China – Climbing the ‘Great Wall of Worry’

Navigating the new normal

INTRODUCTION

After our most recent field trip to China, we have been left more pessimistic on growth, while still believing that the authorities have the resources to avoid a hard-landing. However, policymakers need to maintain discipline and ensure structural reforms materialise.

China GDP growth

![Diagram of China GDP growth]

Source: Datastream, Bloomberg, Cazenove Capital.

Despite an evident lack of intention to introduce a more overt and significant stimulus, targeted easing measures are likely to tame the amplitude of the cycle as the economy decelerates. While fine-tuning measures are likely to prop up activity and boost sentiment to some extent, these will be progressively less effective. Equally, structural reform is needed to increase productivity and market efficiency, and to facilitate the transition from an investment to consumption-based growth model. Without it, the underlying problems will endure.

Politics are critical to the direction of reform and economic growth, with President Xi Jinping seeking to consolidate power in his early years of leadership. The market-oriented reforms necessary for China’s economic transition may conflict with Xi’s agenda. With key-man risk and a greater possibility of policy error, we have turned more cautious on long-term growth.

The biggest area of concern remains the property sector and the extent to which it could destabilise other parts of the economy. Most commentators believe the authorities have the ability to contain the problem in the short-term, but some believe there will be a major – painful – correction at some point. Real estate, shadow banking and local government finances are intertwined areas of increasing vulnerability.

The domestic experts we met in China are all looking for a slowdown, towards a lower “new normal” growth. That said, the Chinese authorities have the tools to deal with the country’s near-term challenges, but the risks are greater in the long term.

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POLITICS AND REFORM

The Chinese authorities are fully aware of the need for structural reform as a pre-requisite for more balanced and sustainable economic growth, and a comprehensive reform agenda was announced at the 3rd Plenum in 2013. However, in reality it is difficult to deliver all reform measures at the same pace during a period of economic transition and lower growth.

Since Xi Jinping took power, he has become the head of the party, state and military. He also claimed the chairs of the National Security Commission and the Central Leading Group for Comprehensively Deepening Reforms which were established at the 3rd Plenum, and also the newly-created Internet Security Group. Moreover, the Politburo Standing Committee, the top decision-making body in China, has been downsized from nine to seven members, creating greater concentration of power.

The theme of the 4th Plenum was “rule of law” (or perhaps, “ruling through Chinese law”), which was aimed at tackling corruption campaign and centralising power. Over the past year, the anti-corruption campaign has been in full-force, with high-profile arrests alongside numerous official investigations. While the campaign is part of Xi’s political agenda to consolidate power, the general public is hoping that it represents the beginning of the end to deep-rooted institutional corruption.

Improving transparency

A key initiative from the 4th Plenum is to formalise government functions through legislation and to improve the transparency of government administration, essentially a way to unwind power previously devolved to local governments on economic, social and political matters.

In order for Xi to further strengthen party leadership, reform is likely to focus on those areas with maximum popular impact. After all, there are 1.3bn Chinese and social stability is vital. As a result, market reforms in the areas of social security, healthcare and education for the working class will be top of the agenda.

The anti-corruption campaign will intensify, as it can improve the efficiency of the Chinese Communist Party (CCP)’s rule as well as win popular support. This will put further downward pressure on demand for luxury goods, high-end catering and Macau’s gaming industry.

Key points

Since Xi Jinping took power, there has been increasing centralisation of power.

Reform is likely to focus on those areas with maximum popular impact - social security, healthcare and education.

The anti-corruption campaign is likely to intensify.

Financial market reform will be sluggish given domestic and international limitations.
Financial market reform on hold

It is difficult to see significant progress on financial reform given the current economic concerns. The approach of the People’s Republic Bank of China (PBoC) remains interventionist, tending to favour scattergun injections of liquidity. Most banks still take their lead from the authorities. Given the prospect of policy tightening in the US and the need to safeguard the Chinese financial system, any further opening of the capital account is likely to be deferred.

