

China: Skating on thin ice

China is reshaping the economy to keep steady growth, while to mitigate the high debt and asset bubble risks.

December 2017



Gníomhaireacht Bainistíochta an Chisteáin Náisiúnta
National Treasury Management Agency

Index

Section 1: Debt problem

Section 2: Asset bubbles

Section 3: Congress updates



Summary: China implemented various policies to mitigate risks

Risks	Sectors	Policies
Debt problem	Local Government	Government debt replacement scheme Financing infrastructure projects using PPP style
	Real estate	Transferring leverage to households
	SOEs	Supply side reform
Asset bubble	Housing market	Prohibiting capital outflow Rental housing, social housing, trading limitation Tight-balanced monetary policy
	Stock market	IPO flood, delisting mechanism, bringing in long-term capital
	Bond market	Deleveraging in the financial system

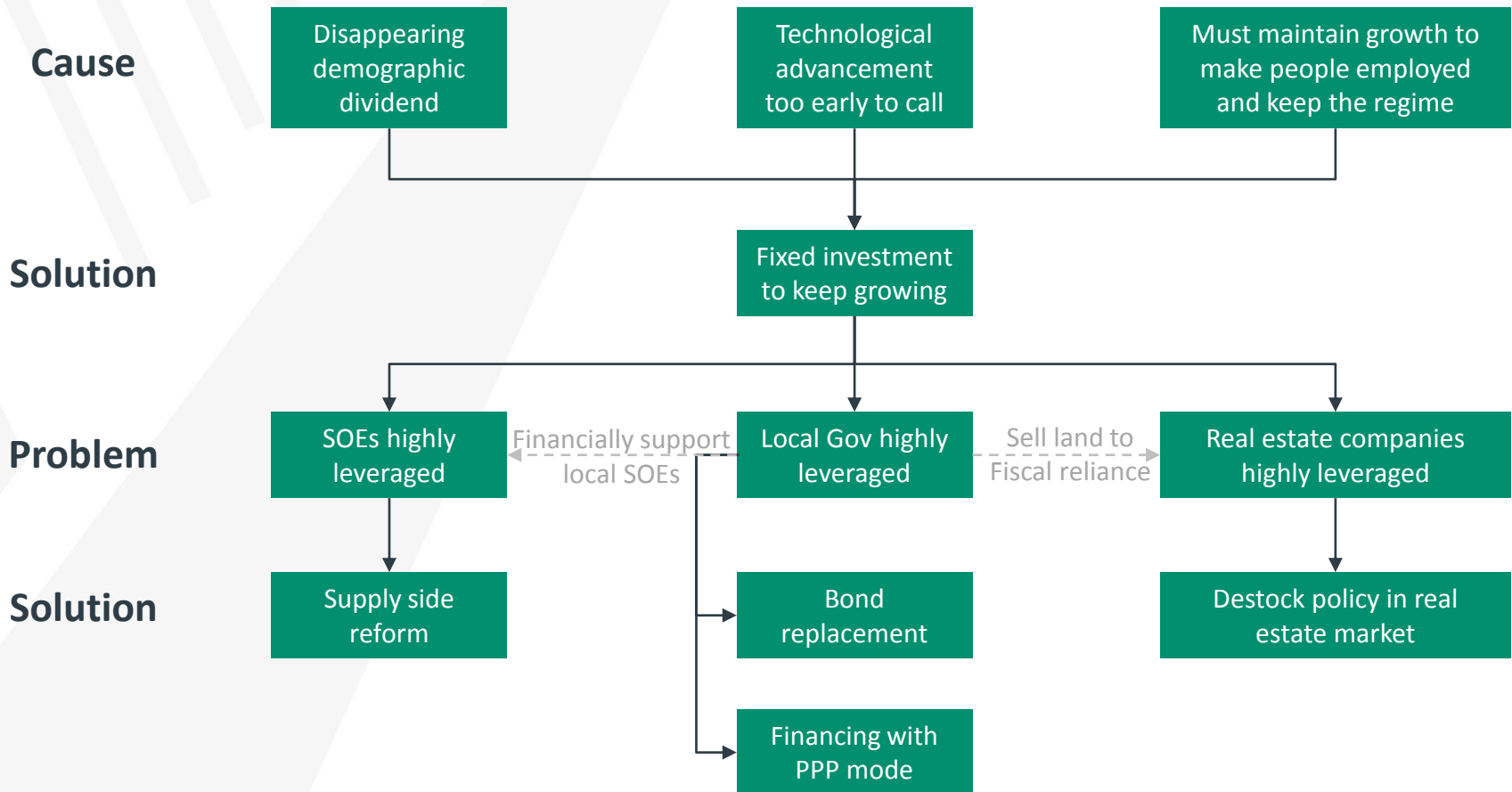


Section 1: Debt problem

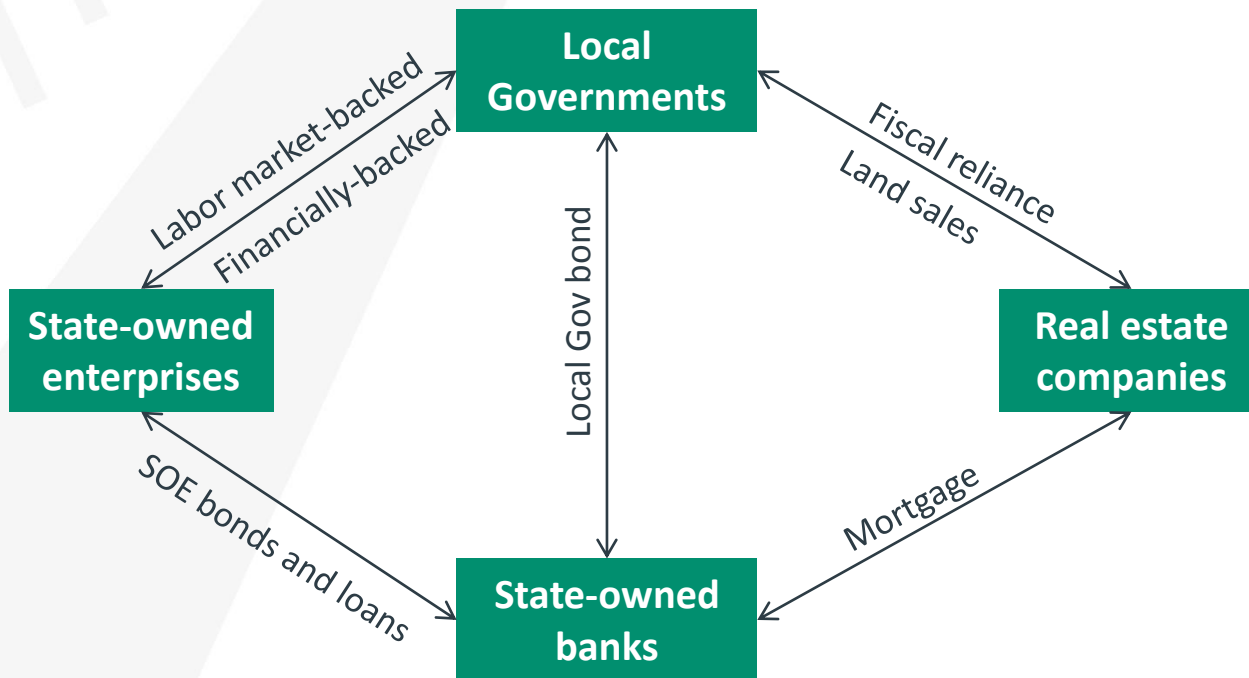


Gníomhaireacht Bainistíochta an Chisteáin Náisiúnta
National Treasury Management Agency

All about China's debt



State bodies form a closed debt cycle in China



Why China keeps over-investing

There are three main factors that drive economic growth: capital investment, labour inputs and technological advancement. Capital investment is the only choice for China to maintain its high growth when the cheap labour period has passed and technology R&D is still in its early stage.

Economic Growth



Labour

Disappearing demographic dividend; Urbanization drawing to a close

Technology

The main driver of long-run growth. China just increased investments in R&D and education in recent years, too early to drive the growth

Capital

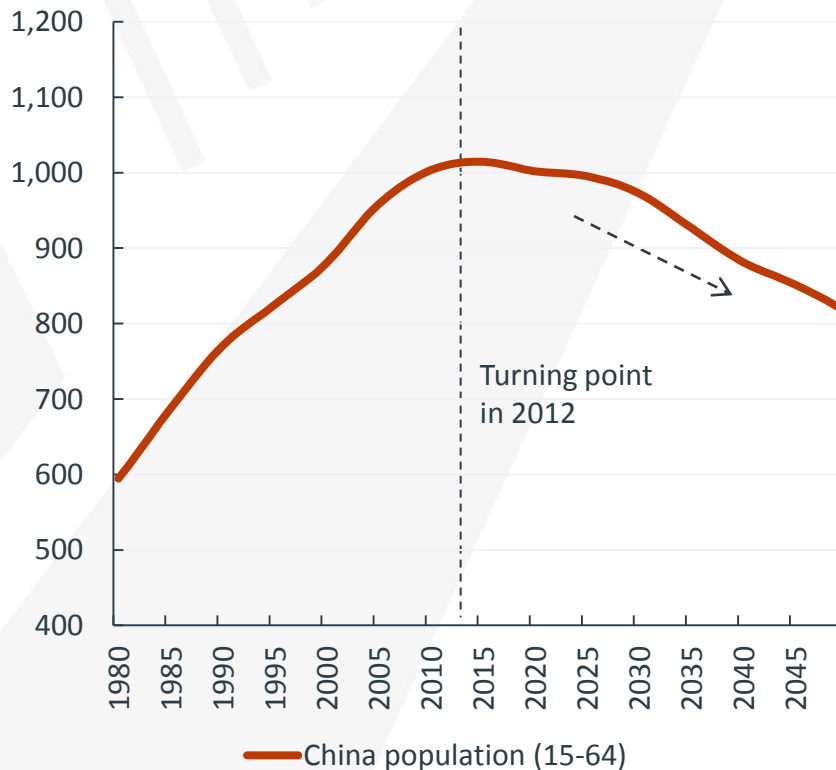
Large fixed investment could maintain the employment rate and economic growth at high level in short term



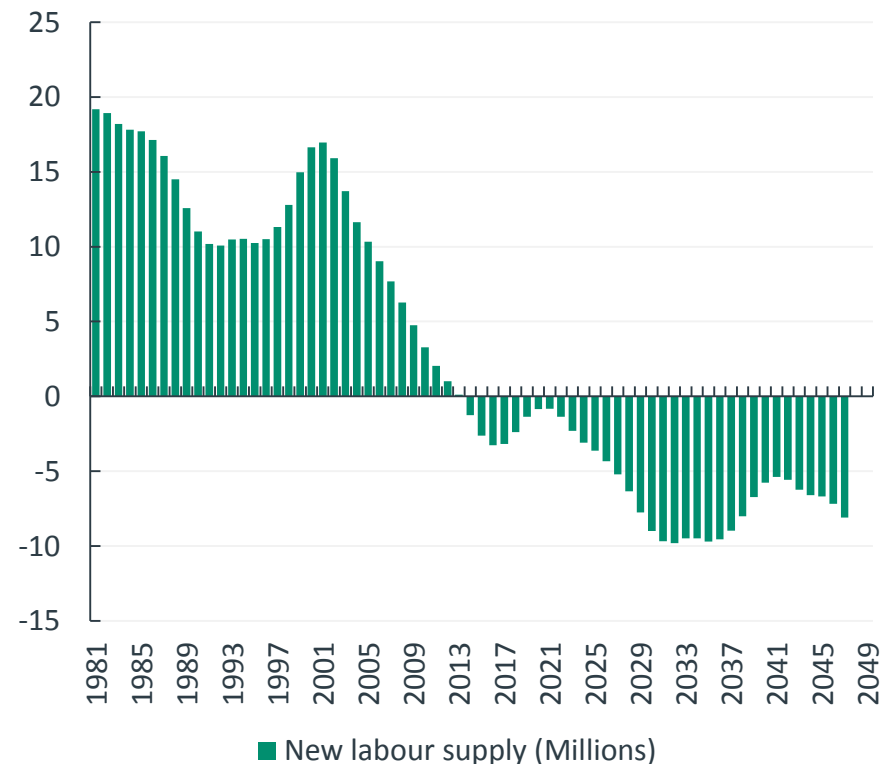
The disappearing demographic dividend makes fixed investment the only choice to maintain high growth

The disappearing demographic dividend pushes China to expand fixed investment to maintain high growth and low unemployment. High unemployment would threaten the Regime, which was seen in 1989.

China working population (15-64, Millions)

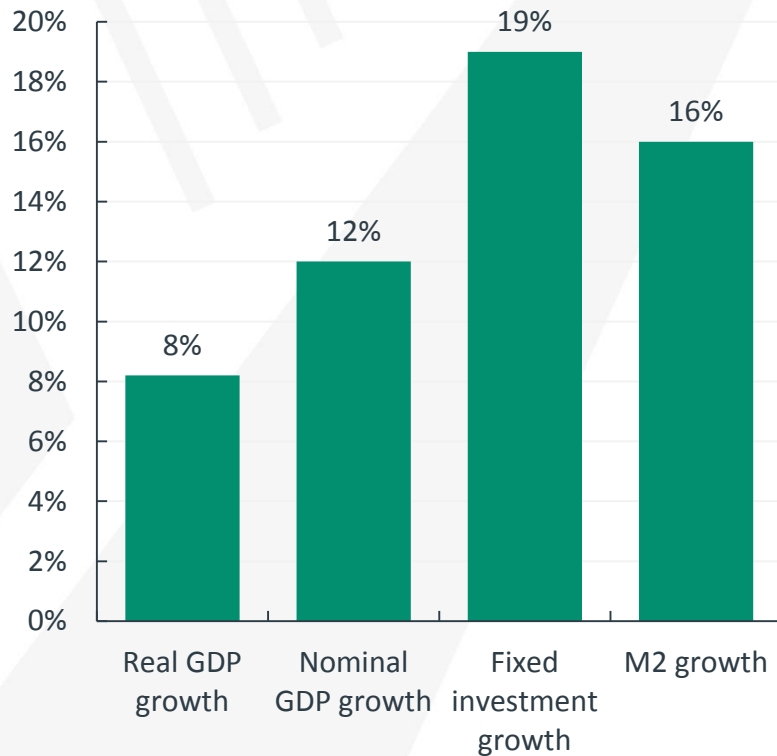


New labour supply growth turned negative

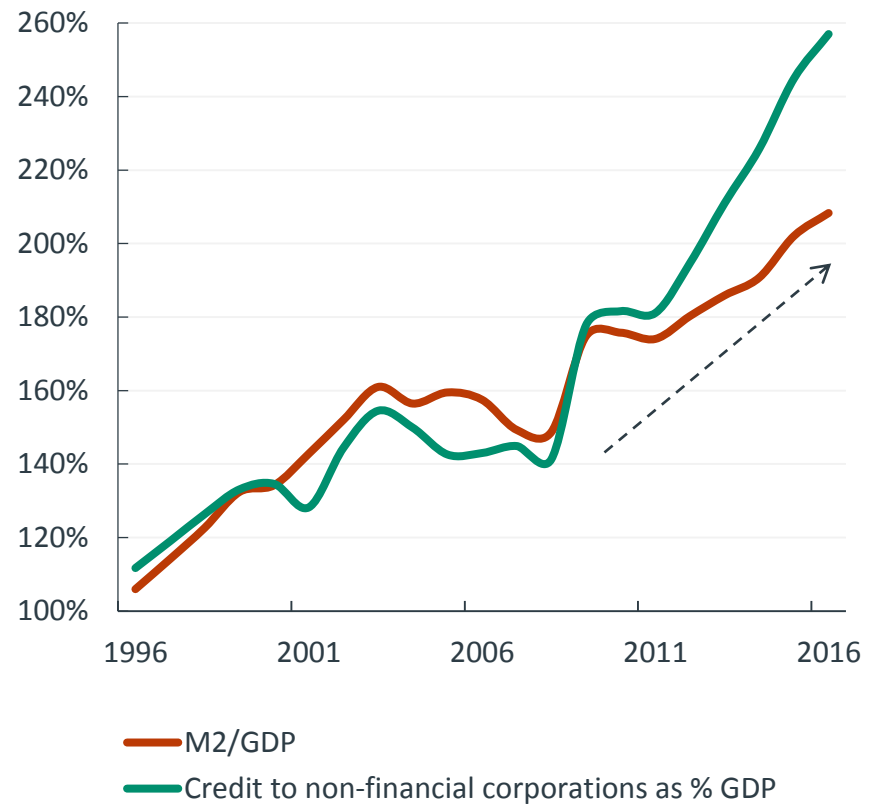


The consequence of 8% growth is high debt and over-investment

2009-2016 annualized growth



Loose monetary policy created high debt level



Local Governments, real estate companies and Zombie SOEs are sectors need deleveraging

