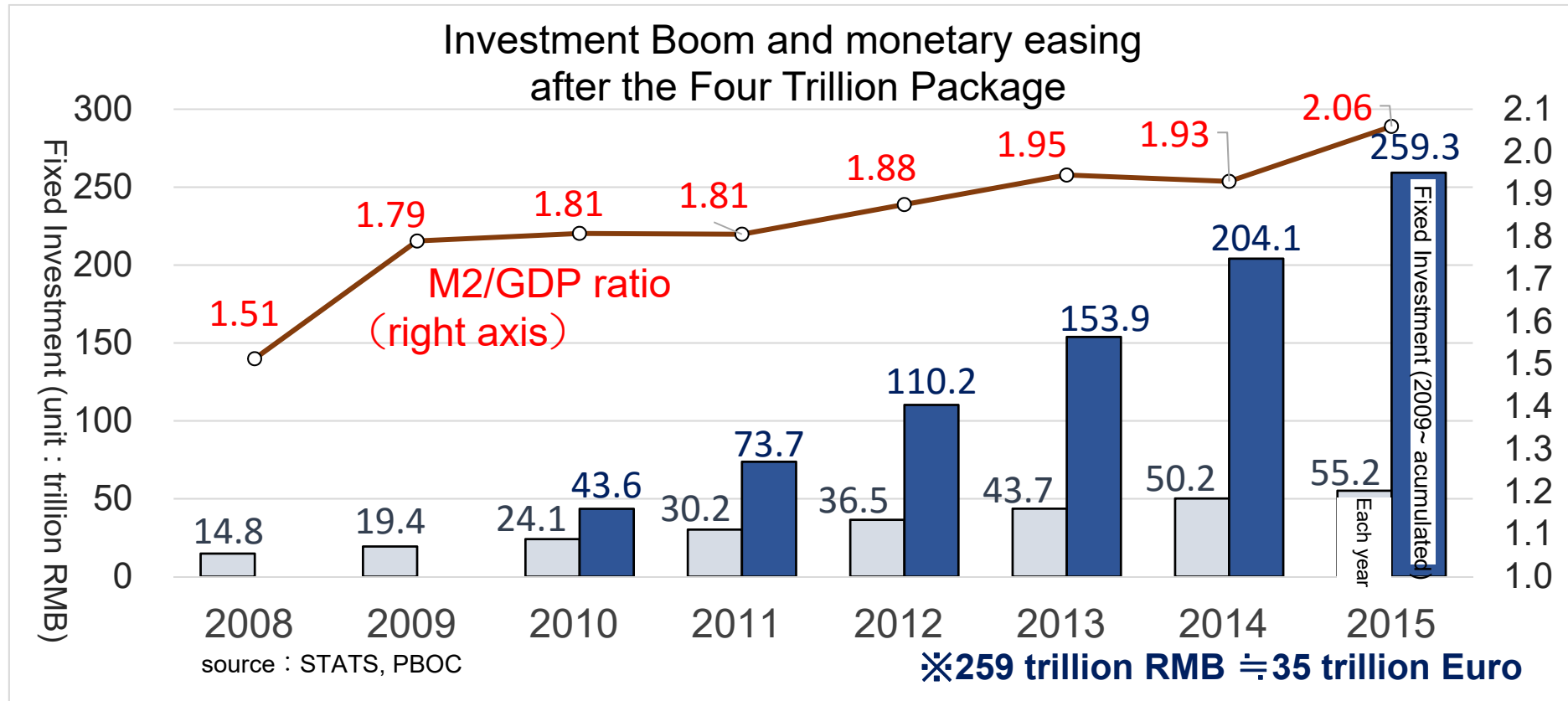


Huawei : an ICT device manufacturer, ICT service provide Solution provider with annual turnover \$ 60billion



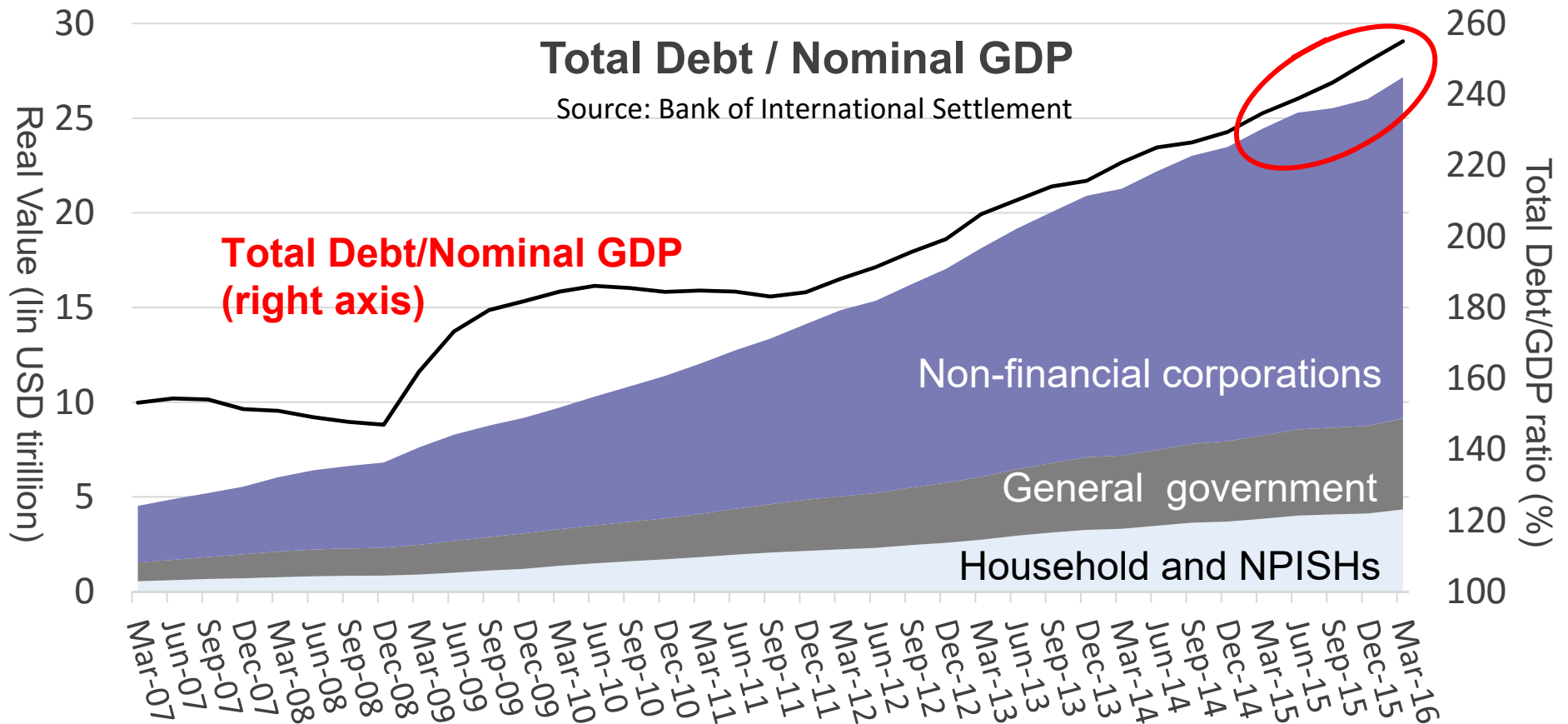
DJI: a consumer drone manufacturer with global share of 70%