There are pros and cons to the centralisation of power in China. On the positive side, a strong central power base and greater domestic focus may make decision-making more efficient. In contrast to the bureaucratic decision-making process at the European Central Bank, China has the ability to react quickly and effectively in the event of a crisis. On the flipside, the concentration of power in one individual risks vanity policymaking and potential errors.

Generations of Chinese leadership

<table>
<thead>
<tr>
<th>Generations</th>
<th>Period</th>
<th>Core leader</th>
<th>Background of leaders</th>
<th>Ideology</th>
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<tbody>
<tr>
<td>Centralisation of power</td>
<td>1\textsuperscript{st}</td>
<td>1949-1976</td>
<td>Mao Zedong</td>
<td>Political and military</td>
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<tr>
<td>Decentralisation of power</td>
<td>2\textsuperscript{nd}</td>
<td>1976-1992</td>
<td>Deng Xiaoping</td>
<td>Political and military</td>
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<tr>
<td></td>
<td>3\textsuperscript{rd}</td>
<td>1992-2003</td>
<td>Jiang Zemin</td>
<td>Most were engineers</td>
</tr>
<tr>
<td></td>
<td>4\textsuperscript{th}</td>
<td>2003-2012</td>
<td>Hu Jintao</td>
<td>Most were engineers</td>
</tr>
<tr>
<td>Centralisation of power</td>
<td>5\textsuperscript{th}</td>
<td>2012-2022*</td>
<td>Xi Jinping</td>
<td>Economics, law, engineering</td>
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</tbody>
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*Provided China’s power transitions and government institutions remain stable, the 6\textsuperscript{th} generation of leaders will come to power at the 20\textsuperscript{th} Party Congress in 2022.

Source: Cazenove Capital.
PROPERTY MARKET

A slowdown in the property market is universally identified as the biggest risk to Chinese economic stability and the most likely cause of a potential hard-landing. This is due to the risk of contagion throughout the economic system. Oversupply is the major underlying issue. The authorities recognise that an adjustment is inevitable and their role is to ensure a slow and controlled process. They have already lowered purchasing restrictions and the deposit ratio, which is likely, temporarily, to improve demand.

China real estate investment as a % of GDP

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<tbody>
<tr>
<td>% GDP</td>
<td>5.9</td>
<td>6.4</td>
<td>7.1</td>
<td>7.9</td>
<td>8.4</td>
<td>8.9</td>
<td>9.4</td>
<td>9.8</td>
<td>10.3</td>
<td>11.1</td>
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Source: Datastream, Cazenove Capital.

China 70-city home prices

<table>
<thead>
<tr>
<th>Month</th>
<th>Jan 11</th>
<th>Jul 11</th>
<th>Jan 12</th>
<th>Jul 12</th>
<th>Jan 13</th>
<th>Jul 13</th>
<th>Jan 14</th>
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<tr>
<td>YoY</td>
<td>-5.3</td>
<td>-4.7</td>
<td>-3.9</td>
<td>-3.4</td>
<td>-2.9</td>
<td>-2.4</td>
<td>-2.2</td>
<td>-2.1</td>
</tr>
<tr>
<td>MoM</td>
<td>0.3</td>
<td>0.5</td>
<td>0.4</td>
<td>0.3</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
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Source: Bloomberg, Cazenove Capital.

3rd and 4th tier cities – the starting point for a crisis

One concern is that developers still have sizeable inventories of land that they hope to release should there be any rebound in sentiment. This creates a potential moral hazard for the authorities if weakness in the property market necessitates increased policy support to help the sector. The situation in 3rd and 4th tier cities is particularly serious and may be the starting point for a crisis. While price cuts by developers may work in tier 1 cities, where supply remains relatively tight, it is unlikely to work in lower tier cities where prices have already stagnated. The risk is that while housing transaction data may improve for a quarter or two, thanks to the fine-tuning measures, it will deteriorate in two-to-three years’ time. And, unlike banking, the real estate sector is one over which the government cannot exert full command.