Local Governments

- Bond replacement scheme
- Financing infrastructure projects with PPP mode

Real estate companies

- Real estate destocking policy to transfer leverage to households

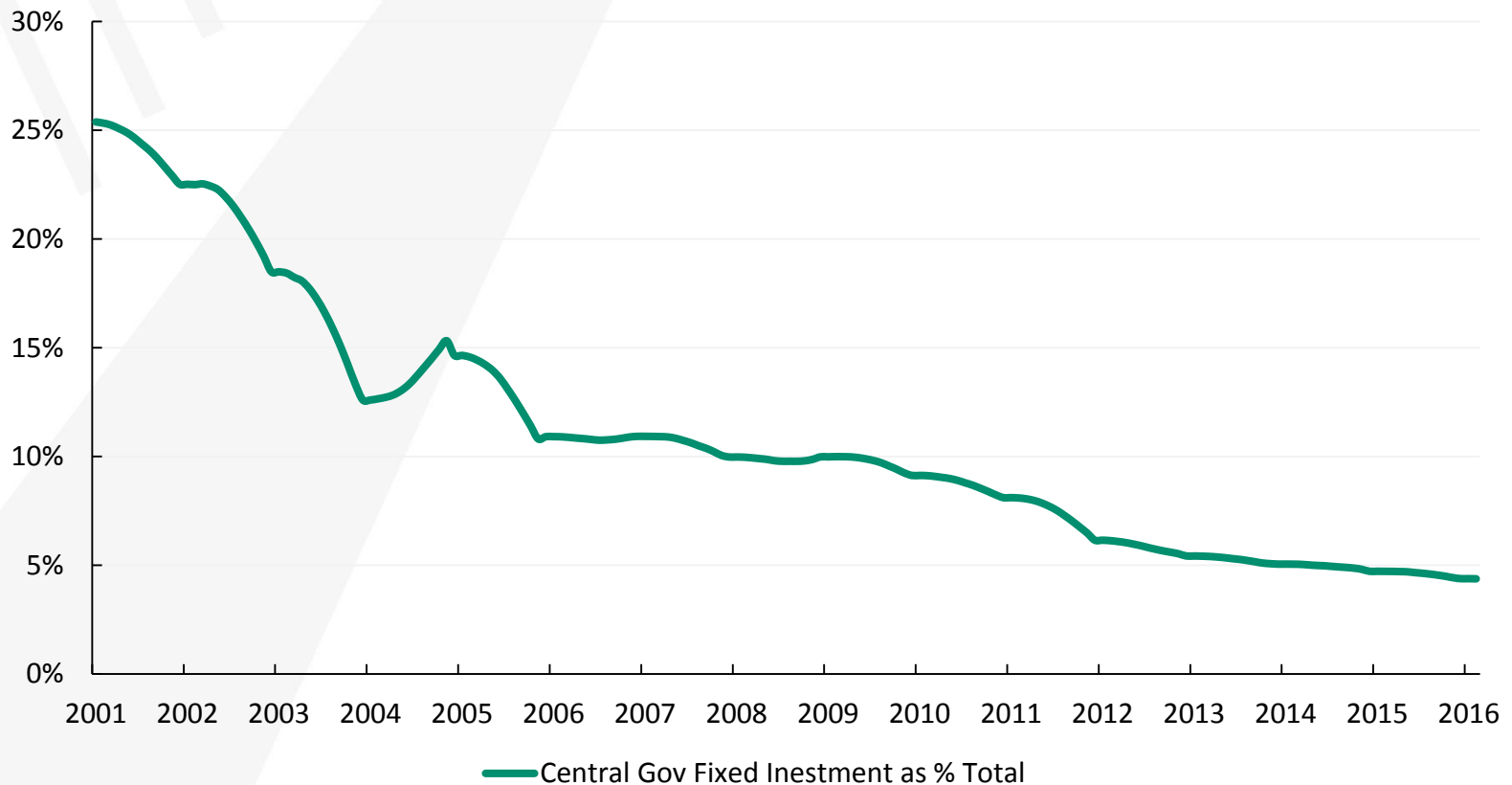
Zombie SOEs

- Supply side reform



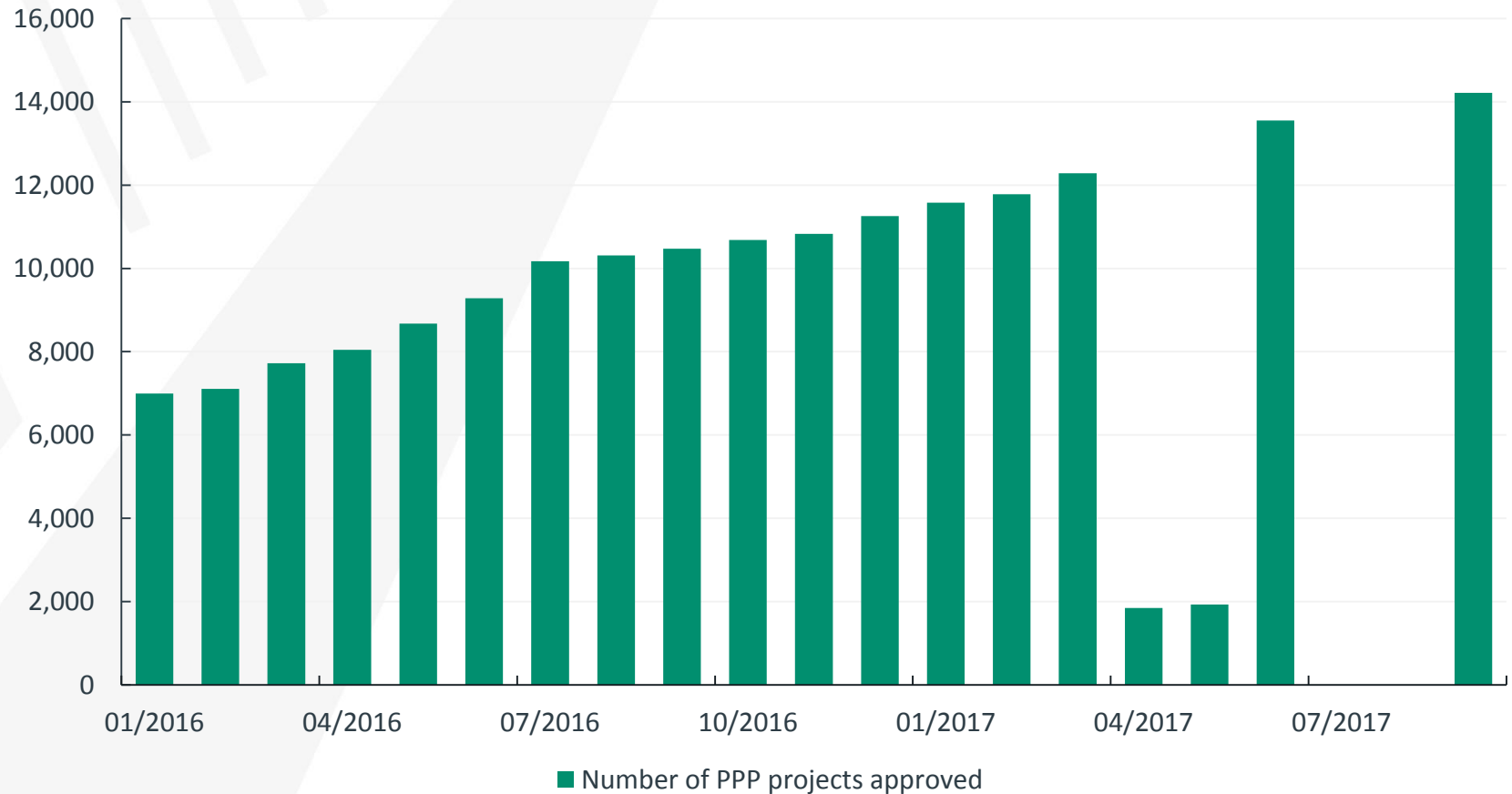
Majority of infrastructural fixed investments are done by local Governments

Central Government wants to control the house price and this will impact the local Governments' revenue. PPPs are the only way to maintain current fixed investments.



Local governments finance projects with PPPs mode to keep its fixed investment with relatively less fiscal burden

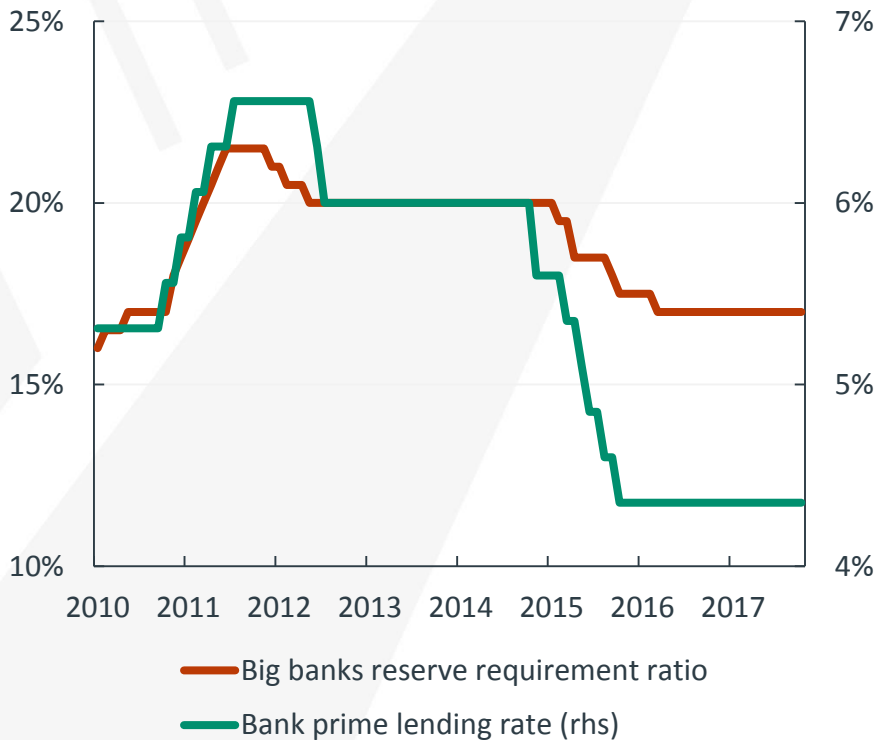
Total value of PPP projects approved by Sep 2017 is 17 trillions RMB



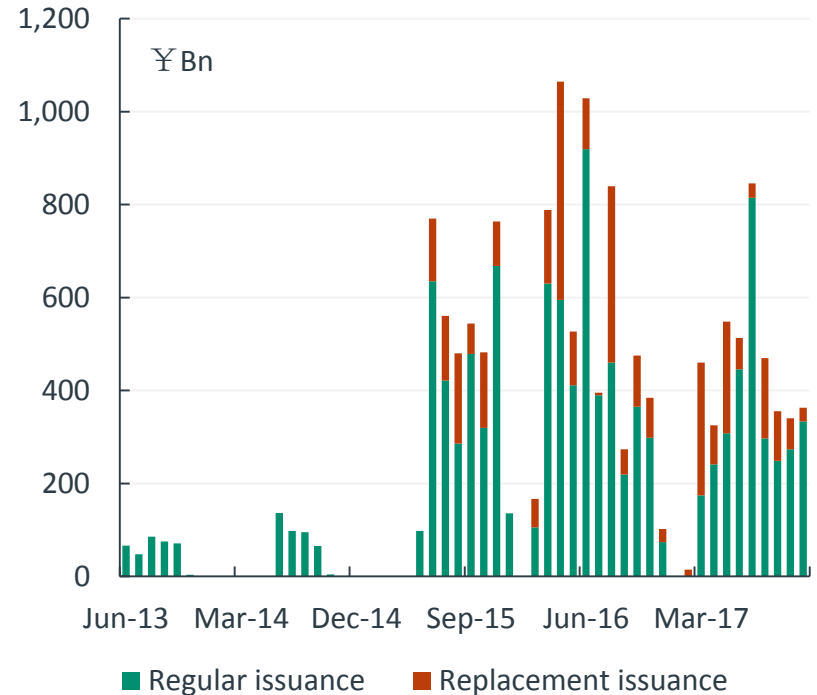
Central Gov started bond replacement scheme during low rate periods to help local Gov deleveraging

PBoC cut the rates in 2015 due to the stock market bubble burst. The Government started a scheme to replace the high interest rate bonds with lower cost debt.