China's high growth in 2009~2013 was largely a result of an investment bubble



Over capacities in industries, dead stocks in real estate sector, inefficient public infrastructure...Massive amount of **non-performing “assets”** were cumulated and **eroded the national Balance Sheet**. So is the case on the liability side. Massive **non-performing debts** were cumulated on the B/S

Aiming at deleveraging (“new Normal”), but not doing well



The Debt/GDP ratio continues to rise due to:

1. Slow down of GDP growth (denominator)
2. Debt redemption is slow, “zombie” can’t even pay interests (numerator)

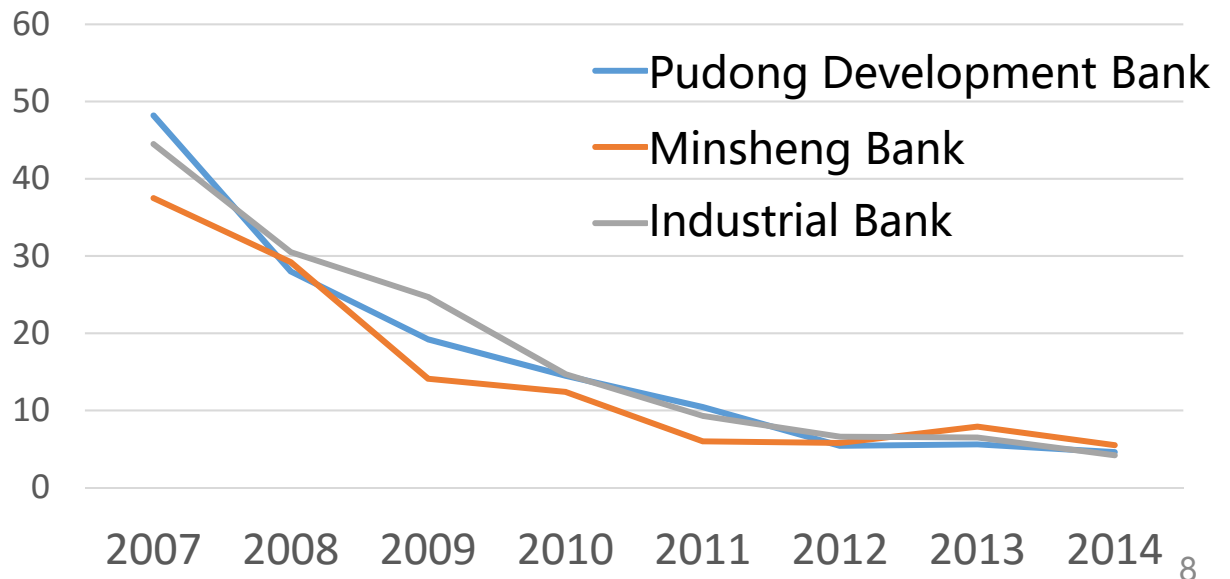
Banks' capital adequacy already hurt

- Bank's NPL ratio is still 1.8%, but in wider definition comes close to 7%. Private institution's estimate is even higher
- If 5% of Banks' outstanding corporate-loan (70 trillion RMB) can't be paid back, more than half of their capital will be blown out
- Banks' share prices suggests that erosion is already happening

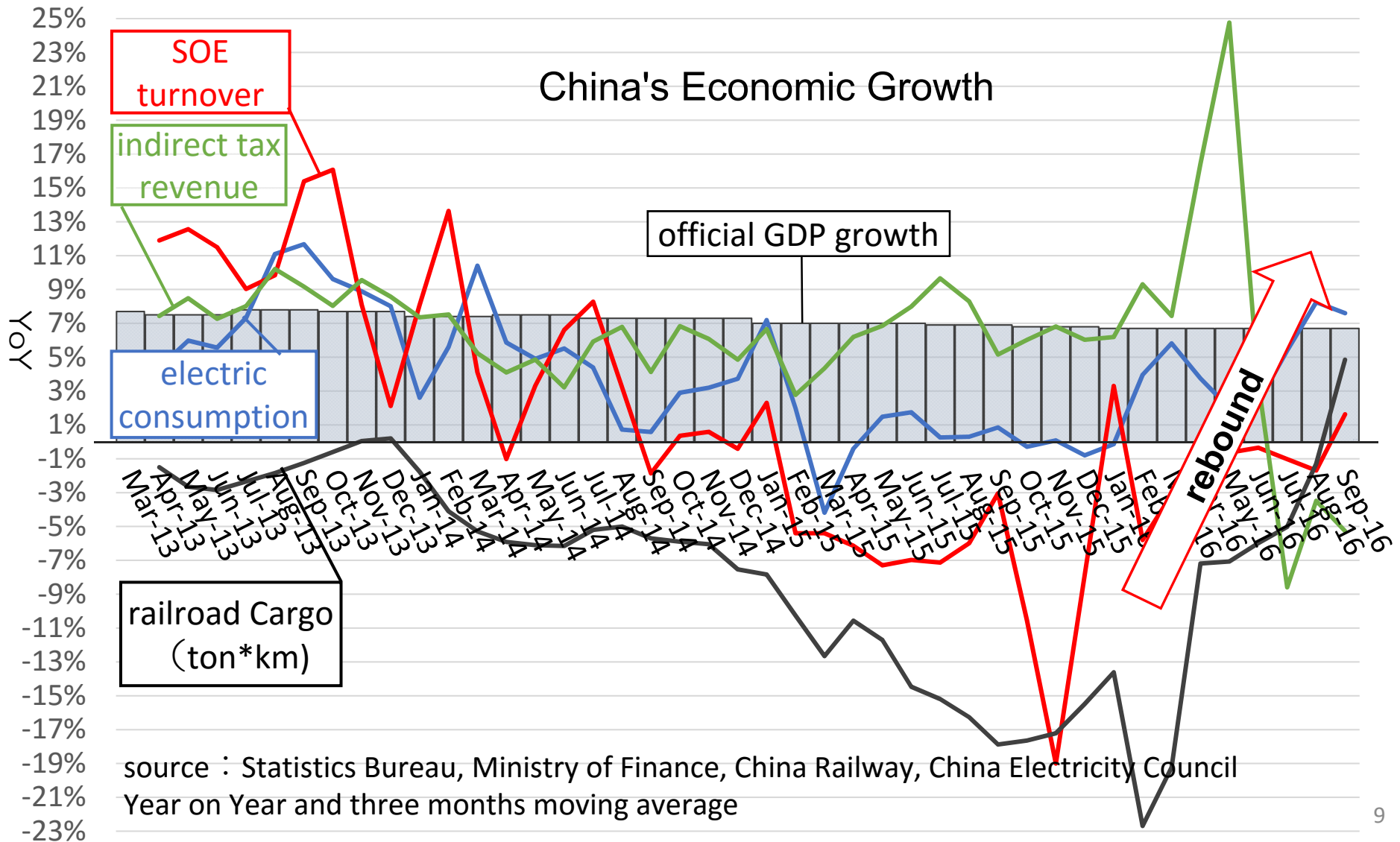
Sector	Averaged PER
IT	68
Raw Material	56
Pharmaceutical	48
Telecom	46
Consumption	33
Industry	31
Energy	30
Selective consumption	29
Public Utility Industry	15
Real Estate	21
Automobile	15
Insurance	14
Conglomerated Finance	12
Bank	6