Key points

The property sector remains the biggest source of risk for the Chinese economy.

Oversupply is at the heart of the problem.

The demand dynamics are weakening, with inventories high, and speculative and first time buyer demand diminishing.

There may be contagion from 3rd and 4th tier cities, where the problem is most acute, into 1st tier cities.

Our view

Historically, the Chinese property market has had too many restrictions on purchases, so the recent relaxation of these restrictions will help improve transactions modestly. Chinese households have ample savings and property has always been a preferred investment.

However, inventories in 3rd and 4th tier cities are at multi-year highs and demand may not be enough to absorb both inventories and new supply. Speculative demand, particularly in 1st tier cities, is likely to taper given the deteriorating outlook for the sector. Also, the percentage of demand from first-time home buyers has been steadily declining, reflecting demographics and the slower pace of urbanisation. Lastly, the majority of future demand is likely to come from households looking to upgrade. Unfortunately this group of buyers is sensitive to underlying macro conditions and may postpone purchases as prices fall.
Over supply in commercial property

Commercial property is also subject to the problem of oversupply, with vacant office space concentrated in tier 2 cities. The prices of commercial properties will need to fall, as there is structurally less demand for satellite offices outside tier 1 cities, as a result of the massive improvement in traffic infrastructure.

The major hit will be taken by property developers, which have high leverage, and there is likely to be consolidation in the industry. In contrast, the level of borrowing on residential property is lower and there are fewer concerns over negative equity. On the positive side, social housing, as well as hospitals and school construction, is likely to compensate for some of the shortfall in the private sector real estate fixed investment.
SHADOW BANKING

Shadow banking refers to all credit intermediation outside the regular banking system. It comprises trust loans, bankers acceptances, entrusted loans (corporate-to-corporate lending administered by a bank), and interbank corporate bonds. As such, it includes direct credit extension by banks off-balance sheet and by non-bank financial institutions, especially trust companies and securities firms. The proliferation of shadowing banking is due to inefficient capital allocation, with state-owned enterprises getting preferential rates and an excessive share of credit extension from the mainstream banking system. Chinese banks generally engage in risk avoidance rather than risk management. As a result, many smaller businesses and riskier projects cannot obtain financing from the official channel.

After bank lending conditions were tightened, following the 2009-10 credit boom, shadow banking expanded at twice the pace of official lending, reaching over 50% of GDP by early 2014. The funding side of shadow banking often consists of Wealth Management Products (WMPs), which offer much higher rates than bank deposits. WMPs are often marketed by commercial banks, and households believe that these are implicitly guaranteed, resulting in a moral hazard problem.

Breakdown of shadow lenders in China (to end-2013)

![Chart showing the breakdown of shadow lenders in China](chart)

Source: CBRC, China Trust Association, China Leasing Association, UBS estimates.

Underlying risks are manageable

While the rapid pickup in trust loans is a concern, it is worth noting that underlying risks are manageable. Although there is rising risk in the property market, only around 10% of trust companies’ assets are exposed to the sector. Moreover, distressed trusts are likely to follow a managed default route instead of an opaque and hasty resolution as some investors fear. This view is supported by the circumstances surrounding a China Credit Trust Company product named Credit Equals Gold No. II. In the event, the trust publicly announced the delay of payments on its RMB 1.3 billion product backed by coal mining assets, while it undertook legal action and carried out asset sales. Previously, such situations would have been handled with less transparency and in a less organised manner.

One issue is that credit structures often involve an asset-liability mismatch as WMPs are essentially short-term in nature, while underlying borrowers are often funding long-term projects with long-term cash flows. Hence, restructuring of loans could alleviate near-term problems. A shadow banking expert at UBS suggests that trust companies conduct comprehensive due diligence, focusing in particular on the quality of collateral. They also pre-identify asset management companies (AMCs) as backup buyers in the event of default.