Rate cut in 2015



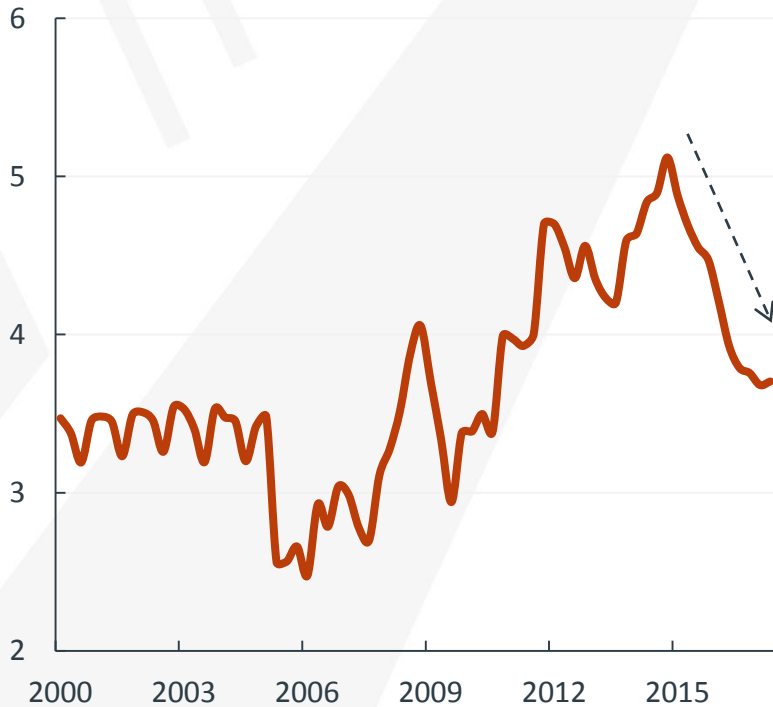
Gov bond replacement started in 2015



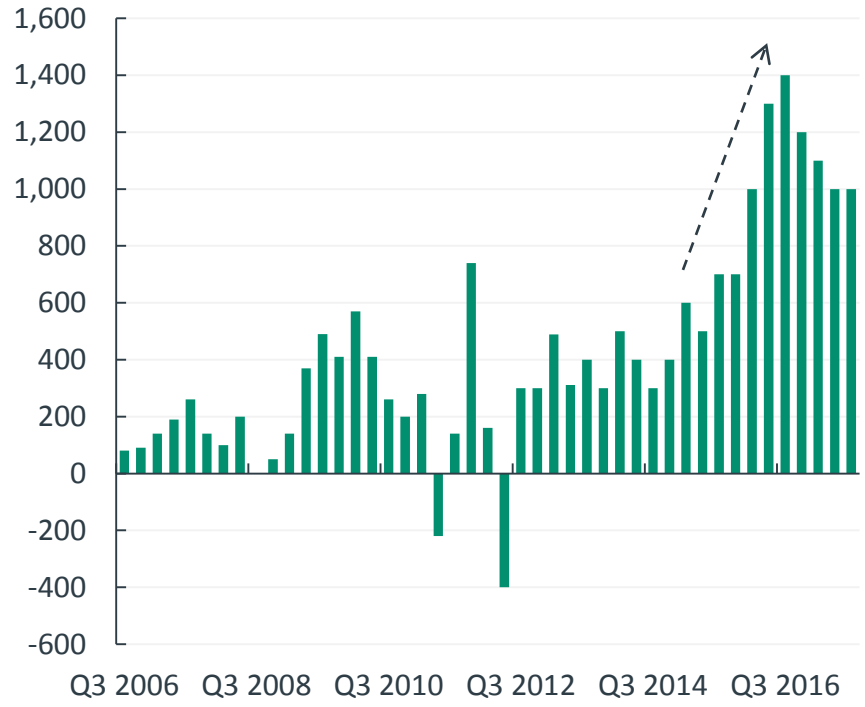
To help real estate companies deleveraging, the Gov proposed the destocking policy, transferring risks to the less leveraged households

Now the Fed has started to hike rates; the Party is concerned about over-supply in housing market and the cash flow of developers. A real estate market destocking policy was proposed. Chinese households' leverage is relatively low and they are encouraged to increase leverage.

Residential property sales turnover ratio



New household mortgage loans (RMB, bn)



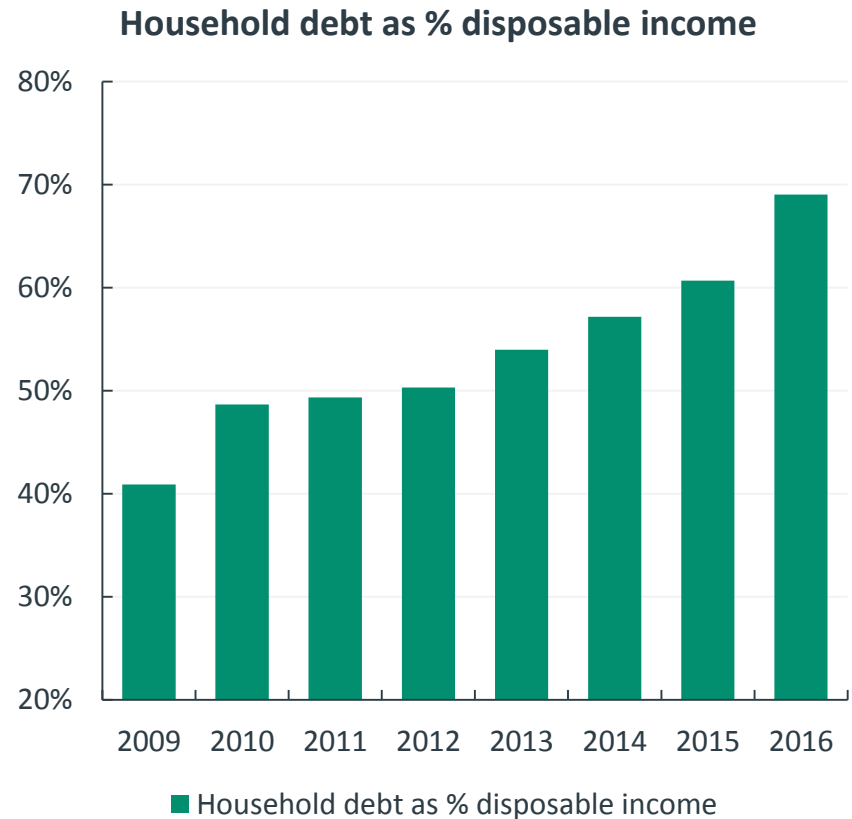
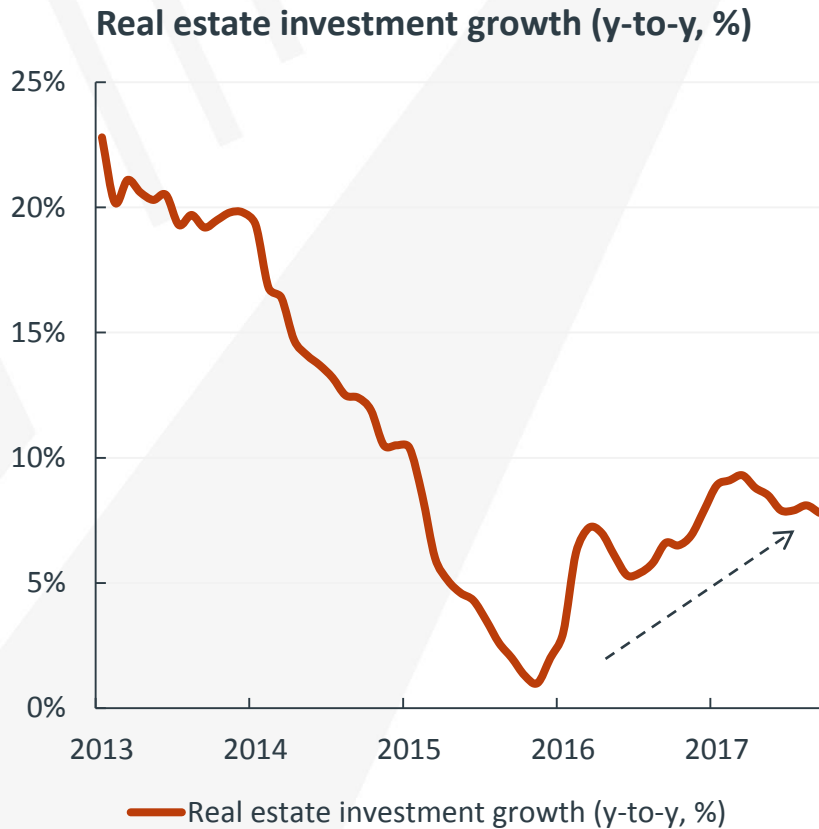
— Residential property under construction / residential property sales

■ Household mortgage loans (RMB, bn)



But the destocking policy end up with more stocks and higher household debt level

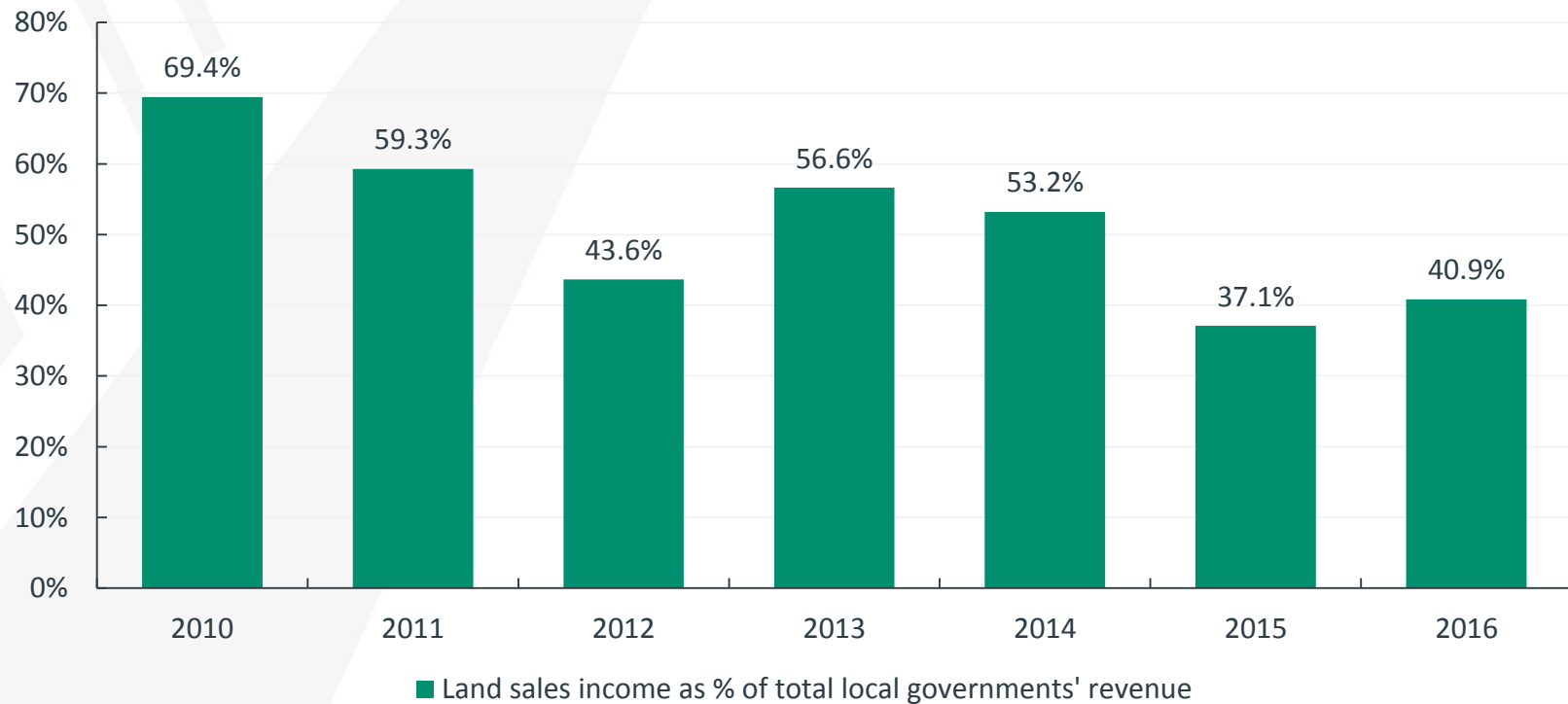
However, developers' investment growth picked up again afterwards. The destocking policy just pushed household's debt to a higher level.



One of the reason is that local Gov's revenue heavily relies on land sales* and wouldn't like to see lower house price

However, developers' investment growth picked up again afterwards. The destocking policy just pushed household's debt to a higher level.

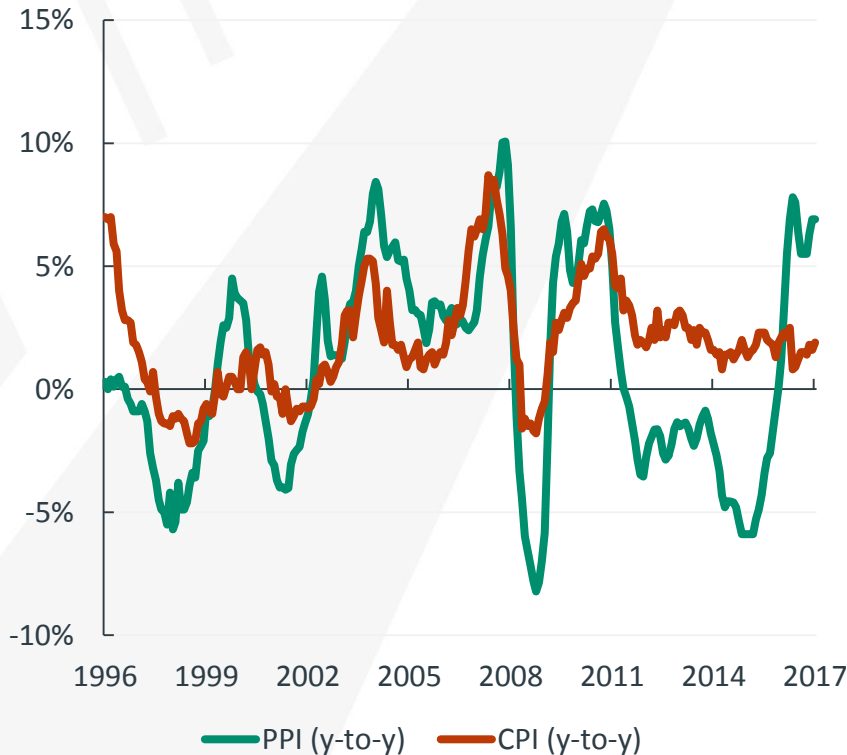
If music stopped, local Governments will have fiscal crisis



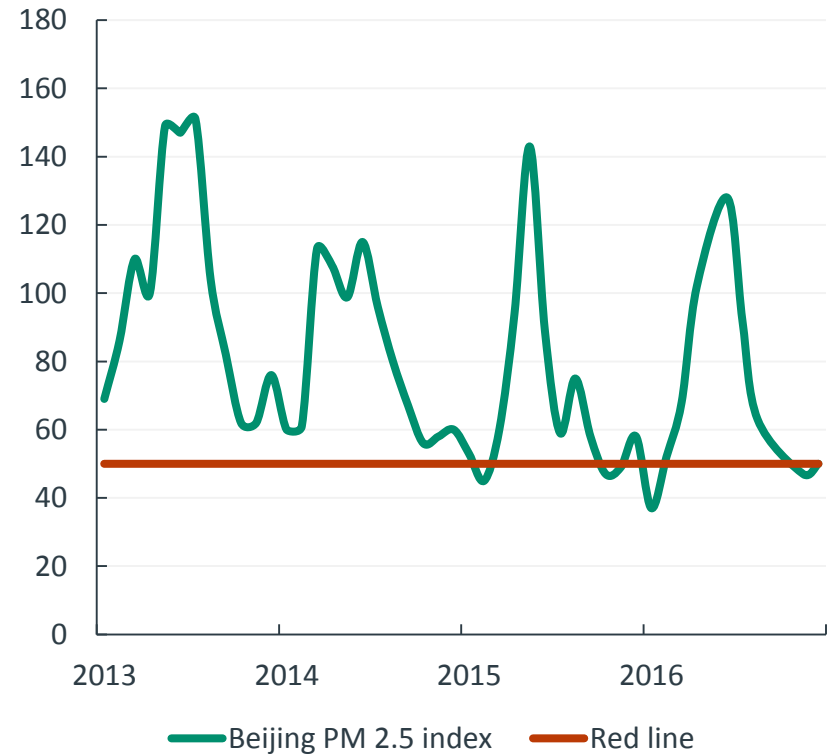
To help zombie SOEs deleverage and to improve the environment, supply side reform was proposed

The over-supply in heavy industry led to PPI being negative for 54 months from 2012 to 2016, high debt levels and successive loss making zombie SOEs. Environmental pollution is impacting health. Supply side reform has dual benefits.

