ceasefire: growth/ de-leveraging

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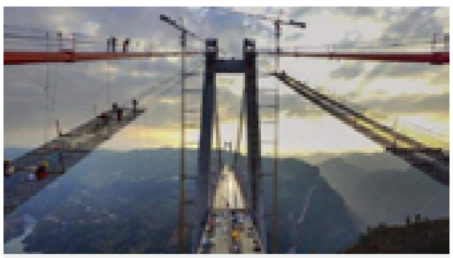


local bonds to fuel more infrastructure

As the centre fights fires on many sides, the 'siege' on debt is succumbing to growth policies.

strategic shift from de-leveraging to stability

while the 'three sieges' are ongoing, the focus of financial risk prevention shifted from rigid deleveraging to stabilisation

One of Xi's signature 'three sieges', the battle against financial risk has moved from de-leveraging to safeguarding growth. The siege on pollution (see signal) remains on track, though focus is more on market-friendly and less disruptive regulation; while that on poverty alleviation (see signal) has moved into high gear in endemically poor ethnic regions in the lead up to the 2020 target.

In early 2018, Beijing set a goal of making 'significant progress' in preventing financial risk, with emphasis on internal controls, regulations, and local borrowing discipline. November statistics showed slower than anticipated growth, and the Q3 Politburo meeting fretted over economic slowdown, removing all reference to de-leveraging and containing housing prices. Fast on its heels the 2018 Central Economic Work Conference confirmed Beijing is softening its stance on implicit government debt and financial risks.

the policy shift is a rational move to curb excessive deleveraging, but long-term solution still lies in reform

This is a return to rationality from the extreme financial deleveraging policies that helped trigger the slowdown. But loosening credit controls reflects the tug-of-war between growth at-all-costs and long-term sustainability. While structural adjustments and demand stabilisation policies are not mutually exclusive, points out Zhang Bin 张斌 China Finance 40 Forum senior researcher, balancing them is a tough task—strong central preference one way or the other leads to local over-implementation, but centrism baffles local officials.

A major initiative to expand high-tech infrastructure, for example, is considered both a short-term growth driver and a development engine. But state-sponsored expansion in other areas, like solar panels, often results in high debt and over-capacity. Redesigning financial regulation to prioritise growth maintenance is reasonable, but not sustainable: success in the longer term still requires genuine reform in the growth model.

‘yes-man’ financial sector

private enterprises first stricken by extreme deleveraging and downward cycles

Private enterprises were first to sound the alarm that financial policy was not working as intended. The tightening in local government financing activities, shadow banking regulations, and excessive capacity cuts leading to a credit crunch. Implicit local government debt was the main target of de-leveraging, but the campaign generated major knock-on effects, decreasing government spending, reducing financing to the real economy, and putting pressure on the housing market. External shocks such as the trade war and slowing global demand exacerbated the situation.

China is entering a ‘downward cycle’, says Yi Gang 易纲 People’s Bank of China (PBoC) governor: monetary easing is needed to reassure firms and investors who tend to overreact to cyclical shocks. The worst-case scenario is a vicious cycle, where pessimistic investors escape the asset bubble altogether and trigger mass unemployment. Stock market fire sales gave early warning of such risk.

politically-mandated financial sector perpetuates the state-led model in delivery of support to the private sector

While justifiable, current monetary expansion could roll back gains made in de-leveraging, strengthening the state-led growth model. PBoC struggles to direct commercial banks in targeted easing; despite designing policy to encourage lending to private enterprises, banks still perceive SOEs as better investments and remain reluctant to finance private firms.

This dynamic significantly hinders ‘policy transmission’: money earmarked for the private sector often fails to reach its destination, adding to SOE debt risks instead of increasing lending to the private sector. Moreover, targeted easing falls prey to banks’ politically-mandated risk preference for borrowers who align with industrial policies. This privileges corporations with strong political connections that operate in state-supported areas. Li Yang 李扬 Chinese Academy of Social Sciences bluntly remarked that political functions have distorted the fundamental role of capital markets in efficient resource allocation.

‘see-saw’ economy

state-led growth creates a political business cycle leading to ‘see-saw’ between expansion and deleveraging

Recognising this issue, the Politburo has resorted to stimulus, expanding infrastructure investment and boosting local government spending. Wu Jinglian 吴敬琏 Renmin University says alternating between stimulus and de-leveraging is a ‘see-saw’ dilemma that can only be solved through marketisation. Policymakers try to curb overspending by local officials judged on GDP growth with stronger law enforcement and more regulated borrowing, but they have not addressed the underlying institutional dynamics.

At the local level deleveraging initially dampened overspending. But de-linking the political advancement that fosters this excess from economic growth, is a work in progress. While local revenue bonds do attempt to translate implicit borrowing into explicit debt, raising local governments’ share of fiscal revenue to match their spending responsibilities remains highly contentious. Whether the rule-by-fear lifetime accountability system will induce genuine behavioural change among local officials or simply motivate more innovative ways to bypass the rules, remains up for debate.

Governments and state-owned enterprises (SOEs) often behave as if they are solely responsible for local development, and, in less developed areas, function as the primary growth drivers. Lack of faith in private enterprise, ignorance of market principles and the lure of rent-seeking all contribute to over-leveraging among local governments and SOEs.