Key points

- Shadow banking has been seen as a key risk to the economy, particularly due to the potential requirement to bailout Wealth Management Products (WMPs).
- The government has the capacity to bail out any default on WMPs.
- The authorities are aware of the risks inherent in the shadow banking sector and more stringent regulation is emerging.
- Slower economic growth is also likely to act as a brake on the sector’s expansion.

Our view

There is a strong view in China that any defaults on WMPs will be bailed out by the banks or by the government. Indeed, despite being an unofficial channel for credit, China’s shadow banking activities are often closely tied to commercial banks. For example, trusts rely on banks for funding, banks are also allowed to hold controlling shares in trust companies, and entrusted loans also are administered by banks. As a result, the official and unofficial systems are intertwined.

Given strong balance sheet positions, liquidity buffer and official reserve, banks are in a position to bail out any default without exerting significant strain on the system. However, the belief that defaults will be bailed out creates a problem of moral hazard and would be counter-productive in the longer term. More stringent regulation would address the issue at source.
Breakdown of shadow lenders’ AUM in China (to end-2013)

Source: China Trust Association, Cazenove Capital.

Tougher regulation

The regulator has toughened its position on shadow banking: The China Banking Regulatory Commission (CBRC) has taken an aggressive tone (Circular Nos. 127 and 140) in suggesting shadow banking activity needs to be curbed. The authorities have strengthened the regulation of shadow banks, including tightening the regulation of non-standard credit products, forbidding trusts from funding cash pay-outs on maturing products with the proceeds from new WMP sales, and restricting ways to fund off-balance sheet credit through the interbank market.

These more stringent regulations should dampen the growth of shadow banking, and it is noteworthy that June 2014 saw the first month-on-month decline in trust assets under management. Given slower economic growth and a greater awareness of the risks inherent in the sector, both the demand and supply sides are likely to exercise more prudence. Despite the implicit guarantee embedded in these products, trust companies are likely to be more cautious.

More competitive environment

Interest rate liberalisation, were it to occur, would lead to a more competitive deposit market and would tend to restrict the growth in WMPs. While there is a risk that trust companies would continue to find alternative ways to conduct regulatory arbitrage, the scale of these activities would likely be more contained and visible to the CBRC.

Shadow banking will continue to be an area of vulnerability and there may be negative news from time to time. Potential re-intermediation of trust assets back onto bank balance sheets will likely cause capital strain. The risk is that despite having the tools to contain a crisis, the authorities may lack the experience to react with the most appropriate measures. Accordingly, vigilance is necessary.

Amid all the uncertainties, it is possible to say with some certainty that total social financing will continue to slow as a result of the crackdown on shadow banking activity. While the authorities would like to see more credit provided through official channels, overall credit demand is likely to slow as highly leveraged sectors such as real estate and mining contract. This will slow wider economic growth.
LOCAL GOVERNMENT FINANCES

Local governments have historically played a major role in supporting economic activity, mostly through investment spending. The boom in investment spending was usually financed off-budget, either through local government financing vehicles (LGFVs) or land sales. According to the International Monetary Fund (IMF) and on provincial audit results, outstanding provincial debt in 2013 was equivalent on average to around 23% of provincial GDP. Adding government-guaranteed and contingent liabilities would push the average to about 33% of provincial GDP, and over 60% of GDP in some provinces. This may be considered high, given the small revenue base. The problem is that land sales and tax on real estate related activity account for around 60% of local government revenue; therefore, the sustainability of LGFVs is related to the real estate sector.

Central vs local government debt as a % of GDP

![Graph showing the comparison of central and local government debt as a percentage of GDP]

Source: CEIC, NBS and BofAML.

Cross-country comparison of government debt-to-GDP ratios (end-2013)

![Graph showing cross-country comparison of government debt-to-GDP ratios]

Source: CEIC, ADB, IMF, BIS, BofAML.