Source : China Securities Index Co.,Ltd
2016/8/3

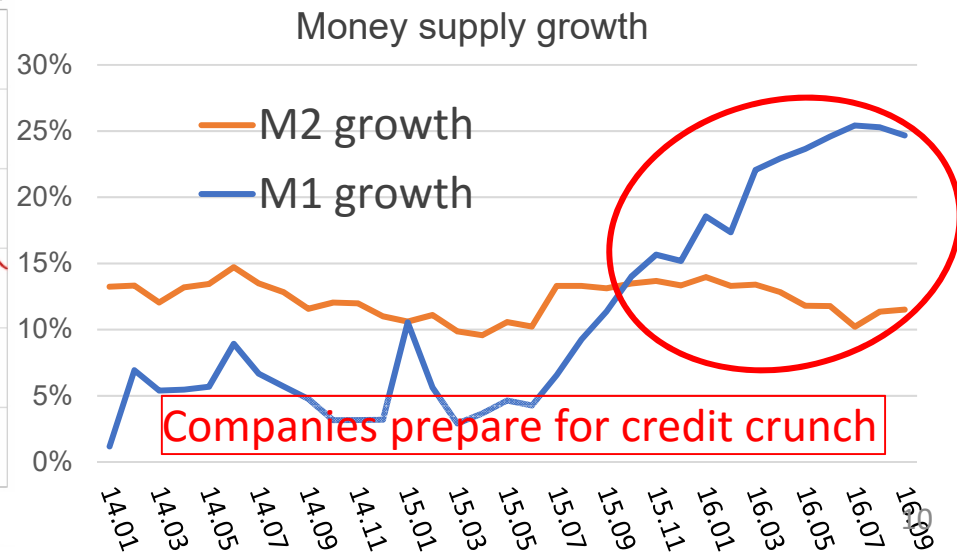
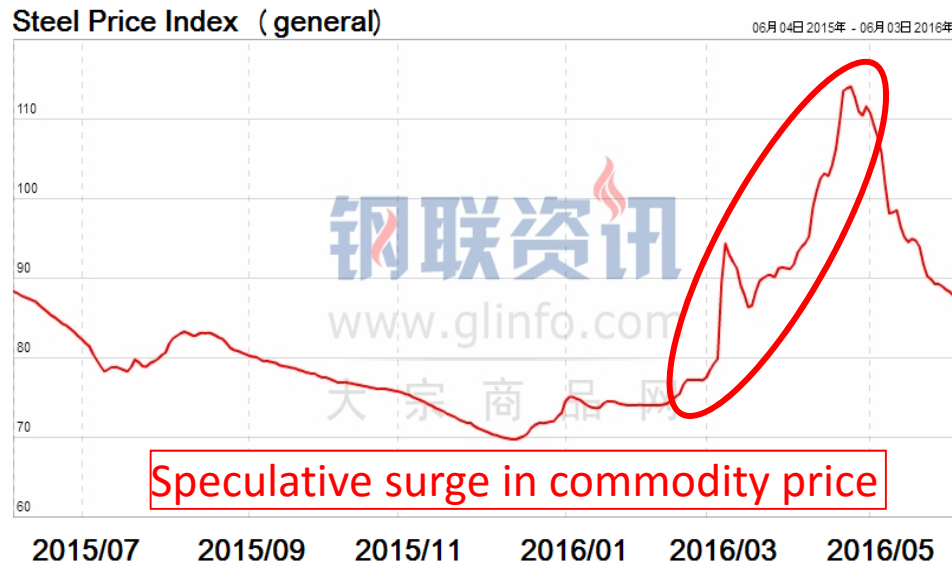
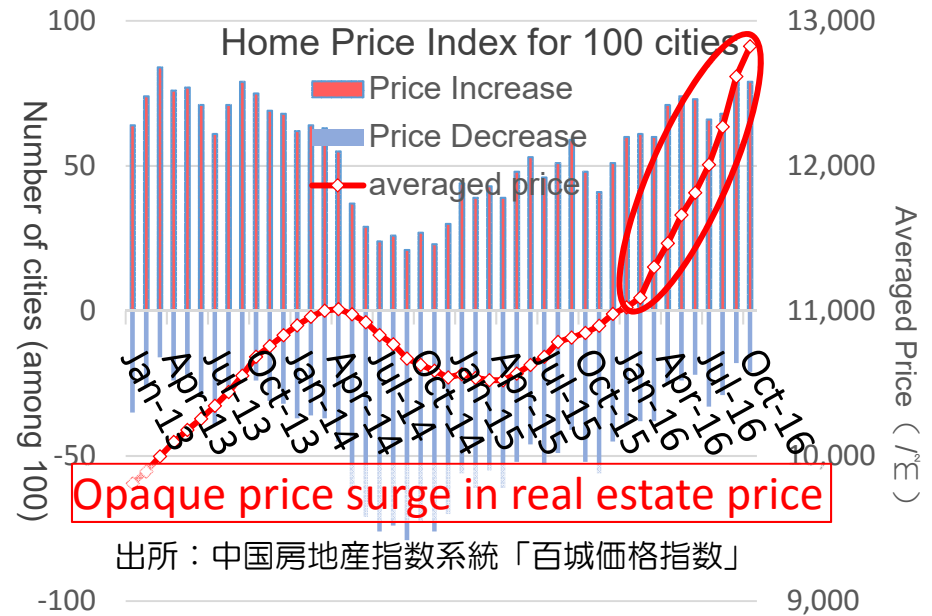
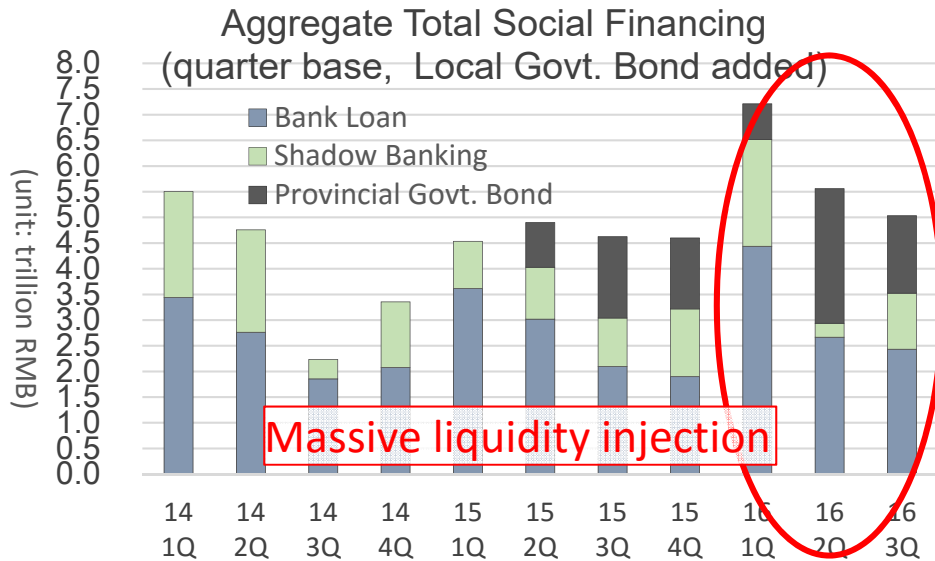
Bank share's PER



Another Stimulus made Economy rebound in 2016 1st half : Not a good news



Why the rebound was not a good news? Signs of deteriorated financial sector



A policy discord in the administration?