'see-saw' economy

stabilisation buys some 'peace' time for gradual reforms through positive incentives

Two years of intense financial deleveraging (end 2016 to end 2018) brought shadow banking into the light; economic stabilisation makes complete shutdown impossible, but the industry is increasingly compliant. While fiscal reform is far from completion, tough penalties and increased borrowing quotas diminish the allure of illegal borrowing. Beijing is also promoting full-fledged budget performance reviews in 2019.

In the near-term, the centre will relax de-leveraging and focus on reorienting government and market institutions that have been slow to respond to top-level emphasis on quality over speed. Carrots will be used more often than sticks to encourage prudent local borrowing, efficient fund usage, and financial compliance. In the longer term, Beijing is betting on industry upgrading and market reforms; the debt problem is being temporarily shelved to buy some 'peace' time for gradual reforms.

profiles

Lou Jiwei 楼继伟

National Council for the Social Security Fund chair and former Minister of Finance

Two issues keep local governments joined at the hip with their financing vehicles, says Lou: first, they often depend on LGFVs to service outstanding debts or contingent liabilities. Second, many LGFVs cannot be marketised because they lack stable, sustainable operating cash flows. The complexity associated with disposing of LGFVs is a major obstacle to central government efforts to discipline local government borrowing.

Chen Dongqi 陈东琪

Chinese Academy of Macroeconomic Research (AMR) expert

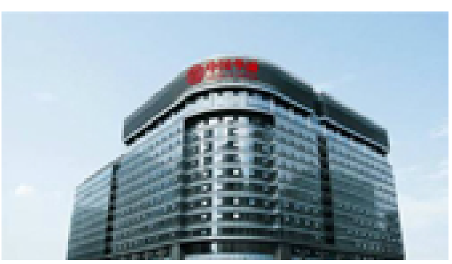
Twice recipient of China's highest economics award, the Sun Yefang prize, Chen is a senior expert on the CPC Central Committee and lectures at Politburo study sessions. His proposals on micro-adjustments and stabilising growth and price levels were well-received among the leadership. Policy should not only target specific problems, he argues, but also consider long-term modernisation. Four key areas of financial control, suggests Chen, are managing systemic financial risks, implementing robust and prudent monetary policies, deleveraging SOEs and zombie enterprises, and ensuring orderly operation of financial markets.

Wang Yongqin 王永钦

Fudan University economics professor

A financial and development economist Wang writes extensively on local government debt issues, asset bubbles and implicit policy bias against small firms. The most important local debt challenge is breaking institutional barriers to enable legal borrowing for local governments. Given considerable spending responsibilities, constraining legal borrowing only incentivises illicit lending through costly financing vehicles. But with the stock market plummeting, rising household and corporate debt risks are more immediate than government liabilities, warns Wang. Local governments still enjoy soft budget constraints and they will not be forced to pay back or go bankrupt; households and private firms do not enjoy this privilege.

'big four' Asset Management Companies (AMCs) 四大资产管理公司



The 'big four' AMCs refer to China Cinda, China Orient, China Greatwall and China Huarong. All initially capitalised in 1999 with C¥10 bn from Ministry of Finance (MoF), they were intended to remove non-performing loans from the balance sheets of major commercial banks, and played a crucial role in the country's first round of debt-for-equity swaps. In the year of their founding, the commercial banking system had a non-performing loan rate of nearly 40 percent, and these AMCs rescued China Construction Bank, China Development Bank, Industrial and Commercial Bank of China, and Agriculture Bank of China. Though initially set to stop operating after ten years, between 2006 and 2008, MoF began transforming the AMCs into financially sustainable and market-driven 'comprehensive financial services firms' focused on asset management. Since then, all have grown into financial conglomerates branching into securities, commercial banking, financial leasing and trust management.

context

21 dec 2018	the Central Economic Work Conference hailed achievements of the ‘three sieges’ but emphasised control, order, and moderation
1 nov 2018	financial de-leveraging was conspicuously omitted in the Q3 Politburo economic meeting, in stark contrast with previous meetings
16 oct 2018	PBoC governor Yi Gang 易纲 first signalled a policy change from de-leveraging to stabilise leverage ratio at the G30 finance conference, suggesting domestic economic stability weighs heavier than international monetary concerns; localities also moved to address their debt problems in October
30 aug 2018	two high-level documents were published to enhance accountability for local borrowing behaviour, after a cross-agency investigation of local debts in July
31 jul 2018	Politburo Q2 meeting marks an official strategic shift from intensive de-leveraging to targeted and moderate expansion, in an effort to counter domestic slowdowns; in the following two months, localities struggle to balance conflicting political agendas between de-leveraging and expansion
27 apr 2018	PBoC and three relevant regulators released ‘Guiding opinions on regulating asset management business of financial institutions’, a critical step to crack down on shadow banking practices disguised as asset management products; this move is also accused of pressuring financial support to the real economy
5 mar 2018	a comprehensive roadmap for winning the ‘three sieges’ outlined in the government work report to the National People’s Congress, emphasising prevention of systemic financial crisis
18 oct 2017	financial risk prevention listed as the first priority of the ‘three sieges’ at the 19th Party Congress
18-25 dec 2015	Central Economic Work Conference first coined the term ‘four reductions and one improvement’ under the mantra of supply-side structural reform, making financial de-leveraging part of the top-level initiative