Destabilising credit expansion

Decentralised government spending has resulted in rapid economic growth, but also unsustainable credit expansion. This is potentially destabilising, given the link between local real estate and the financial system. The 4th Plenum focused on the “rule of law”, which consolidates the Communist Party’s power. From here, decision making and power will become more centralised, inhibiting local government activities and hence LGFVs. Local government financing is likely to be more market-oriented and standardised in future. This is likely to slow economic growth.

While the current state of LGFVs poses the risk of potential defaults, there are mitigating factors provided there is a shift in the financial model of local governments. First of all, there are often maturity mismatches of asset and liabilities, as infrastructure projects undertaken by local governments are long-term in nature while loans are medium-term. Hence, loan restructuring is a viable way to mitigate or delay the problem.

Key points

With the centralisation of government, local governments will play a smaller role in economic development in future.

The link between local government finances and the real estate sector poses some systemic problems.

The problems could be mitigated by loan restructuring, examining new financing channels or the fire sale of local assets.

Poor visibility on government finances remains a significant issue.

Our view

The LGFV model looks unsustainable and will be curbed in the future, given the economic and policy backdrop. On the economic side, the slowdown in the real estate market is likely to dampen fiscal revenue and lower collateral values, resulting in fewer projects financed via LGFVs. On the policy side, the anti-corruption campaign and changes in provincial performance metrics mean there is less incentive to carry out large-scale investment.
New financing channels

Secondly, new channels of finance will be opened: The State Council has recently laid out a new framework for local government finances. The new framework will make local governments as the entities for raising new debts via bond offering, with the limit approved by both the State Council in Beijing and by provincial congress. While Bond issuance in the domestic market will be an option, to start with it will likely be limited to high quality assets with predictable revenue streams.

Also, local governments should now be more focused on returns on investments than on the magnitude of the projects. Lastly, in the event of financial difficulty, there are good-quality state-owned enterprises, including infrastructure or resources that can be sold to private investors. It is widely understood that the central government will bail out local governments if they are in financial difficulties.

The major risk is associated with the poor visibility of local government finances: audits are done only annually by the National Audit Office. It is also worth highlighting that in the event of extreme financial stress, local government assets will need to be sold at a steep discount and there may well be difficulty in finding buyers.
STRUCTURAL REBALANCING

It is widely acknowledged that China needs to rebalance away from investment-led to consumption-led growth. Prolonged credit-driven investment is unsustainable due to mounting inefficiencies and leverage. The ideal transition involves a rebalancing fuelled by rising income and social reform, which would combine to support sustainable consumption.

Contributions to China GDP growth

Key points

Structural rebalancing of the economy from manufacturing dependency towards higher-value added industries and services is a necessity.

There has been double-digit wage growth and a significant rise in living standards, but this may not be sustainable.

Slowing property prices and the anti-corruption campaign may conspire to dent consumer confidence in the short-term.

Over the longer-term, the transition to higher-value added industries is likely to promote wage growth and create a virtuous circle for consumption.

Our view

There is no doubt that Chinese workers have enjoyed significant real wage growth and improved living standards. However there remain questions over whether the increase in domestic consumption will be sufficient to offset the slowdown in investment.

In the near-term, the anti-corruption campaign not only has a negative impact on the consumption high-end products, but also on catering and festive products. The authorities’ tough line will be felt in the short-term, during Chinese New Year for example, but also longer-term.
On the positive side, if China transitions successfully from an economy based on lower-end manufacturing to one driven by higher-value-added industries and labour-intensive services, wage growth – and therefore consumption – should improve. The transition will take time, however, and is not guaranteed. In the near term therefore, there is limited scope for stronger growth in consumption.
INVESTMENT IMPLICATIONS

Slower trend growth, a vulnerable financial system and the risk of slower market reform, mean investment opportunities in China may lag those available within Western developed markets. Reform may hurt key sectors and even if market-friendly reforms are implemented, it will take time for the positive impact to be felt. Although valuations are attractive from a long-term historical perspective, greater clarity is required with regard to the items on our “wall of worry” before expressing a more constructive view on investing in China.