Sharp criticism against Li Keqiang and his State Council by an "authoritative insider"

1. "Stable growth in the 1st quarter" was mere a result of an **old fashioned debt-fueled stimulus**
2. 'U-shaped' or 'V-shaped' recovery is unlikely, rather we should be ready for '**L-shaped**' path that last for years
3. Main agenda must be to propel '**supply side reform**', demand stimulus must not exceed requisite minimum

The "**authoritative insider**" is supposed to be **Liu He**, Xi's economic brain (FELSG Office)

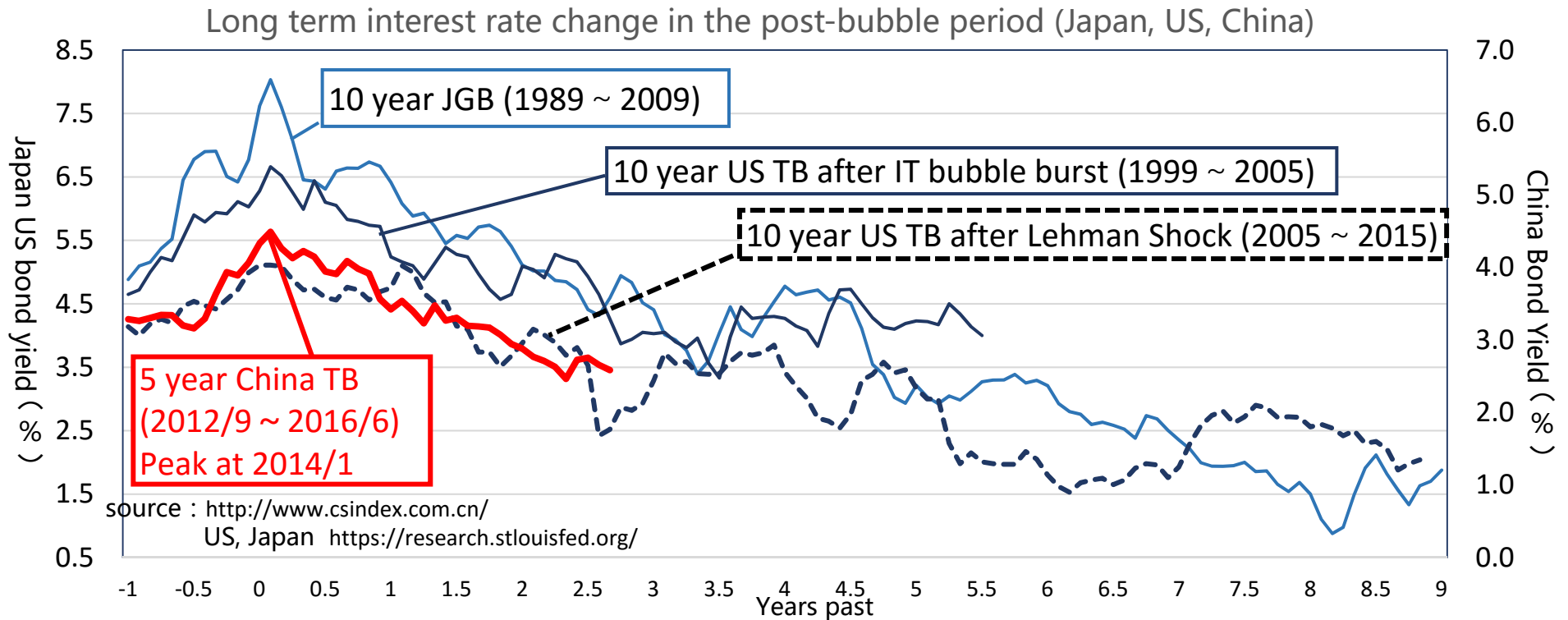
But recently Xi himself seems to incline to maintaining growth (through investment)

- Before: supply side reform = top priority
- After: stable growth is the key to propel supply side reform

Hint: CCP top personnel reshuffle is coming close (2017 fall)

The collage features several key headlines from the People's Daily on May 9, 2017. The top left clipping reports on Xi Jinping's instructions regarding landslide rescue operations in Taian County, Fujian. The top right clipping discusses a drinking water project in Ningxia. The middle section contains a large article titled '全面学 系统学 深入学' (Learn comprehensively, systematically, and in depth), which is a call for deeper study of the Party's new ideas. Below this are several smaller articles, including one on '治国理政新思想新实践' (New thoughts and practices of governing the country) and another on '全面从严治党的根本保证' (Fundamental guarantee of strict governance). The bottom section includes a piece on '这些成本该降!' (These costs should be reduced!) and a large headline '开局首季问大势' (Ask the big picture in the first quarter of the start), which discusses the economic outlook. A final clipping at the bottom right mentions '十三、绿水青山就是金山银山' (Green mountains and clear waters are like gold and silver mountains).

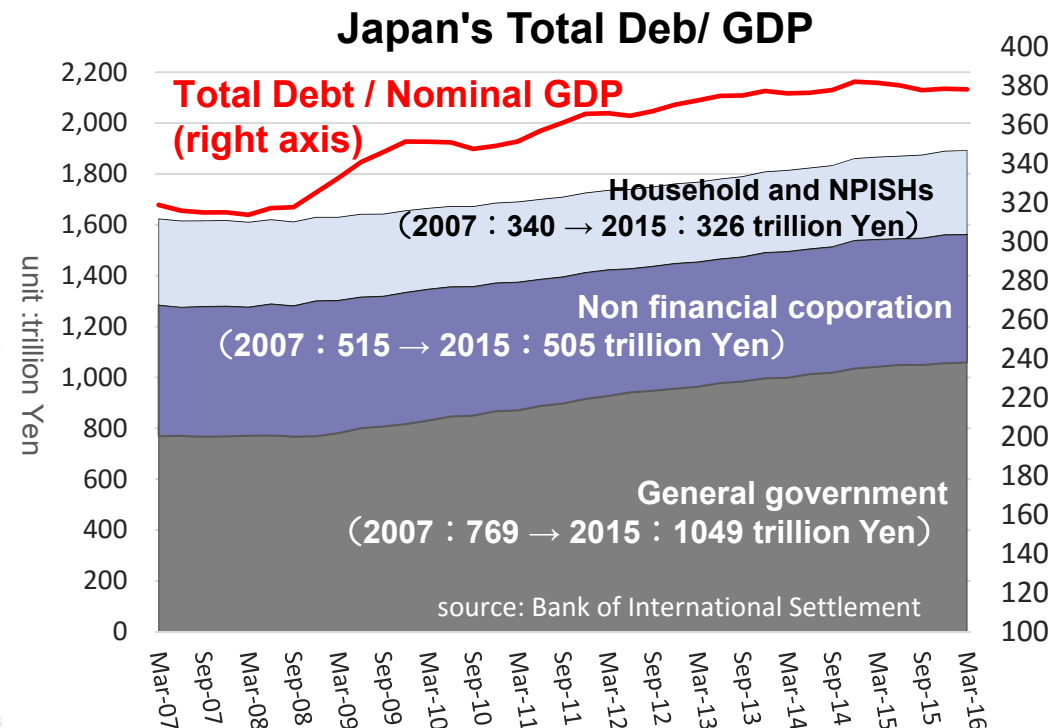
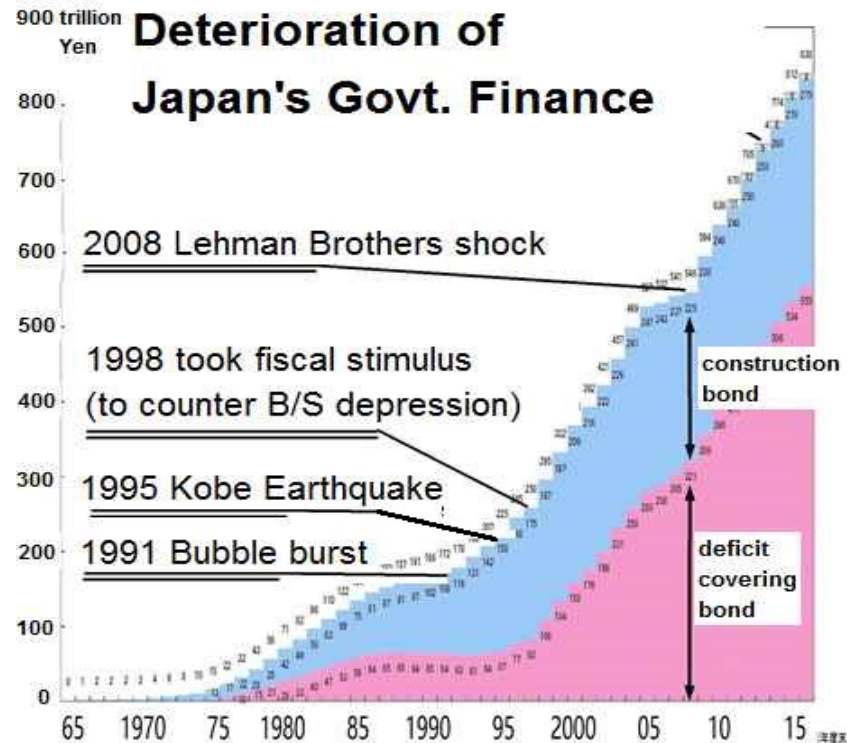
A mixed scene of deleveraging : already started in private sector, but not in govt. affiliated sector