54 month negative PPI from 2012 to 2016



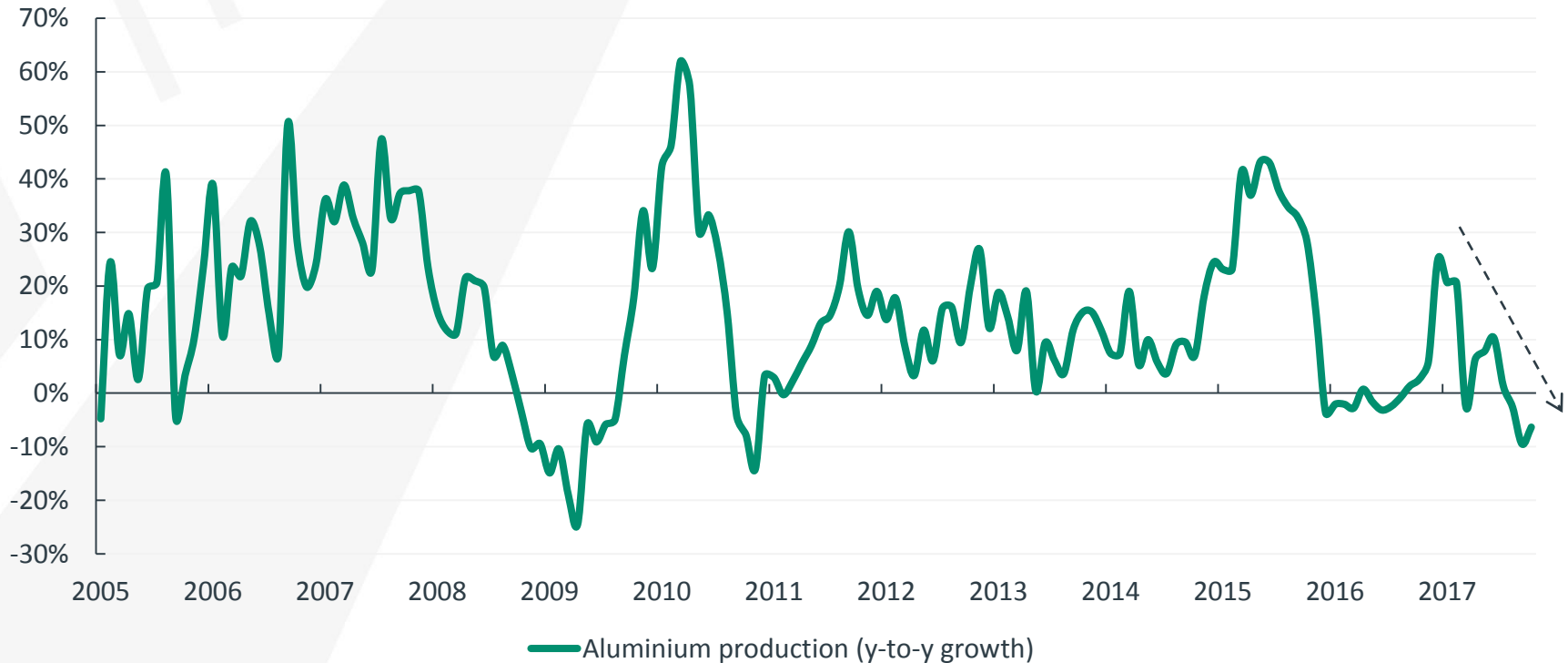
Environmental pollution



Under the name of “Beautiful China”, private competitors’ capacities were shut down

The world’s largest Aluminium refining company – China Hongqiao Group’s (Private) 33% production was shut down due to environmental pollution. Its competitor, China Aluminium (SOE) becomes the largest producer afterwards. The supply side reform pushed the metal prices higher.

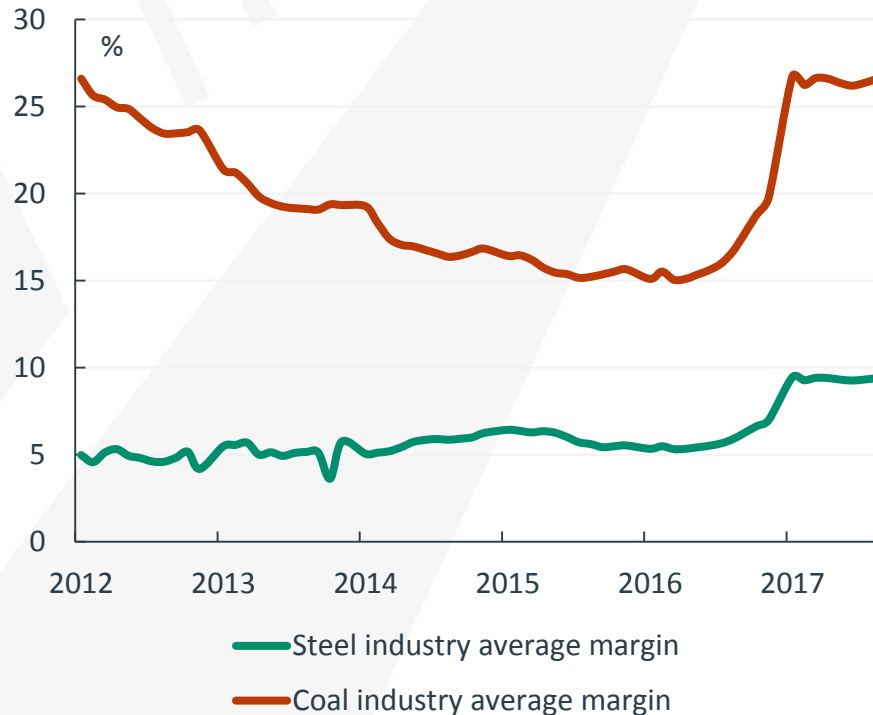
Negative growth in Aluminium production after supply side reform



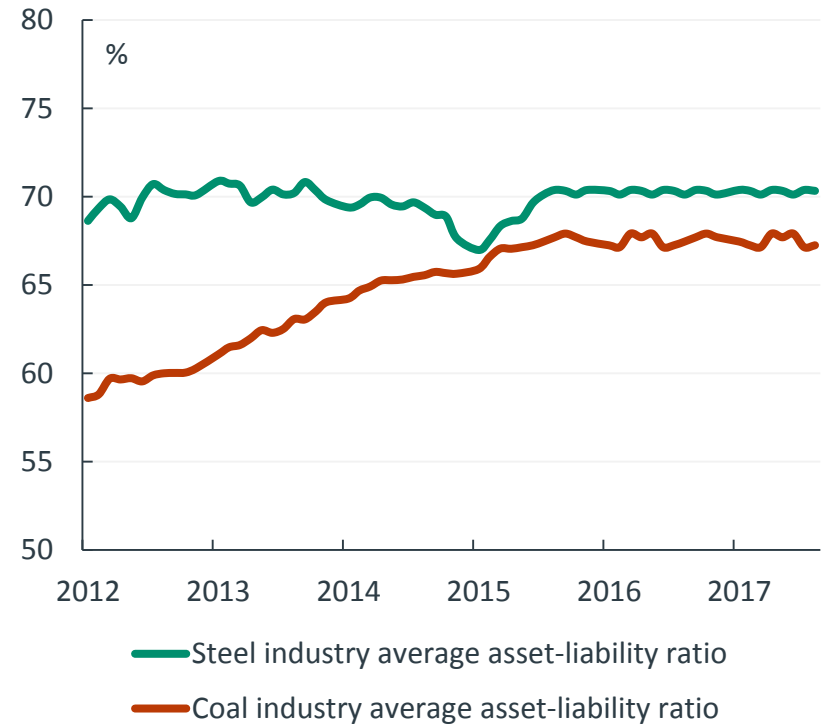
Zombie SOEs back to life, but leverage unchanged yet

SOEs in heavy industries benefited from the supply shortage and price increase. However, leverage remains unchanged, and it is doubtful if they will deleverage. SOEs continuing to expand production for larger market share could be negative.

Margins have improved due to price increase



Leverage unchanged yet

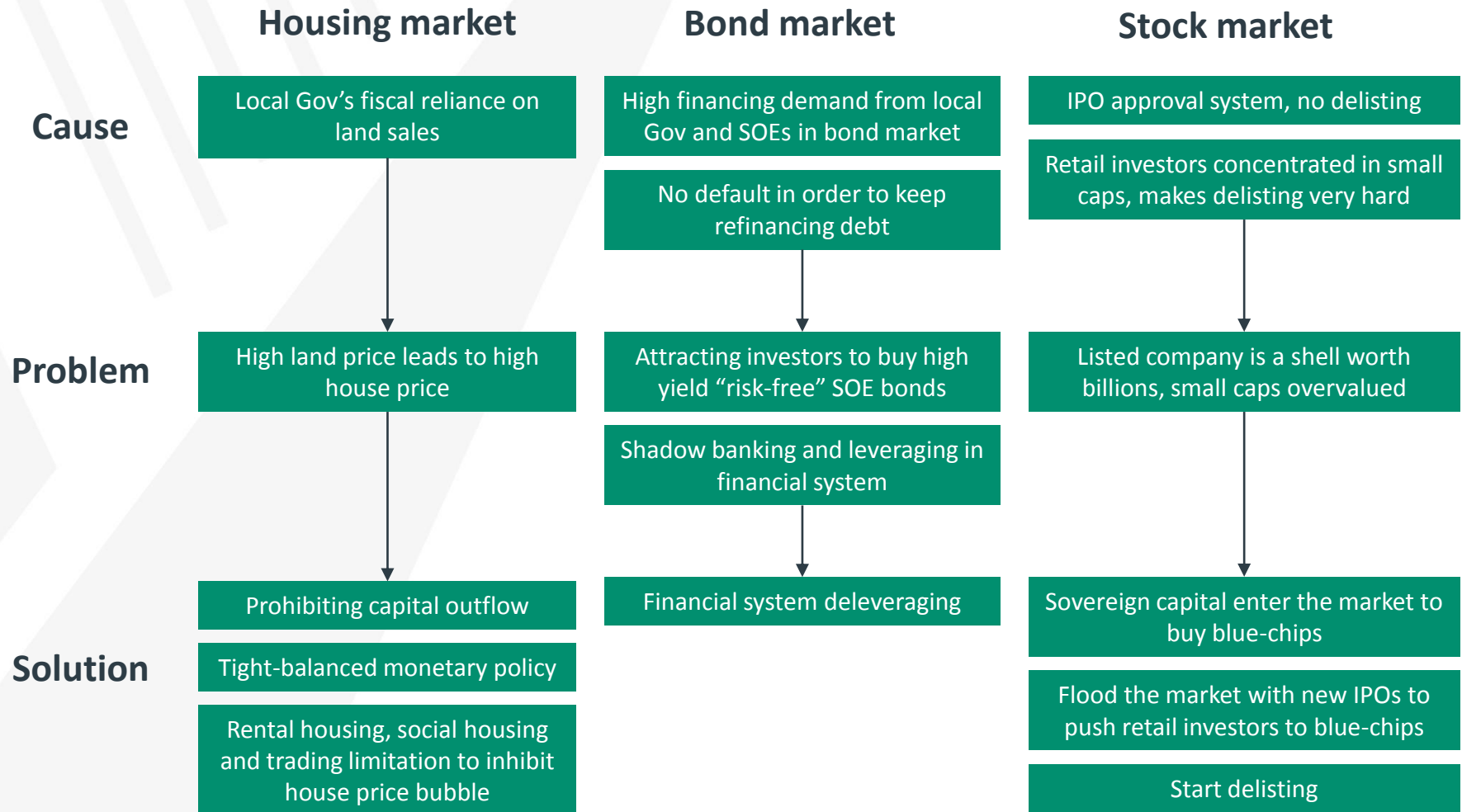


Section 2: Asset bubbles

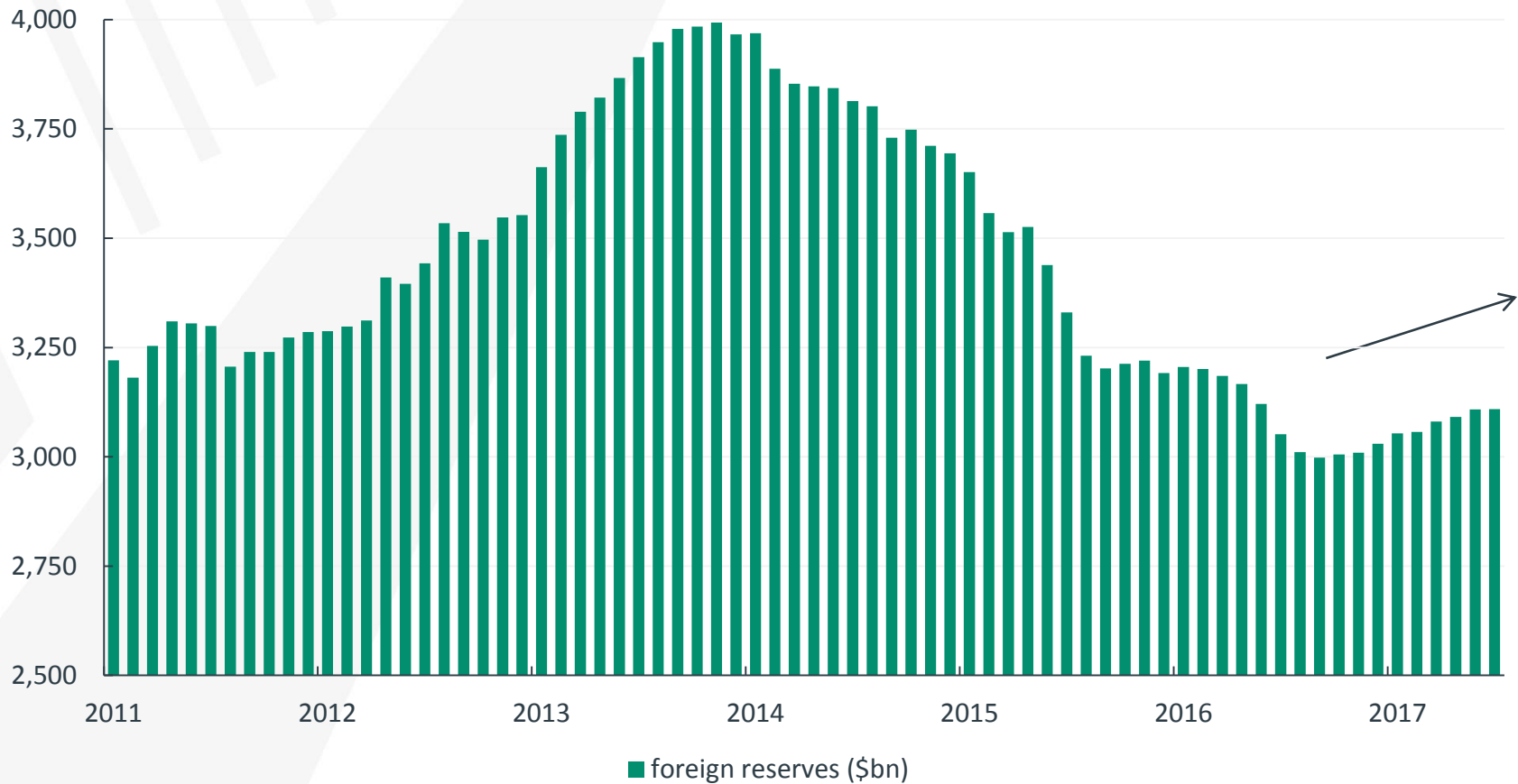


Gníomhaireacht Bainistíochta an Chisteáin Náisiúnta
National Treasury Management Agency

