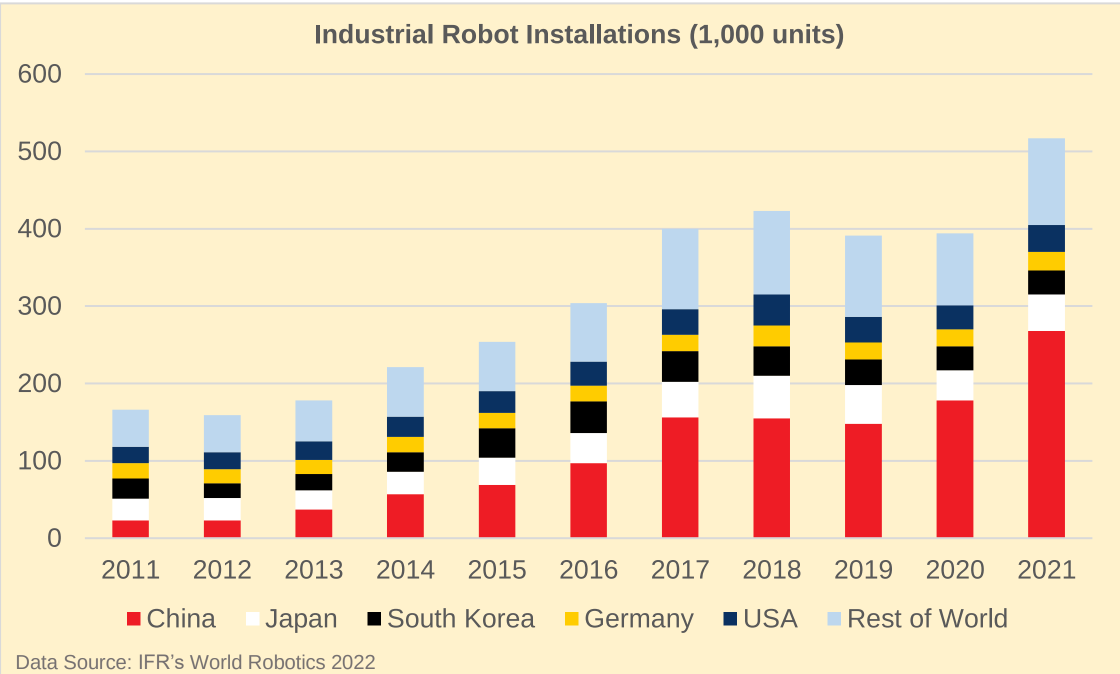
CHINA MONTHLY

SEPTEMBER 2023

The Big Picture



China has made factory automation a core pillar in its efforts to modernize, and in 2021 installed more industrial robots than the rest of the world combined.

September 2023

THE BRIEFING

Hukou Reform

The Ministry of Public Security announced a 26-point package that would lower the bar for individuals to obtain an urban hukou, or household registration, to enable more skilled rural residents to live and work in cities.

Further Border Opening

It will be easier for overseas business travelers to apply for landing visas, including those wanting to visit China for business meetings, exhibitions or investment but are unable to secure the permission before their trip. Foreign nationals would also no longer have to surrender their passports when applying for residence permits in China, a change that would benefit at least 700,000 visitors.

An Easier Time for Home Buyers

City governments will be given leeway to ditch a rule that disqualifies people who have ever had a mortgage – even if fully repaid – from being considered a first-time homebuyer in major cities. The government will also extend till the end of 2025 personal income tax rebates for people who buy new homes within a year of selling their old homes, according to the Ministry of Finance.

Market Support

China's 0.1% stamp duty on stock transactions has been halved, the first reduction since 2008. Margin requirements for securities will also be cut to 80% from 100%, effective after the September 8 market close.

Brics Expansion

The Brics group of Brazil, Russia, India, China, and South Africa discussed deepening the use of local currencies in trade between member states at a summit in South Africa in August. "The world is undergoing major shifts, division and regrouping... it has entered a new period of turbulence and transformation," President Xi Jinping said. "We should let more countries join the Brics family to pool wisdom and efforts to make global governance more just and equitable," he said.