private enterprises have already entered into a deleveraging mode, but the move of local Govts. are still uncertain.

Further piling up of inefficient debts and assets by SOEs and Local Govts. would endanger the soundness of China's balance sheet

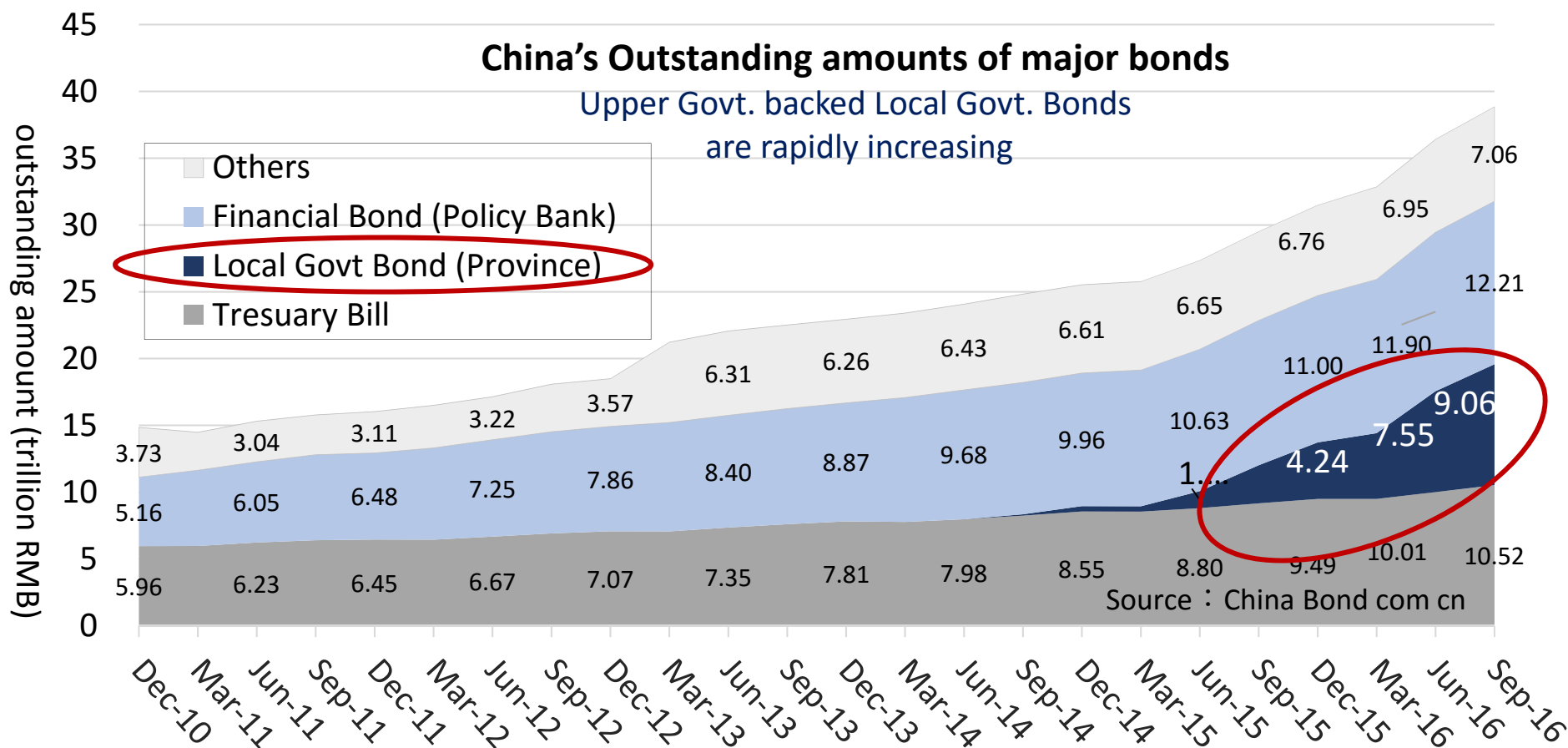
Learn Japan's lesson : debt-driven stimulus; should not exceed bounds; should primarily be borne by the Central Govt.



The reasons why Japan has not yet fallen into financial crisis;

- (1) Debts are concentrated onto the central Govt. (most resilient)
- (2) Interest rate has maintained almost 0% for two decades

Financial reform : The burden of stimulus are already going to be shifted to the upper Govts.



Funding needs of local Govts. (Prefectural level or below) are gathered and met by the upper Provincial Govts' local bond issuance
 Their outstanding amounts will soon surpass the central Govt. bond

The prospect of Chinese economy (near/mid term)

【Macro economy】

- Need to “deleverage” and cure the wounded national balance sheet
- “New normal” is right in direction, but “6.5% growth” is still too high
- Current debt-driven stimulus: don’t follow Japan’s failure

【Micro economy (≡ supply side reform)】

- Grow **New Economy ABAP**
- Restructure **Old and wounded Economy AFAP**
- The two should go in tandem, but the latter one is difficult