All about China's asset bubbles

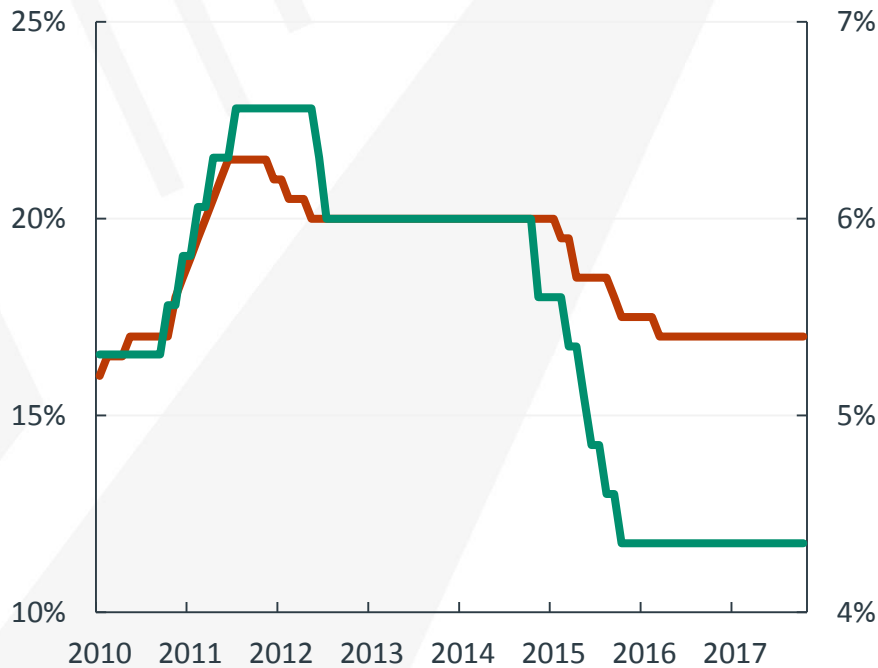


Capital outflow has stabilized after PBoC taking various measures to prohibit FX transfer



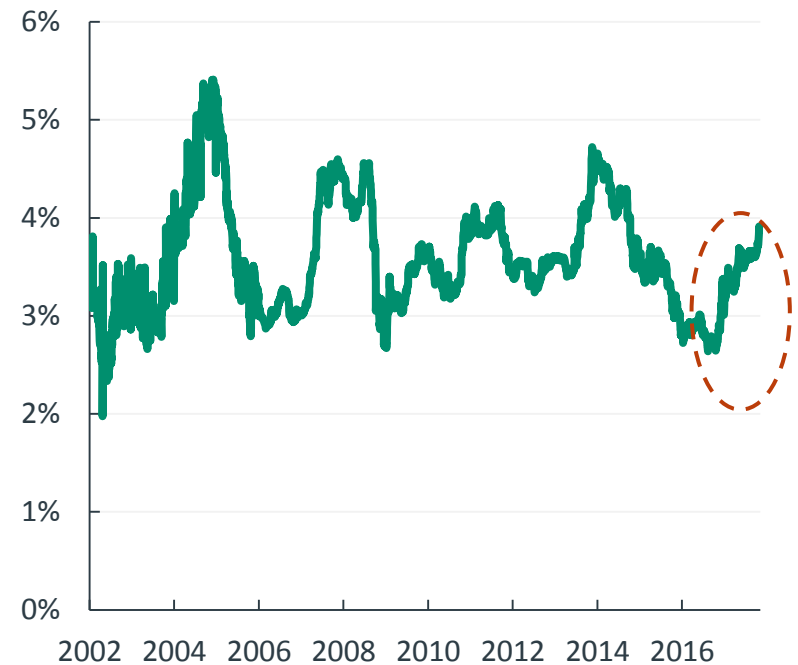
Tight-balanced monetary policy

No rate movements



— Big banks reserve requirement ratio
— Bank prime lending rate (rhs)

Tightening in the market



— 10Y Gov bond yield



This time is different? Various policies to mitigate house price bubble

Rental housing

Social housing

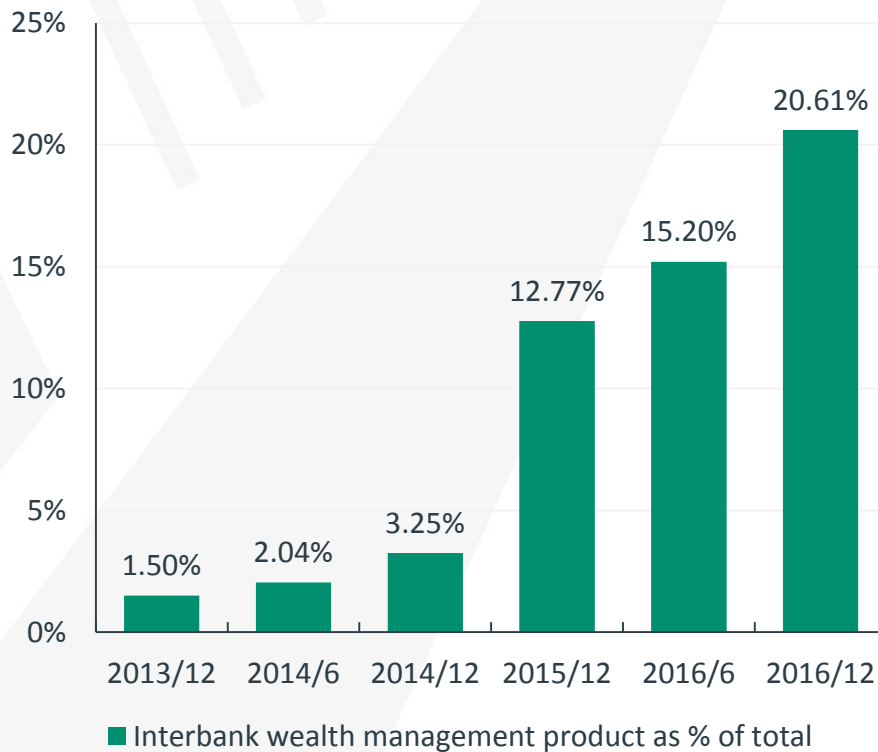
Trading limit

- 70% Mortgage cap
- Non-first time buyer 50% mortgage cap
- Prohibit to trade within two years
- No purchase without local household registration

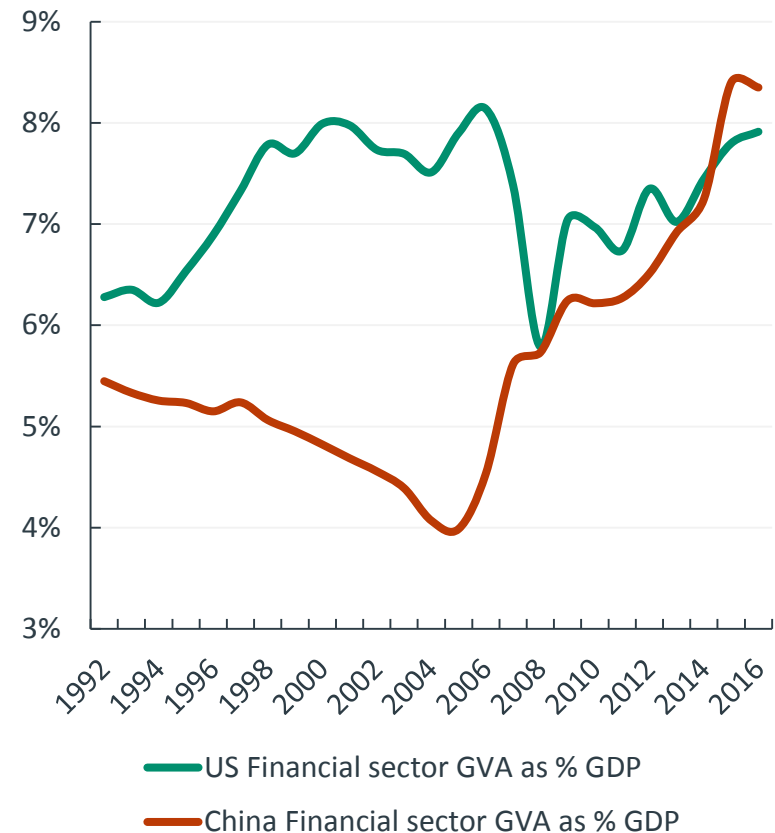


Due to rapidly developing shadow banking, China's financial sector has grown at a fast pace

6 trillion RMB shadow banking products are money flows within a closed financial system

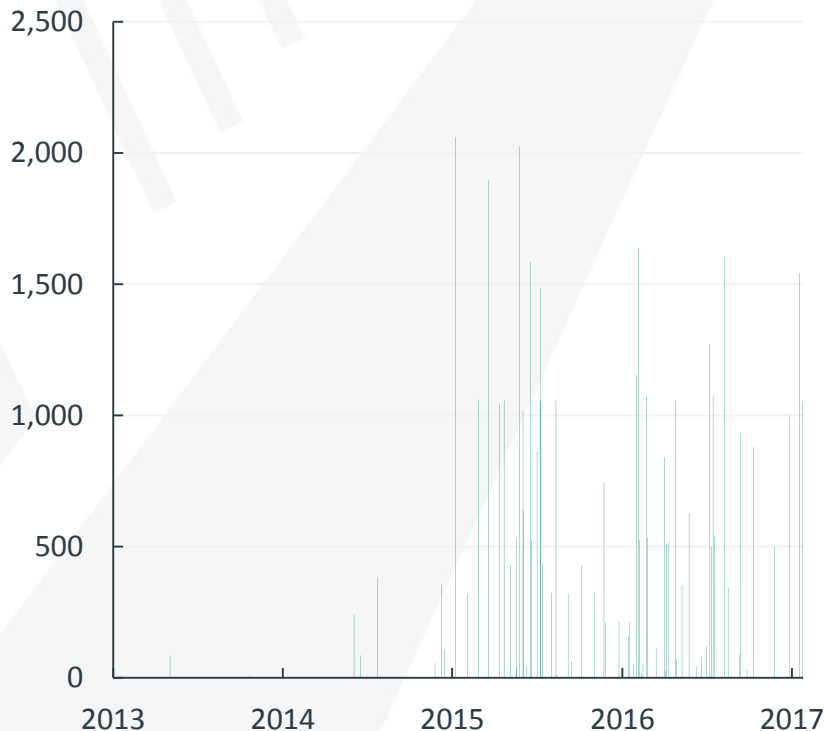


Chinese financial sector grew 400% from 2007 to 2016



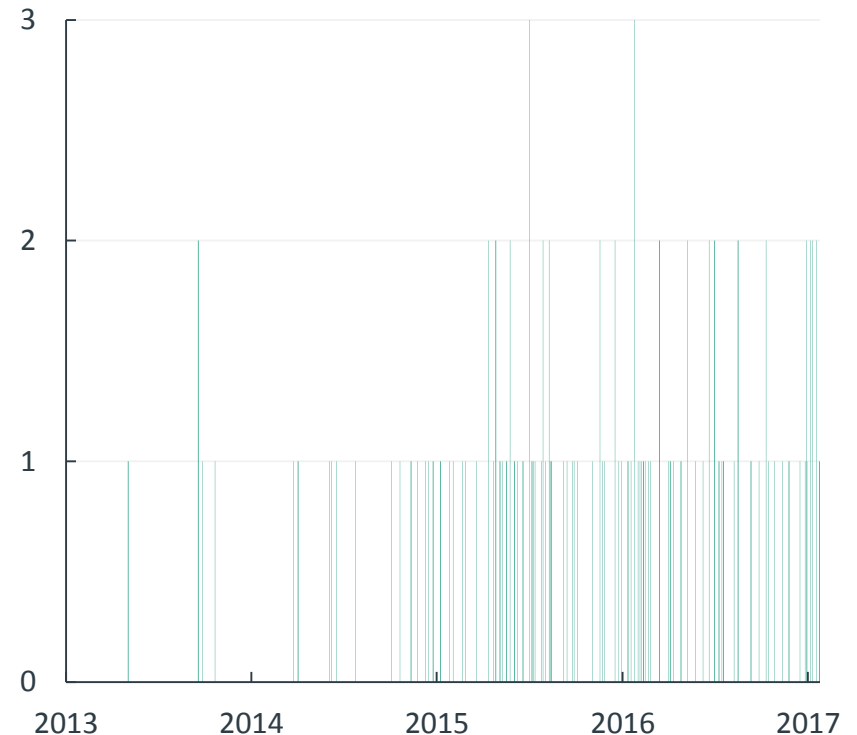
Extremely low default rate makes high yield SOE and local Government bonds “risk free”

4.8 billion default in a 70 trillion market



■ China bond market default amount (RMB, Mn)

Nearly zero default before 2015, local Gov always backed at the last minute



■ Number of default in Chinese bond market



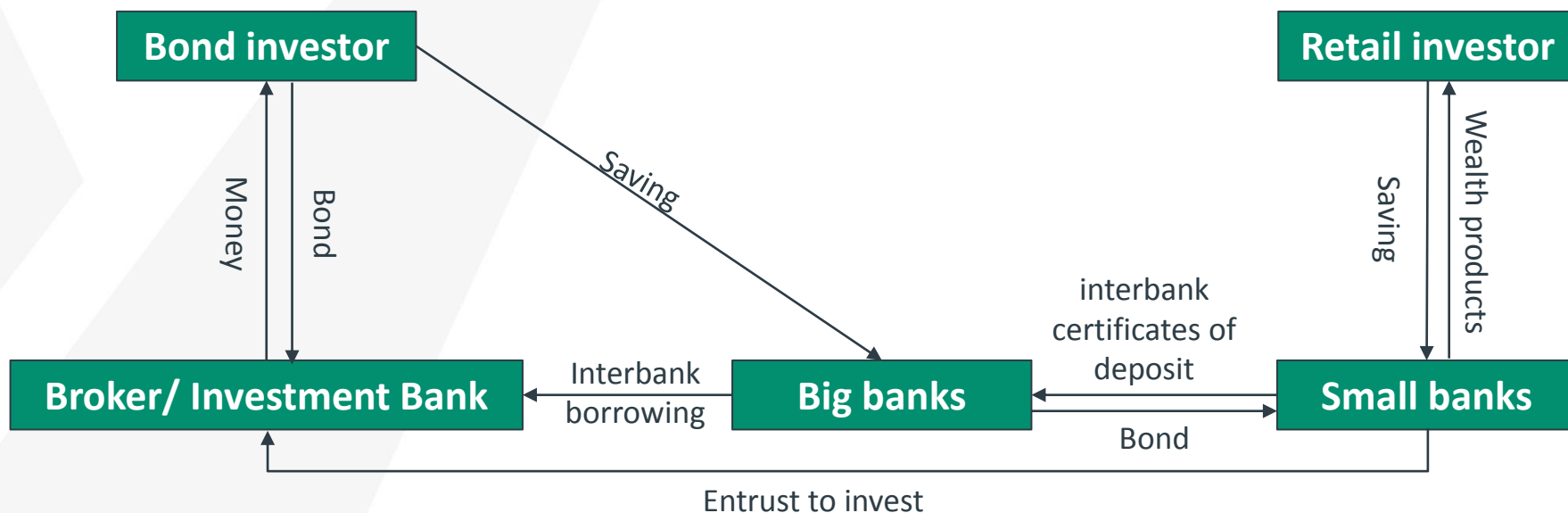
Low default rate makes “risk free” rate as high as 7 to 8%



Highly leveraged bond investment is money flow within a closed financial system and creates no value

Banks issue wealth management products and entrust brokers or investment banks to invest the money in bond market. Typically, brokers will borrow from the bank to leverage up the bond investment. Small banks also issue interbank certificates of deposit to large banks to buy bonds held by large banks or entrust brokers to do the leveraged investment. It is money flow cycle in a closed financial system with high leverage.

After the Nov 2017 new regulation, the leverage of bond investment is capped. Interbank certificates of deposit and interbank borrowing from non-banking financial sector is limited.