Private Capital Tech Ban

The Biden administration will ban some US investment into China's quantum computing, advanced chips, and artificial intelligence sectors, under an executive order that will come into force in 2024. The action will largely affect private equity and venture capital firms, as well as US investors in joint ventures with Chinese groups.

A NEW ECONOMIC PATH

By Tan Kong Yam

Executive Summary

1) China's extremely high national savings rate at 46% of GDP has been invested in real estate and infrastructure. Since 2008, this excessive investment has further ballooned, diminishing returns on assets and total factor productivity. As China continues to deleverage over the next five years, annual GDP growth could fall by one to two percentage points.

2) China's severe Covid lockdown seriously damaged consumer confidence, while tighter party control over the past several years has eroded the confidence of private sector business leaders, manifested in declining private sector investments. Hence, growth has been weak since April 2023, though there are tentative signs in August of green shoots sprouting — rises in real imports and auto sales, as well as improving consumer confidence, among others. Stripped of volatile food and energy prices, core inflation has been positive and rising, indicating no deflationary pressure.

3) The danger of a Lehman moment is much less likely in China due to the high down-payments of 20%-40% on mortgages that are full recourse, the government's significant leverage over the key borrowers and lenders, the central government's robust balance sheet and its regulatory and administrative power over the state-owned banking system.

4) The policy priority is to shift away from the old development path of excessive investments in bloated real estate and infrastructure, to investments in hard tech, EVs, advanced manufacturing, new energy and materials, healthcare, medical equipment, as well as life sciences.

5) With the enduring slogan of "common prosperity", there is also a clear policy focus on income redistribution measures and improving household welfare to enhance consumption as a new engine of growth. Over the medium term, this would mean addressing the underlying causes of such a high household savings rate, by strengthening the country's social welfare system, enhancing the pension system, widening unemployment insurance, increasing health care subsidies, and bolstering health insurance. These could be financed through more effective personal income tax collection, which in China is equivalent to only around 1% of GDP, compared to over 10% in Italy and around 7% for Spain.

6) The old growth model served the interests of corrupt local officials and their cronies, private property developers, as well as members of the wealthy, urban, upper middle class who owned multiple properties and did not pay their fair share of income and wealth taxes.

7) China's new development model is more inclusive, blazing a fresh path. During this three-to-five-year transitional period of deleveraging, annual growth would likely be more moderately paced at 3.5%-4.5% as China sheds the drag from its bloated real estate sector and over expansion in infrastructure. As these excesses get gradually flushed out, confidence will steadily recover, and return to a more sustainable pace of around 5%.

8) For most of the Chinese population, especially young people who are currently priced out of the property market, the urban lower middle class, and rural peasants, this post-Covid economic model would benefit them far more than the previous distorted and unbalanced development model. The upshot is that it would not only strengthen the legitimacy of the Party but would create a more stable and fairer society.

(I) Structural Problems of a Real Estate and Infrastructure Overhang

Deep Savings Pool

At 46% of GDP, China has one of the highest national saving rates, according to the World Bank's data. Cross-country data from the OECD (Organisation for Economic Co-operation and Development) as well as the IMF (International Monetary Fund) indicate that China's households set aside some 35% of their disposable income as savings, much more than the United States' 15%, the EU's 13% and Japan's 10%.

This pile of savings needs to be invested. It was relatively easy 15 years ago, when China's GDP could grow about 8%-10% annually, largely as it was catching up with Western technology and productivity. A rapidly growing economy can make efficient use of huge amounts of capital, investing in infrastructure and capital equipment. But as China has started to approach upper-middle income level, the scope for rapid productivity gains has steadily narrowed.

However, China is presently still trying to invest over 40% of GDP, which is no longer possible given steadily declining growth.

Various researchers, especially at the World Bank, have pointed this out earlier. This looming issue has been obvious for a decade or more. However, China was able to mask it, largely by allowing an immensely bloated real estate and infrastructure sector.