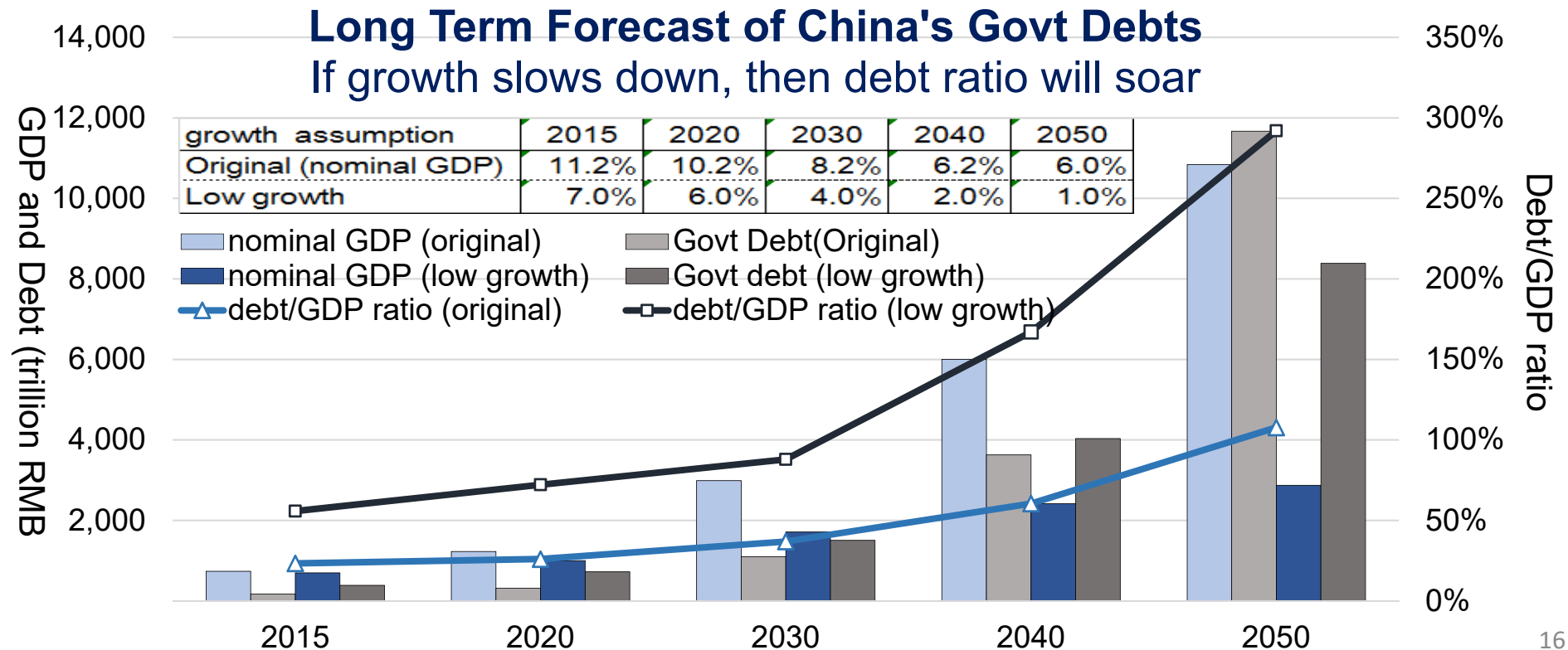
【Up date】

- The reform is lagging, as CCP personnel reshuffle coming close
- Then the question is whether it can be resumed in 2018?

Fiscal Deficit : level is already very high the ultimate risk of Chinese economy

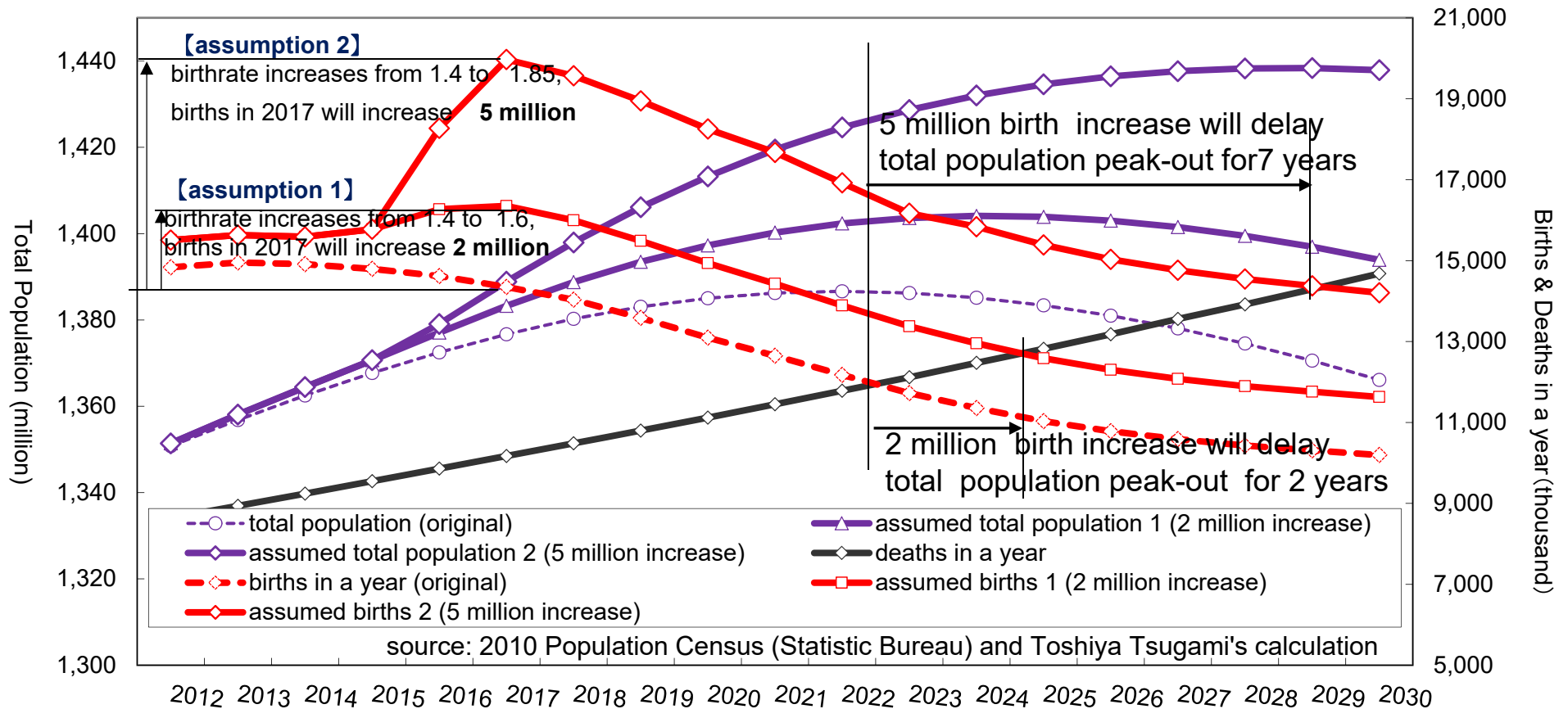
- IMF says Consolidated fiscal deficit may reach 8~10% of GDP in 2016

IMF's Estimate of China's Government Deficit												source:2016IMF Article 4 consu
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	
IMF's forecast of GDP growth	9.5	7.9	7.8	7.3	6.9	6.6	6.2	6.0	6.0	5.9	5.8	
Central Govt. deficit (Official Statistics)	-0.1	-0.7	-0.8	-0.9	-2.7	-3.0	-3.1	-2.9	-2.9	-2.8	-2.7	
IMF's (narrow) Estimate of consolidated Government Deficit	-6.0	-5.1	-7.6	-7.2	-7.9	-8.4	-8.2	-7.8	-7.8	-7.0	-6.6	
IMF's (broadest) Estimate of consolidated Government Deficit	-8.2	-7.8	-10.3	-9.8	-9.5	-10.1	-9.8	-9.3	-9.3	-8.4	-8.0	



China's demography

“One child policy” deregulation will not have a major impact
If there is a major impact, it will bring about another problem