Case 1: Brokers to leverage bond investment via interbank borrowing

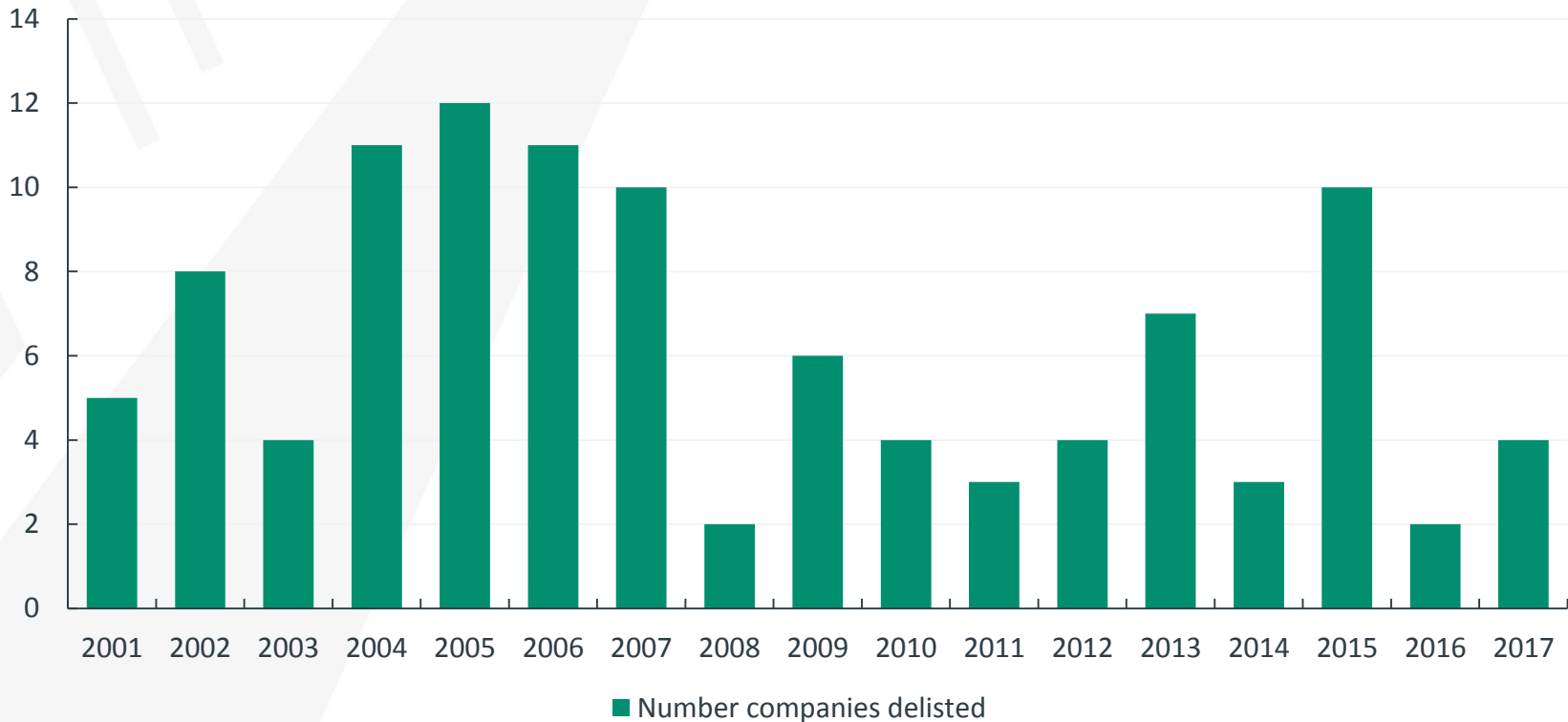
Before							
Bond investor		Broker		Bank		Financial system in total	
Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
¥ 100 bond	0	0	0	Excessive reserve ¥ 100	Savings ¥ 200	¥ 200	¥ 200
				Reserve ¥ 40			
				Loan ¥ 60			
After leveraging							
Bond investor		Broker		Bank		Financial system in total	
Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
Savings ¥ 100	0	¥ 100 bond	¥ 100 interbank borrowing	Excessive reserve ¥ 80	Savings ¥ 300	¥ 400	¥ 400
				Reserve ¥ 60			
				Loan ¥ 60			
				¥ 100 interbank lending			

Case 2: Small banks issue interbank certificates of deposit to large banks

Before					
Small banks		Large banks		Total	
Asset	Liability	Asset	Liability	Asset	Liability
0	0	Excessive reserve ¥100	Savings ¥200	¥200	¥200
		Reserve ¥40			
		Loan ¥60			
Small banks issue interbank certificates of deposit to large banks to buy bonds held by large banks					
Small banks		Large banks		Total	
Asset	Liability	Asset	Liability	Asset	Liability
¥60 bond	Interbank certificates of deposit ¥60	Excessive reserve ¥100	Savings ¥200	¥260	¥260
		Reserve ¥40			
		Loan ¥60			

Stock market delisting mechanism fires backdoor listing and speculation in low quality small caps

IPO approval system makes backdoor listing popular in China and retail investors are highly speculatively involved in rubbish small caps. Delisting may cause systematic risks and social issues. The result is only 106 companies delisted from a market with 3600 listed companies in 20 years. This fires the backdoor listing and speculation in turn.



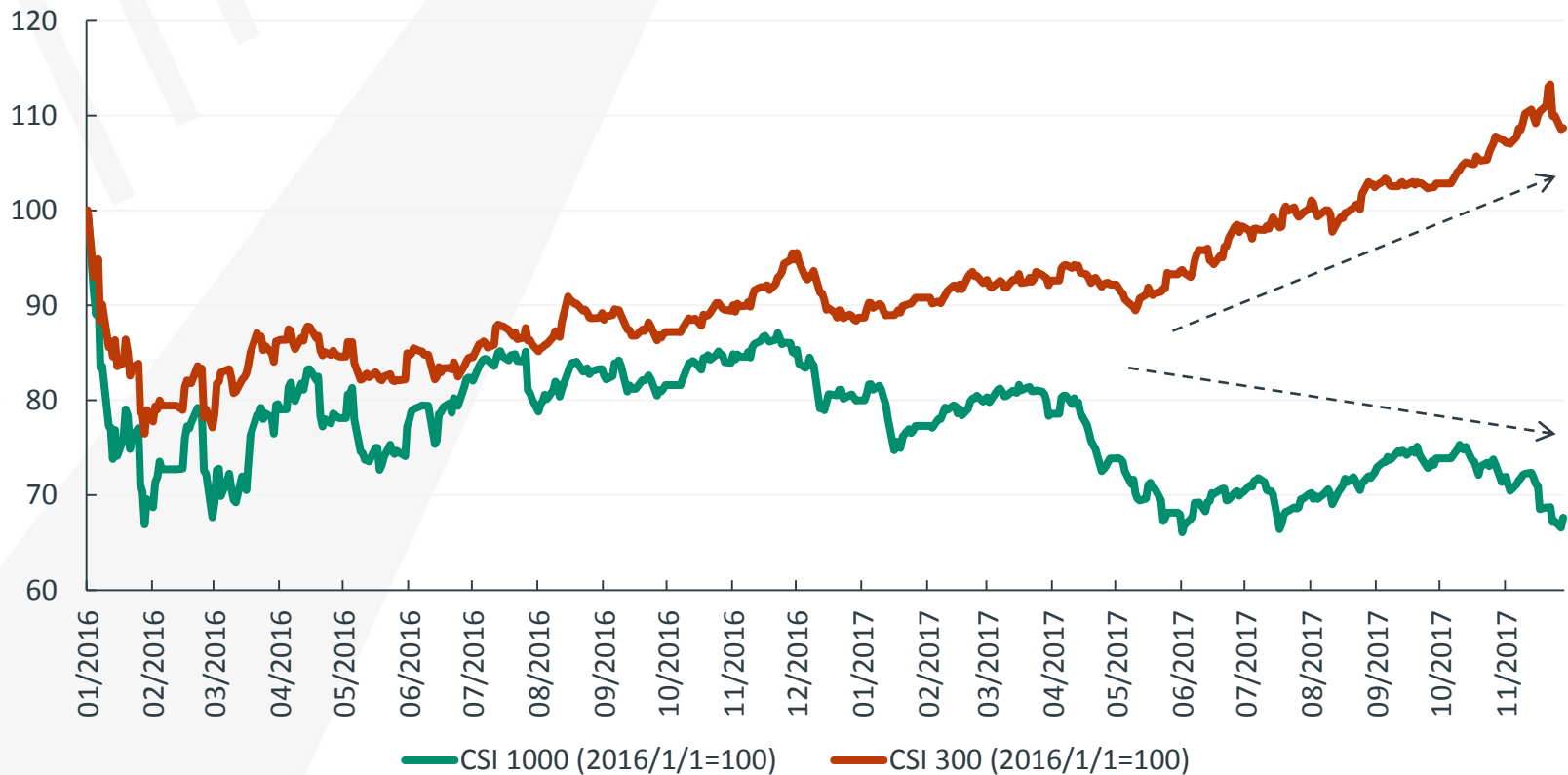
Retail investors dominates Chinese stock market and speculates in small caps

Small caps' average PE never below 40 before, but things are changing now

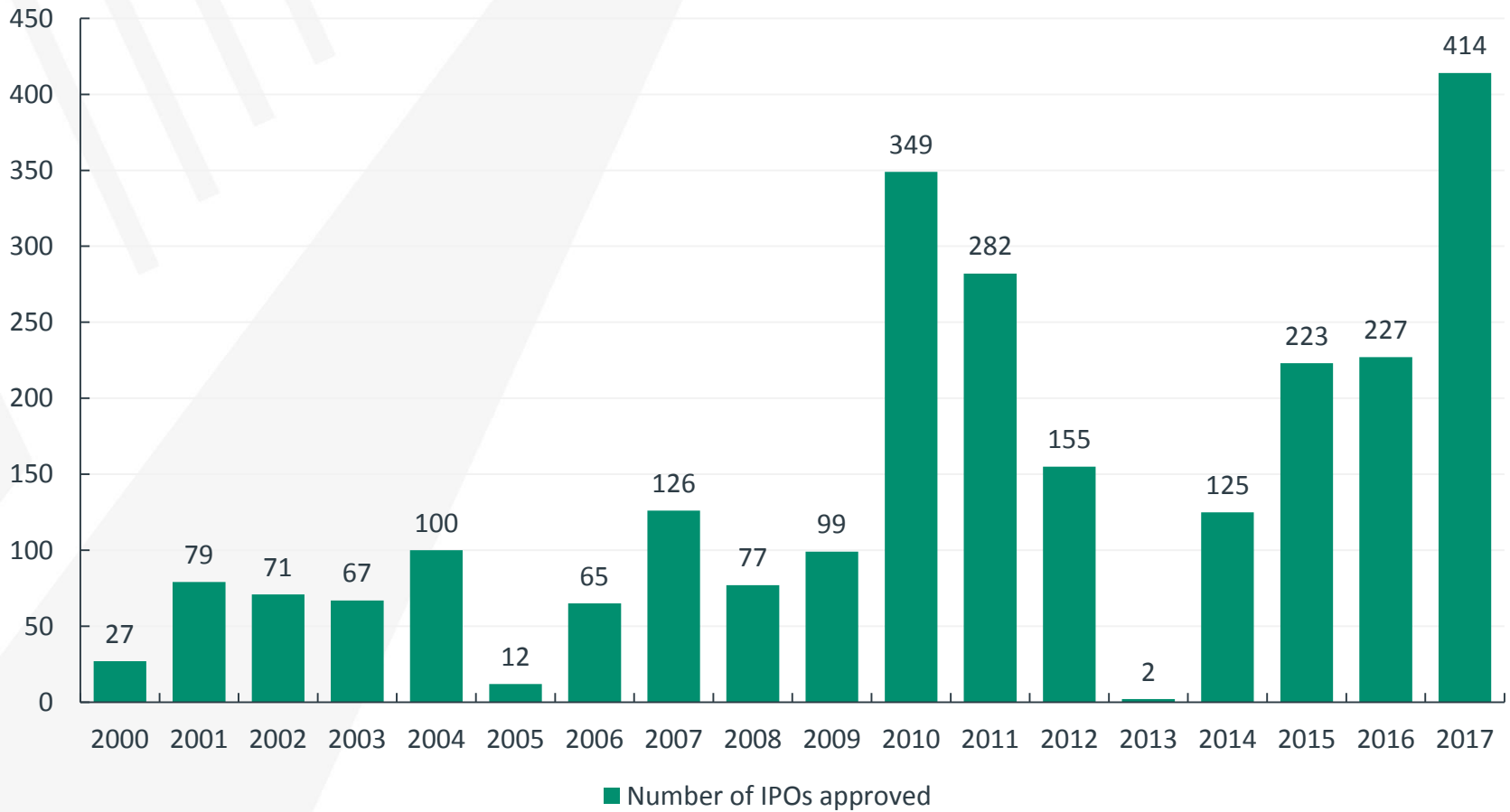


Sovereign long-term capital keeps buying blue-chips to squeeze bubble in small caps

CSI 300 30% up, while CSI 1000 30% down in 2017. The authorities hopes to squeeze retail investors out of small caps



IPO flood adds small caps supply to push retail investors out of low quality small caps.



Section 3: Congress updates



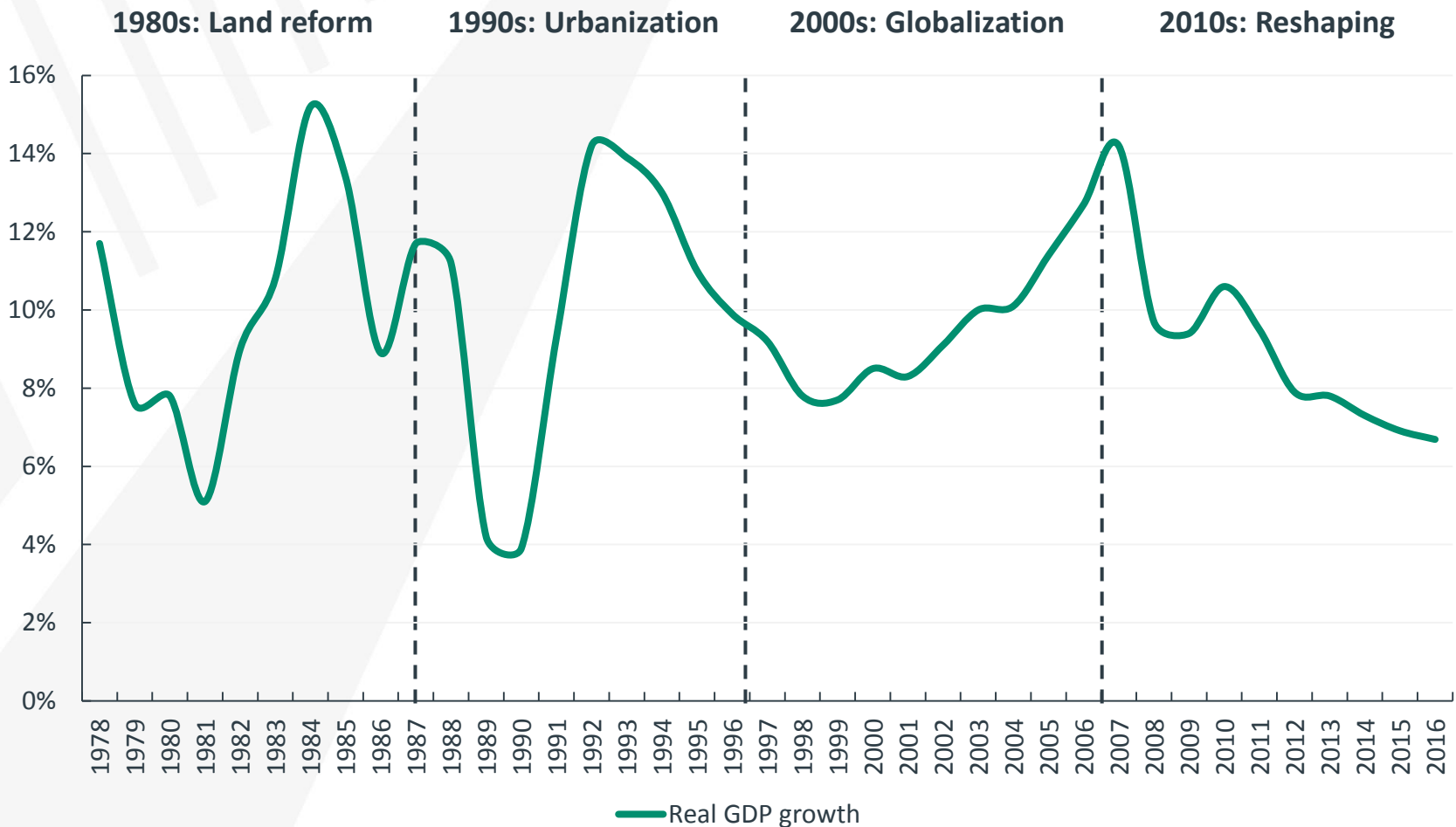
Gníomhaireacht Bainistíochta an Chisteáin Náisiúnta
National Treasury Management Agency

Messages from the 19th Congress

- From high growth rate to high quality growth. GDP growth at 6.3% in 2018-2020 would be sufficient to achieve the Party's 2020 growth target.
- Shifting the growth model, optimizing industry structure and finding new growth driving forces are three main targets.
- Deepening environmental protection and supply side reform, “Green” was mentioned 15 times, compared with once in the 18th Congress.
- Open and innovative.
- Stability overrides everything; the bottom line thinking.