Potential opportunities

However, there are potential opportunities for investors who are interested in China, and there are areas of the economy and market that we might expect to outperform. Despite slower GDP growth, there will be a gradual redistribution of growth among state-owned enterprises and private companies, as well as across sectors. Healthcare, insurance, information technology, tourism, education and higher-end manufacturing are likely to benefit from faster reform and the shift in the economic growth model.

Strong technology and industrial expertise have allowed China’s biggest railway corporations to compete aggressively on international rail projects. China has also begun to focus on the manufacture of commercial aircraft, which it will export. On the other hand, sectors like real estate, construction, financials and mining are likely to continue to underperform.

Opening of A-Shares market

Another interesting opportunity is the Hong Kong-Shanghai Stock Connect. The program will allow international investors to gain exposure to the China A-Share market, providing access to previously unavailable domestically-oriented companies. Again, it will be a stock-pickers’ market and a cautious approach will be required.

Given the high savings ratio in China, there remains buoyant demand for investment products. In view of the fall in property prices and scaling down of WMPs, it is plausible that some capital will flow from those areas to the equity markets. However, it is worth noting that the Chinese A-Share market is notoriously speculative, largely due to these retail cashflows. International investors must also contend with the problem of an asymmetry of information.

Global impact

Financial links between China and the rest of the world remain relatively low because of capital account restrictions. However, China is important as a trading partner and can exert a deflationary impact on its competitors and a disinflationary influence on the West. Slowing growth and weaker commodity demand are likely to impact countries such as Taiwan, South Korea, Australia, Japan, Germany and commodity exporters.

Given the domestic slowdown in China, the authorities may look to net exports as a means to boost growth. While the past decade has seen a sustained appreciation in the renminbi (RMB), China could now resort to weakening the currency to offset weaker internal demand. With the West being net importers of Chinese goods, the resulting lower import prices will be more disinflationary than deflationary. The environment would be more difficult for countries that compete with China in export markets.
Inception of ideas by state-owned media

On the day of the third-quarter GDP release, CCTV (state-owned TV channel) insisted that slower growth is the new normal and that quality of growth is more important. (e.g. “we now have slower growth but, instead, more varieties of products in the supermarket”) The TV commentators and economists being interviewed repeated the same messages over and over again, which sounded like a state-directed plan to soften the impact of slower growth. It can only be done where the media is strictly controlled and it is part of the reason it is difficult to develop a balanced view on Chinese economic and social affairs.

Air pollution

The pollution in Beijing is now so serious that in the recent marathon, some runners wore masks. The reluctance of multinationals to relocate staff to China and the eagerness of wealthier Chinese to move abroad are understandable. The problem is difficult to resolve because of the interaction between geographical issues and years of urbanisation.

Prices

The price contrasts in the cities are astonishing. While public subway costs less than 20 pence for a single journey of any distance, prices in higher-end restaurants are comparable to those in London. Despite much lower average income in China, the price of Starbucks coffee in Beijing is the same as in London. There are also huge income disparities, consequent to the exploitation of workers during the years of economic boom.

Mobile apps are changing everyday life

It has become increasingly difficult to hail a taxi in Beijing. Why? – because taxi drivers are all incentivised to take passengers via mobile apps. Taxi drivers receive bonuses offered by mobile app companies which are competing aggressively for market share. Hence, everyone needs mobile apps to get taxis. The proliferation of mobile apps and the internet in Chinese daily life is astonishing and this will remain a fast area of growth. However, the internet remains heavily controlled (and censored) by the authorities.

Traffic congestion

Traffic congestion is a blight in the major cities, dampening economic activity. It takes people longer to get around, and means they are reluctant to go out for meals and entertainment. The government has already introduced restrictions on traffic, based on vehicle licence plate numbers as well as restrictions on second car purchases. However, such controls seem to have no impact. It is not going too far to say that congestion and also pollution make Beijing an unattractive city in which to live and invest.