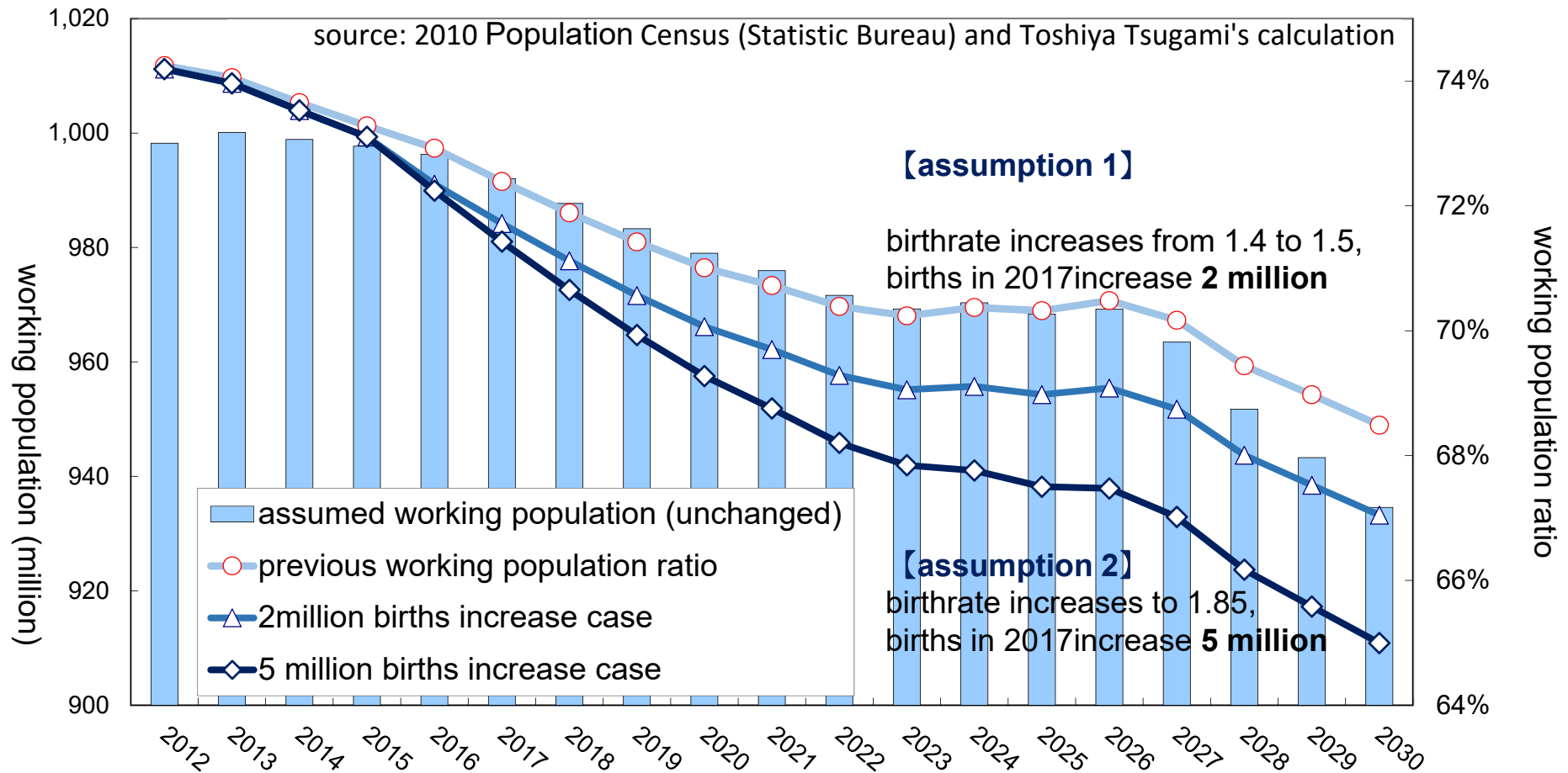
Assume that previous birth rate (TFP) as 1.4 and;

assumption 1 birthrate increases from 1.4 to 1.6 and births in 2017 increases **2 million**, then it will delay total population peak out for 2 years at 1.404 billion

assumption 2 birthrate increases from 1.4 to 1.85 and births in 2017 increase **5 million**, then it will delay total population peak out for 7 years at 1.438 billion

Prospect of Future Working Population

Rapid birth increase will toll future economic growth

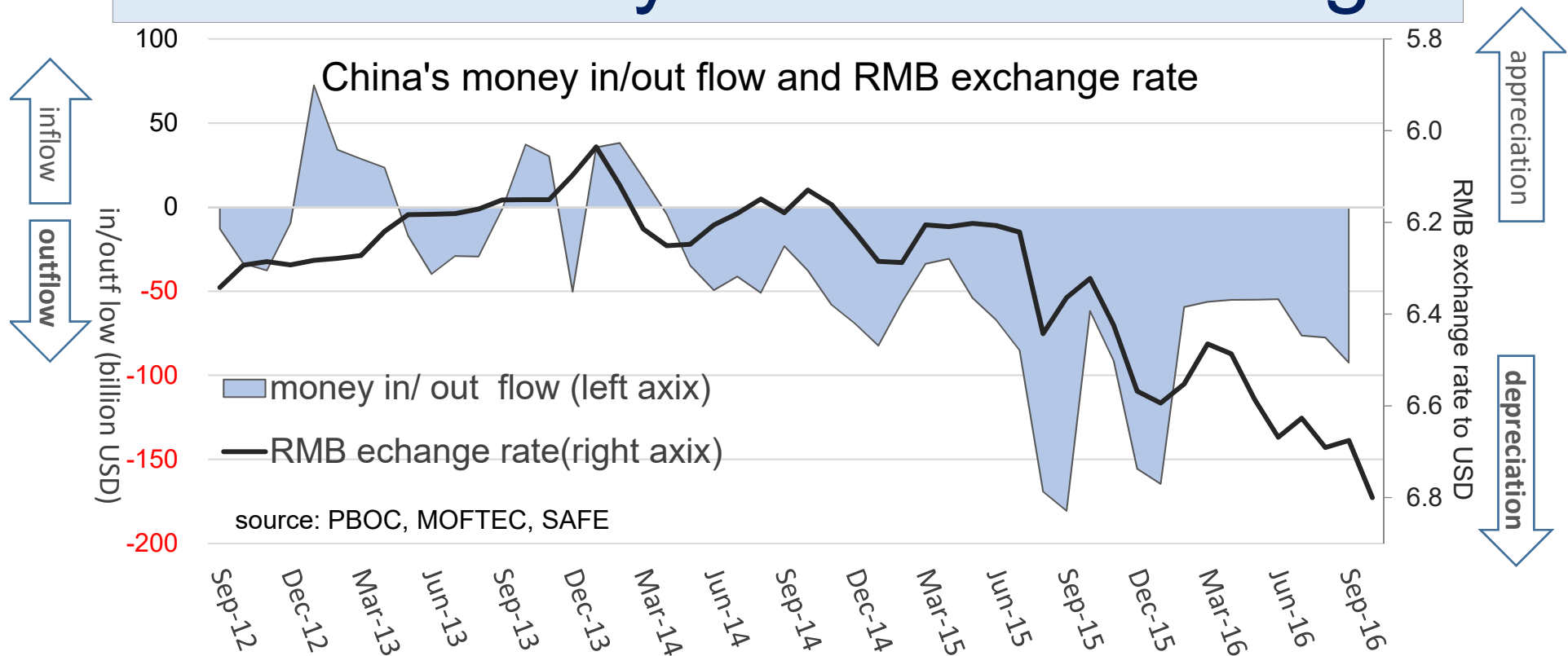


Assume that previous birth rate (TFP) as 1.4 and;

[assumption 1] birthrate increases to 1.6 and births in 2017 increases **2 million**, due to the rise in dependent population, working population ratio will decline 1.5% as opposed to the previous case

[assumption 2] birthrate increases to 1.85 and births in 2017 increases **5 million**, due to the rise in dependent population, working population ratio will decline 3.5% as opposed to the previous case