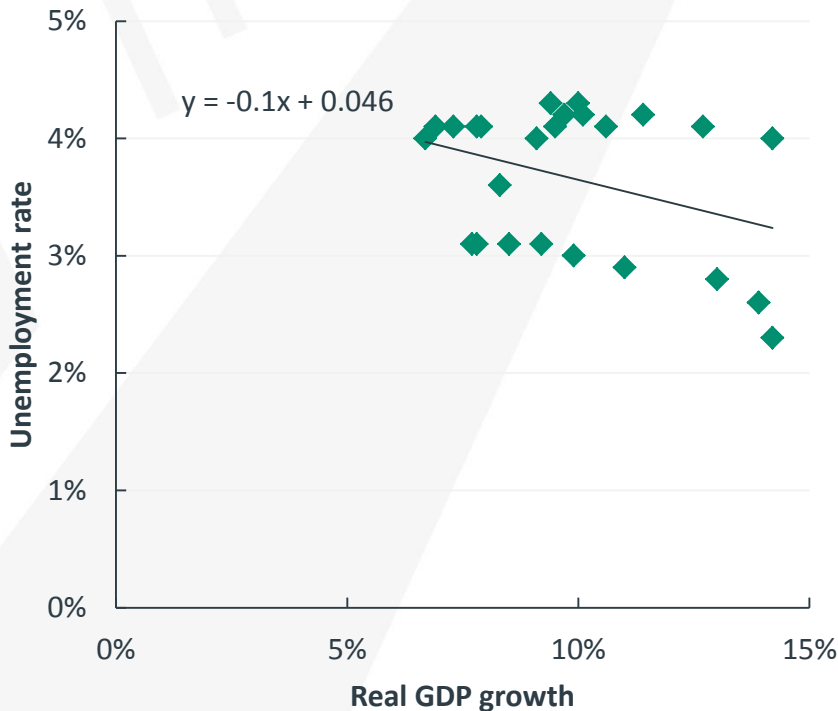
L-shape growth is the consensus for the 2010s, lower but steady growth in the next few years



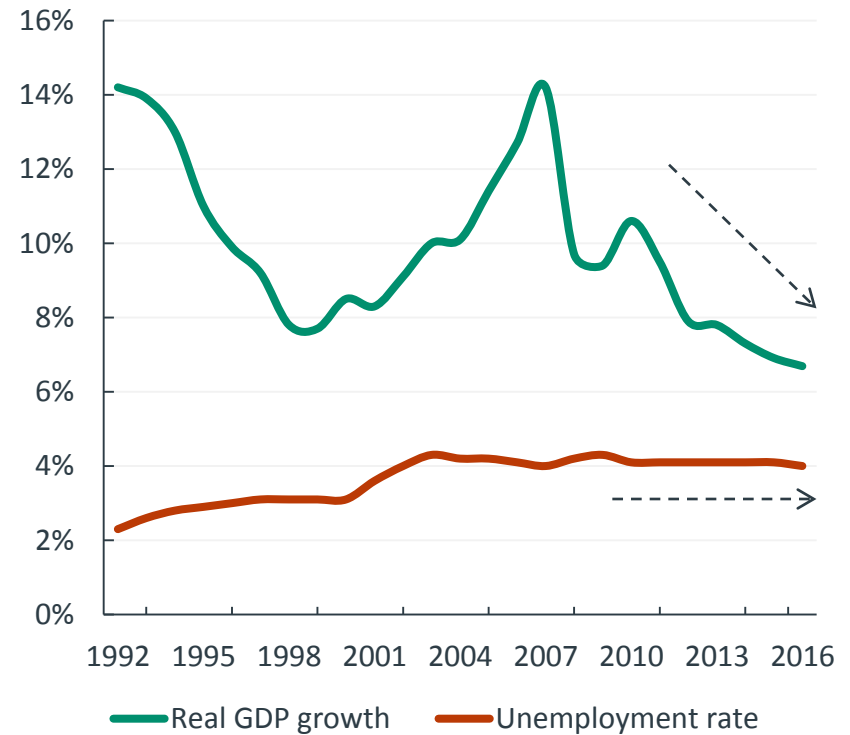
It is believed labor market has higher tolerance of lower growth

The Party's bottom line thinking stresses that lower growth is acceptable as long as no unemployment rate jumps threaten the regime.

Lower growth might not lead to higher unemployment



Unemployment rate flattened under lower growth



Tightening signals released after the Congress

- **Tightening fiscal policy**

Ministry of Finance issued a document on 16 Nov to tighten control over PPP projects. To control the potential fiscal burden, the government will cancel some PPP projects that do not meet its requirements. The Rmb30bn subway project in the city of Baotou has been called off by the central government after 3 months of construction.

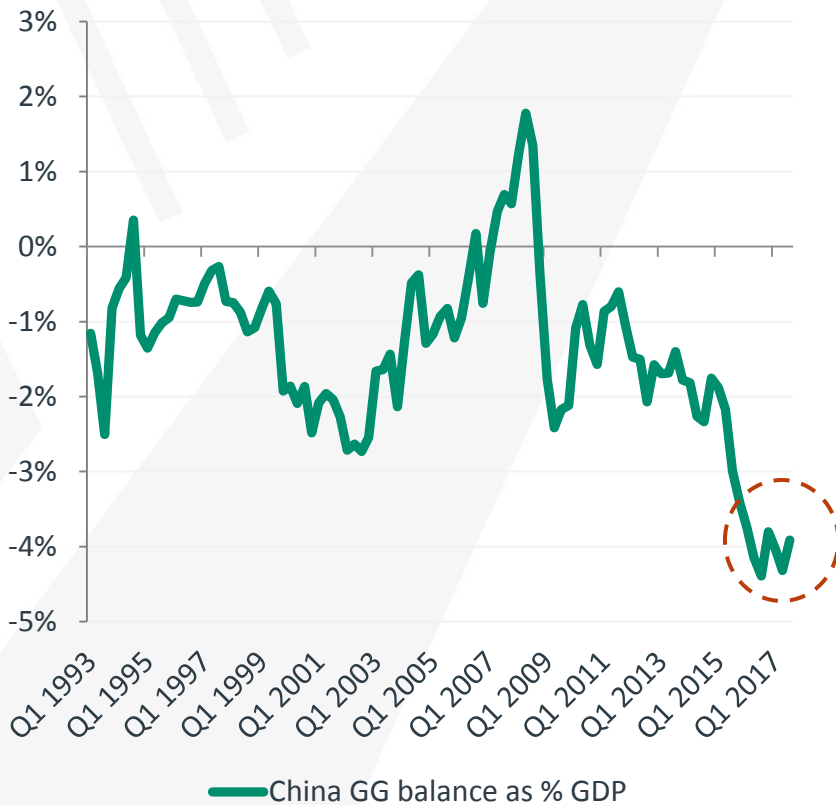
- **Tightening monetary policy**

17 November 2017, China's five regulators, including PBOC, CBRC, CIRC, CSRC and SAFE, jointly released a guideline on the asset management sector (a sector with Rmb102tn). The new guideline is going to implement in 2019, mainly targeting at the risks in bonds and nonstandard credit asset management products. It tries to control the shadow banking issue.

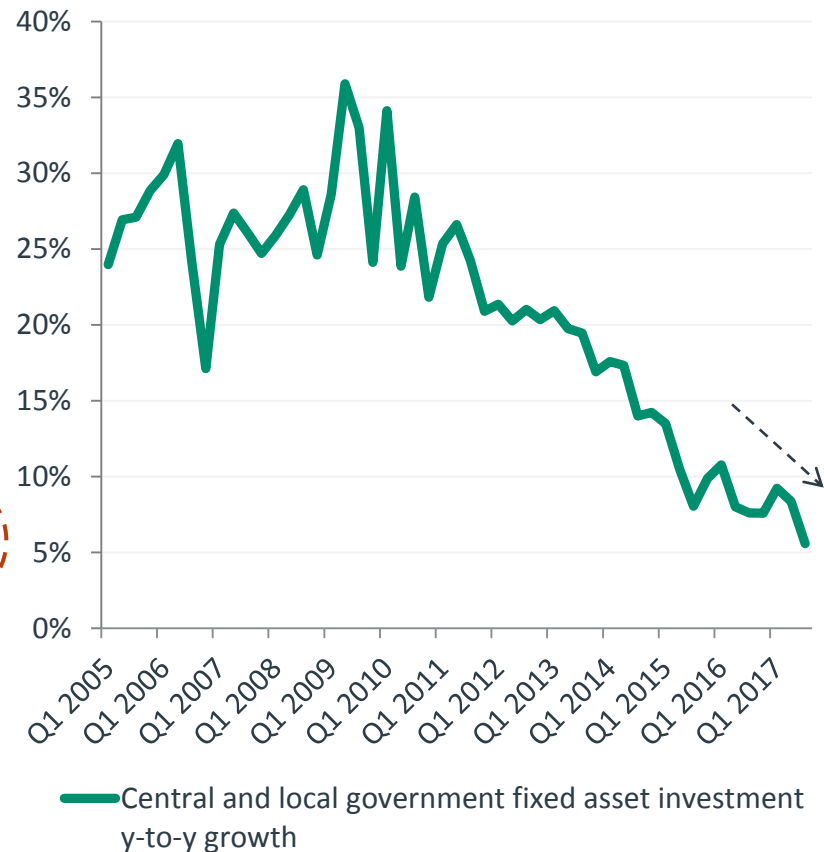


Fiscal policy tightened, fixed investment slowed

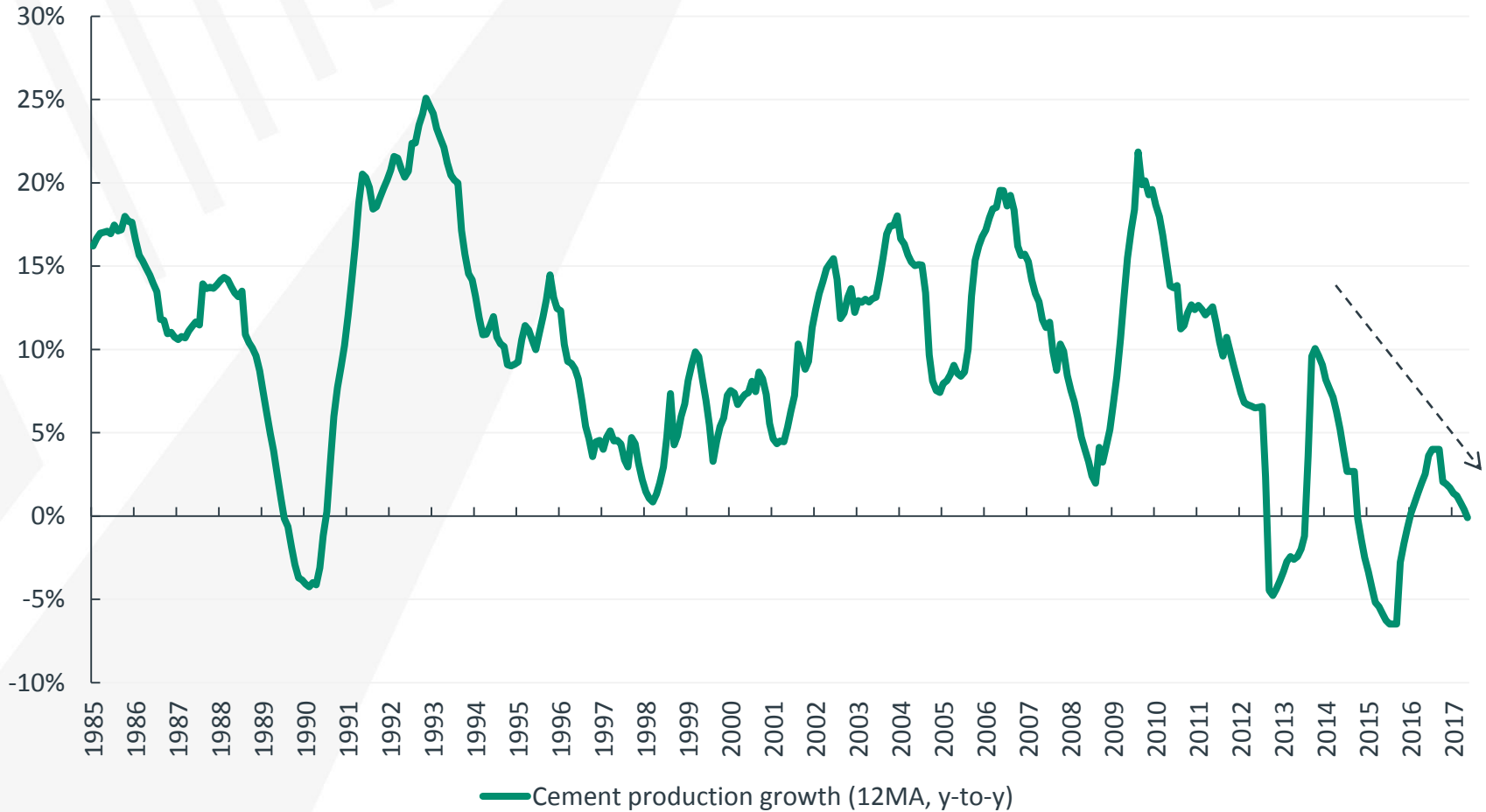
GG balance is deteriorating, no more space for further spending