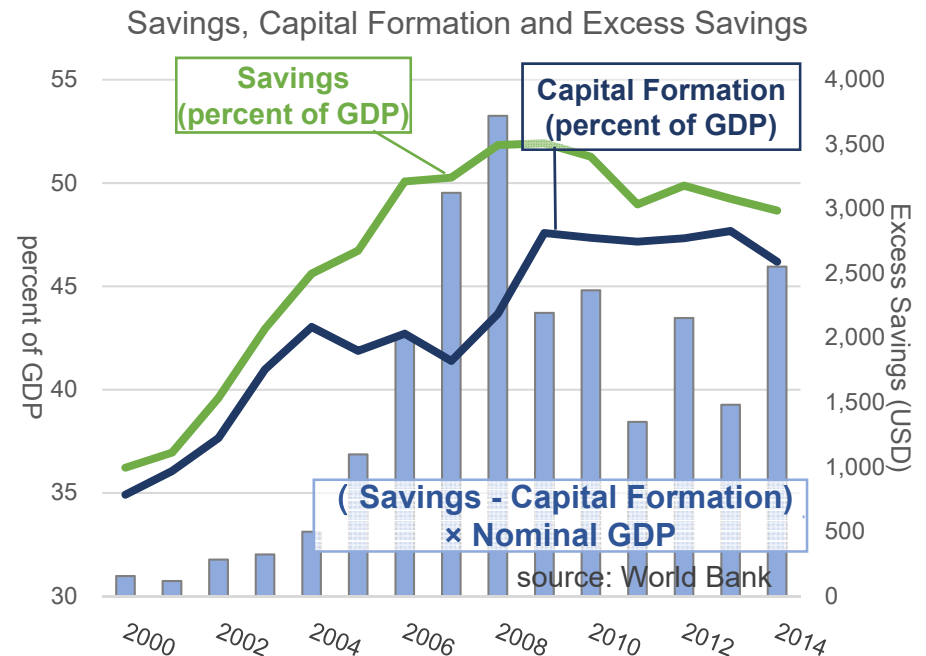
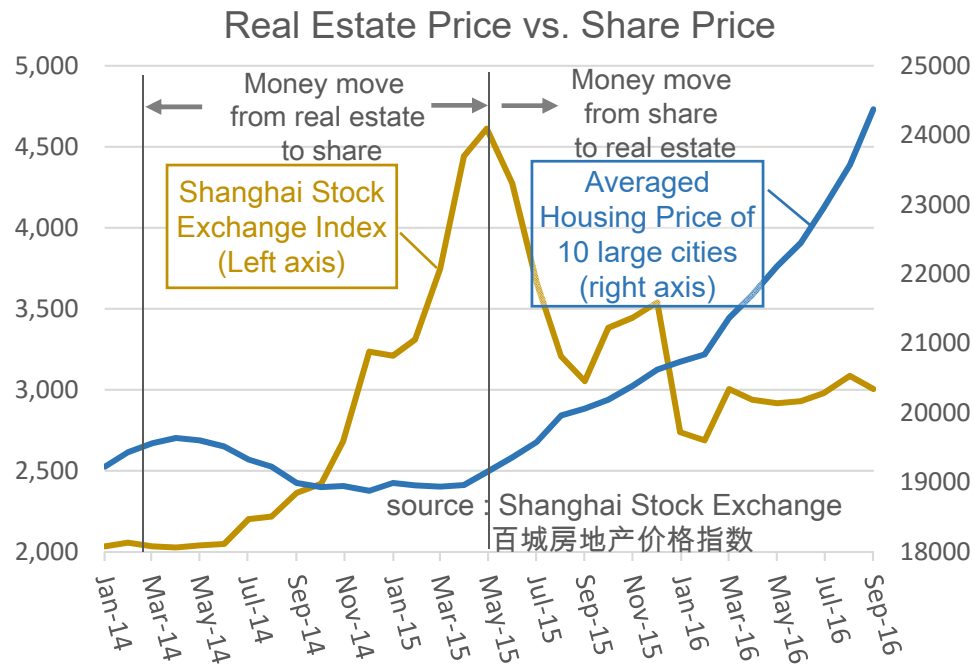
RMB : Further Liberalization unlikely for the time being



- According to a BIS study, Capital outflow were brought about mostly by;
 - 1) early redemption of USD short term debt by Chinese companies
 - 2) cancellation of RMB deposit by non-residents (mostly overseas Chinese?)
- **Chinese have lost confidence about the their economy**, and want to bring money to outside, thus **further capital account liberalization might risk triggering capital outflow**

What is the problem?

“excess debt” or “excess savings”?



- Brad Satser’s view (USCFR) : “Excess Savings” is the root of “Excess Debt”
- “Excess Debt” and “Excess Savings” should be reduced simultaneously, one-sidedly reducing “Excess Debt” would make Savings more excessive
- **Sudden and large export of excess savings from China would jeopardize world economy** (through sudden fall of RMB and/or China’s foreign reserve)

One Belt One Road: becomes much more “prudent” than two years ago

- The projects that the **Silk Road Fund** has invested so far
 - ① Pakistan BOT hydro power plant (co-investment with IFC)
 - ② Acquisition of Italian  (co-investment with ChemChina)
 - ③ Joint establishment of industry fund with Kazakhstan Govt. (investment for cooperation on “production capacity”)
 - ④ Acquisition of 10% share of Russian LNG company (NOVATEK’s Yamal project)
- Current position seems “**cautiously choose bankable projects**” much “**prudent**” than two years ago when we first heard => **Why?**
- **strong antipathy and resentment in the public sentiment** has been growing against Xi’s massive foreign aid commitments
- Most of **the stuff came from the central bank**, who are sensitive about non performing projects

Asian Infrastructure Investment Bank (AIIB): A good partner of the WB/ ADB?

- With European participation, AIIB was substantially upgraded. With Canadian participation, member countries will reach 90
- **Collaboration with World Bank and Asian Development Bank**
 - The two banks seem actively offer AIIB chances of collaboration
 - For the time being, **more than 2/3 of AIIB's lending will be joint lending with WB or ADB**, through which AIIB can cumulate experience and track records
 - The two banks can also be benefited from the collaborations with AIIB by **mitigating their undercapitalization** (kind of “resuming leverage”), This might be a way of **peaceful co-existence**
- Can AIIB really become an “international development Bank”?
It is still unknown, but so long as China go along with internationally recognized order and customary, there is a good chance for that

TPP or RCEP or any other?

Asian or Pacific FTA with/without the new US administration

- No eyesight at all after November 8th
- "There's no doubt that there will be **a pivot to the RCEP** if the **TPP** doesn't go forward" (**Prime minister Abe** at the diet)
- **Japan's other hedge than RCEP**
 - Japan EU EPA
 - Japan US bilateral FTA
- My personal (and tentative) view
 - Add "waiting for someone" clause and validate TPP with the rest of 11members,
 - while accelerating negotiation with EU, China, Korea

Politics: my reading of Xi Jinping Administration

1. Xi administration can be compared with a **broad coalition among CCP's various factions**, whose only common agenda is "**Save the Party in a serious pinch**",
2. Thanks to the coalition, Xi could expeditiously establish a **strong leadership**, on the other hand, he always needs to **keep balance** between various demands among the Party
 - ✓ take reformer's side on the **third Plenum reform**
 - ✓ compromise with the vested interests on **SOE reform** or stimulus
 - ✓ compromise with hardliners (public sentiment?) on **territorial issues**
3. As the **2017 personnel reshuffle** coming close, **Xi Jinping needs to compromise more** with vested interests.
If we witness the resumption of reform under Xi administration, it can only occur after 2017 (another Third Plenum in 2018?)