Government's fixed asset investment growth record low

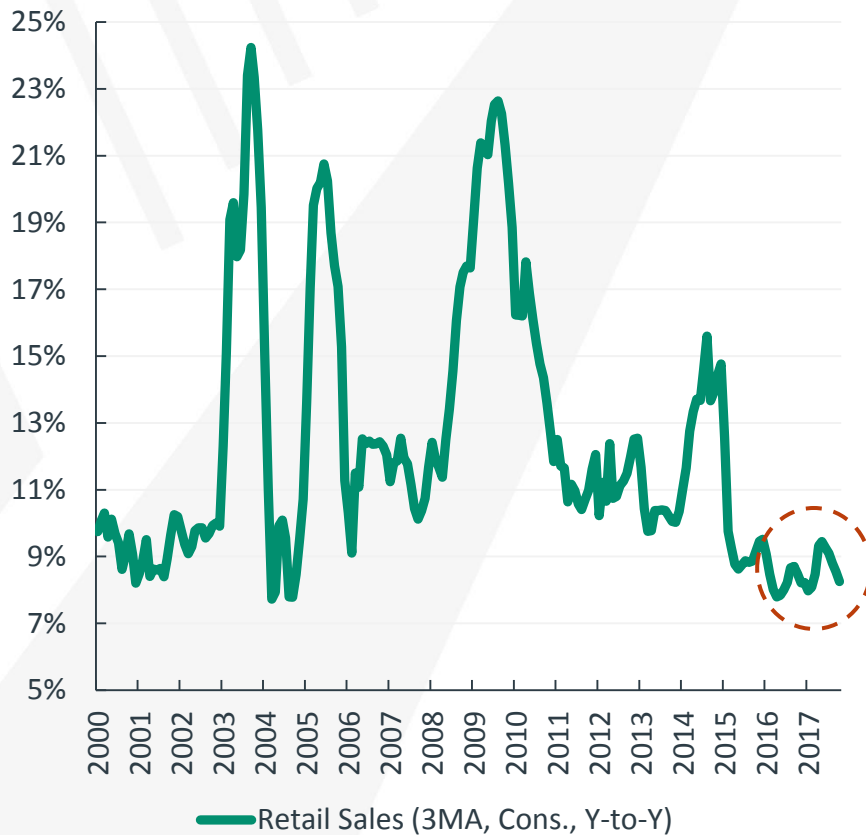


Not surprisingly, construction contracted

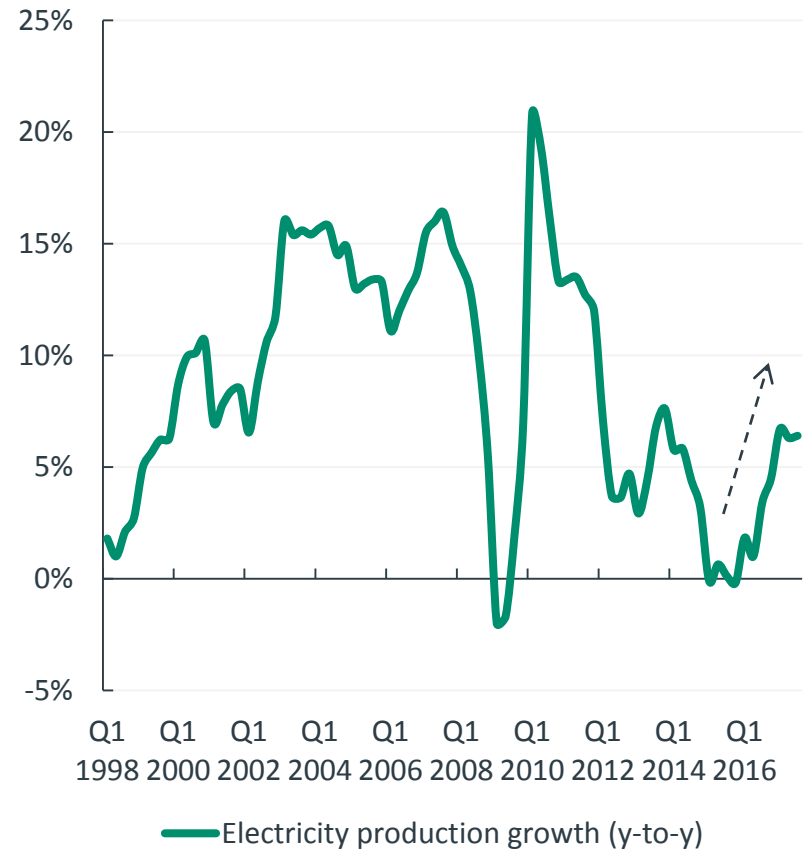


But consumption stabilised, manufacturing rebounded

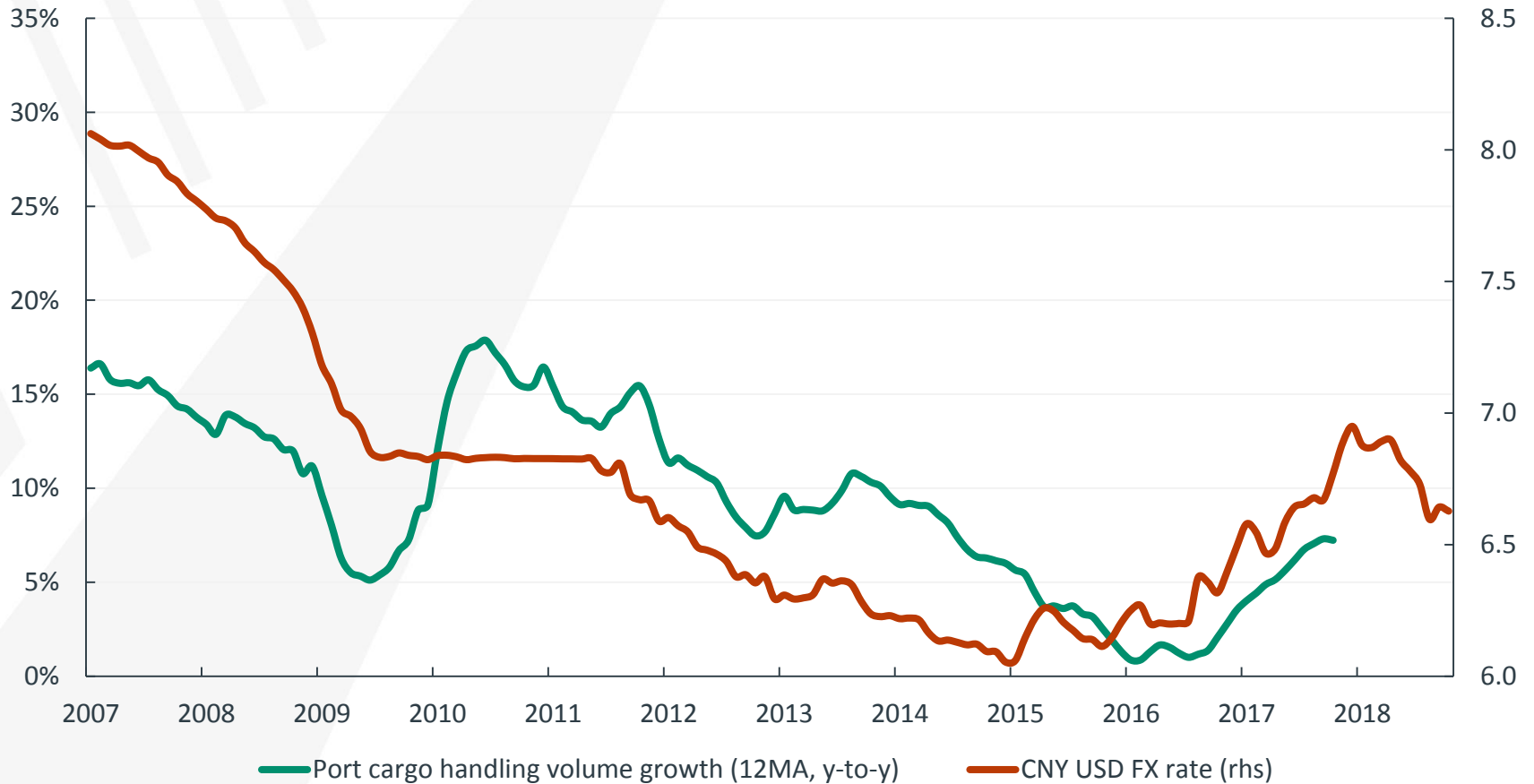
Consumption stabilized



Electricity production rebounded

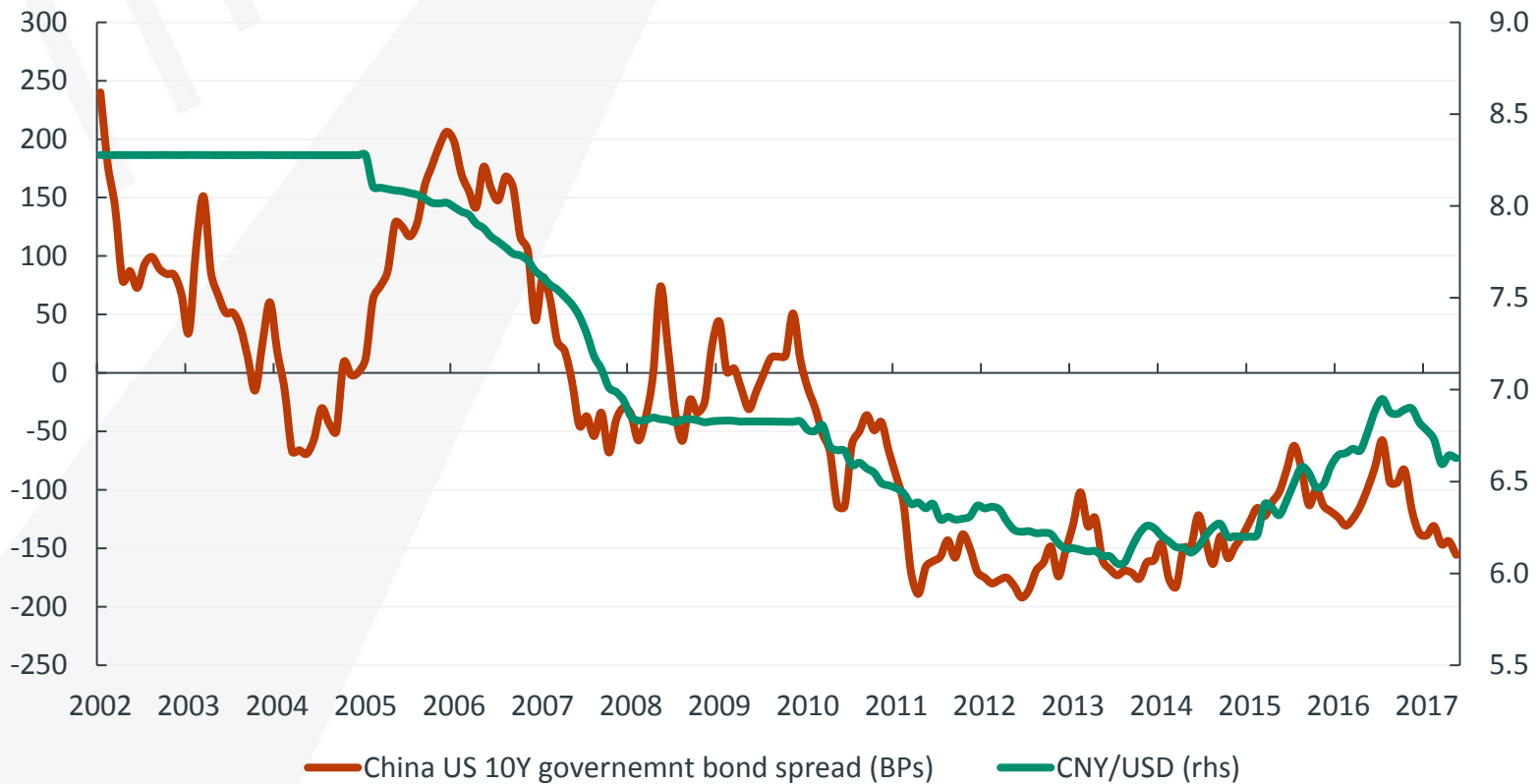


Trade improved, but challenged by unfavourable exchange rate



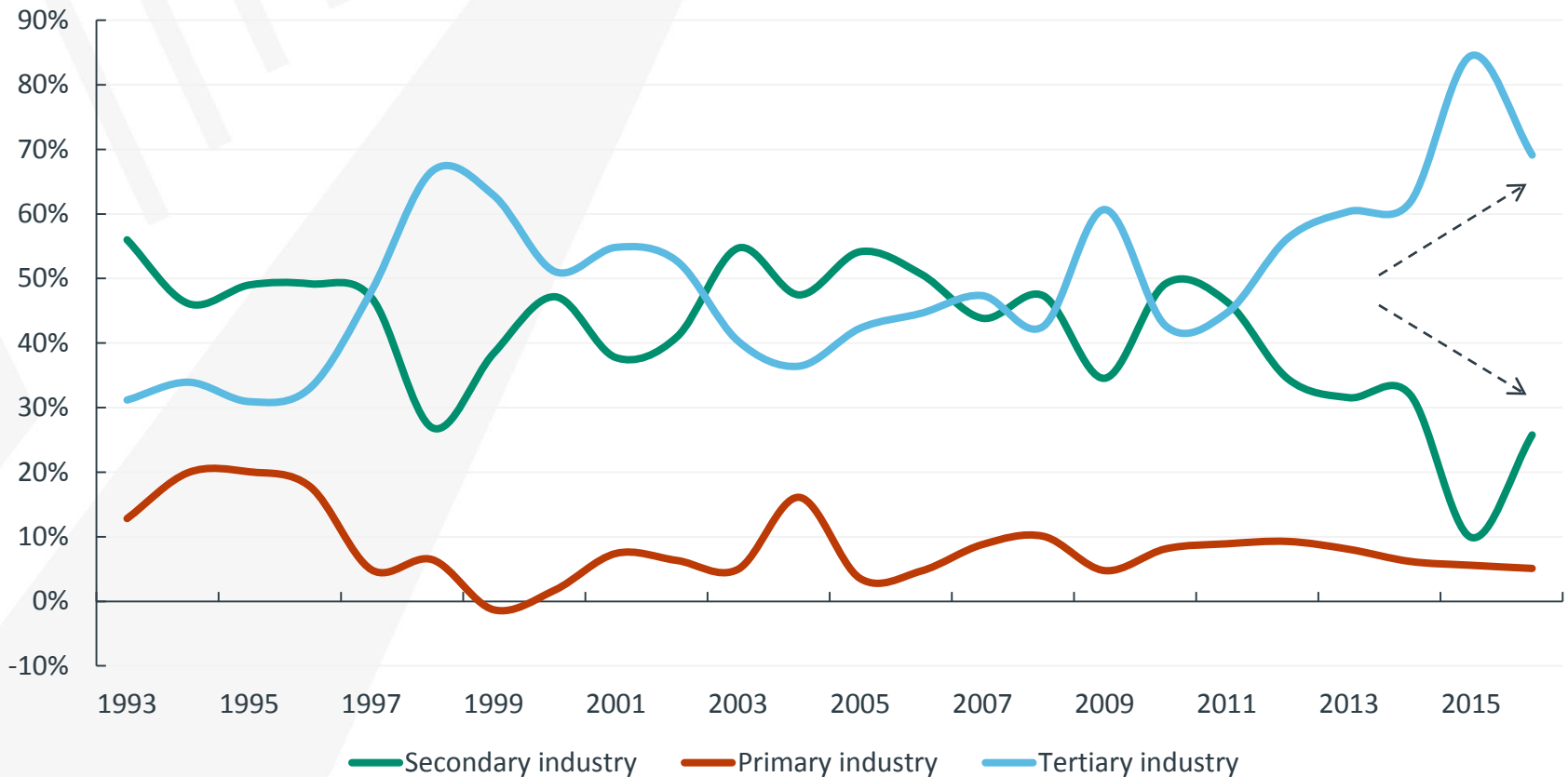
Good news is currency may depreciate if Fed keeps hiking

PBoC won't move the policy rate due to high debt issue, while Fed is likely to keep hiking next year



Tertiary industry has been the new driving force of growth; the economy is reshaping

Contribution to GDP growth



Strong household consumption in automobile and durable goods