In the earlier years of my travels throughout China during 1993-2007, from my observations of its infrastructural and real estate development, it was clear to me they were contributing significantly to China's actual development and enhancing the productivity of the nation's capital. I remember visiting the ancient cities of Luoyang and Kaifeng in Henan province to study the spread and influence of Buddhism in China. The first highway linking the two cities was at that time recently built, and greatly facilitated transportation, trade, and domestic tourism. Train stations, bus terminals, railway tracks, and highways in the central and western regions were expanding and contributed to their rapid integration into the national market, lowering transport costs and driving an economic boom.

I believe China's greatly under-reported, gigantic CNY4 trillion (USD586 billion) fiscal stimulus to combat the effects of the Global Financial Crisis in 2008 was a turning point. The government asked the state banking system to open the spigot, and local governments were encouraged to embark on infrastructural expansion and real estate development. Almost overnight, investments skyrocketed.

I also remember visiting a third-tier city in Hunan in 2013 and was amazed by the local government building that looked like the United States Capitol in Washington, DC. In Chengdu, the local government constructed a huge cluster of ostentatious buildings that collectively resembled a lotus flower when viewed from the air.

A 2015 photo of an abandoned local government building modelled after the United States Capitol in Wuhan, Hubei province.

This huge explosion of construction that started in 2008 grew at a rapid pace, breadth, and scale over the subsequent decade. Throughout China's second- and third-tier cities, there were proliferations of iconic city squares with integrated malls with restaurants, cinemas, garden terraces, entertainment outlets, and hip coffee shops.

Real Estate and Infrastructure

The over exposure of households to the real estate sector is also exacerbated by the limited options for their investments, due to capital controls, low yielding bank deposits, and a volatile retail-driven stock market. This ocean of national savings also facilitated massive investments in infrastructure by local government officials, eager to impress Beijing with stellar economic performances.

Around 2014, one of my students who was the mayor of a city of about five million showed me around and told me the boom would boost his future promotion. When I asked about the debt and maintenance costs, he smiled and remarked that those would be somebody else's problems.

Not surprisingly, capital productivity eventually led to diminishing returns. This is manifested in the decade-long decline in returns on investment. World Bank data indicates that China's incremental capital output ratio, which measures investment efficiency by quantifying the marginal amount of capital needed to generate the next unit of output, had rapidly increased from 3.3 in 2007 to 7.4 in 2020. Goldman Sachs, and UBS analysis showed that returns on assets had also declined: private sector returns dropped sharply from 9.3% in 2017 to 3.9% in 2022, while SOE returns fell from 4.3% to 2.8% over the same period.

Not surprisingly, China's growth in overall efficiency in the use of factors of production (total factor productivity, or TFP) slowed as well. Separate analyses by the World Bank and the Brookings Institution indicated that TFP growth in 1980-2000 contributed some three and a half percentage points to growth, or about a third of the total 10% growth rate. Not surprisingly, this contribution has declined to less than one percentage point in the decade of 2011-2020, or less than 15% of the overall GDP growth of 6.9% in that decade.

Consequently, China has been compelled to deleverage; highly leveraged balance sheets and high debt servicing costs are burdening the economy, especially in the central and western provinces.

Fortunately for China, most of the debt is renminbi debt, not in foreign currencies, as was the case in Latin America and several ASEAN (Association of Southeast Asian Nations) countries during the Asian Financial Crisis of 1997. The fallout of this debt restructuring, which may involve some defaults, would need to be managed well. Beijing will have to balance the deflationary effects of sustained deleveraging against the inflationary forces from credit expansion and monetization.

The Communist Party of China's July Politburo meeting reinforced this message, with the top policymaking body pledging to "put a floor under the property sector, help indebted local governments heal, and boost consumer demand." The July Politburo meeting also called for policies to "better meet the rigid and improved housing needs of residents and promote the stable and healthy development of the real estate market".

Regardless, real estate will likely continue to be a drag on China's growth for the next 3-5 years. A paper by Kenneth S. Rogoff and Yuanchen Yang in 2020 concluded that the sector is quite vulnerable to a sustained aggregate growth shock such as Covid.

In their baseline calibration, using input-output tables and taking account of the very large footprint of housing construction and real-estate related sectors, the adjustment to a 20% decline in housing activity can easily trim a cumulative 5%-10% of output over a few years. Assuming this adjustment is spread across five years, the real estate market downturn will trim about 1%-2% percentage points from GDP growth per year.

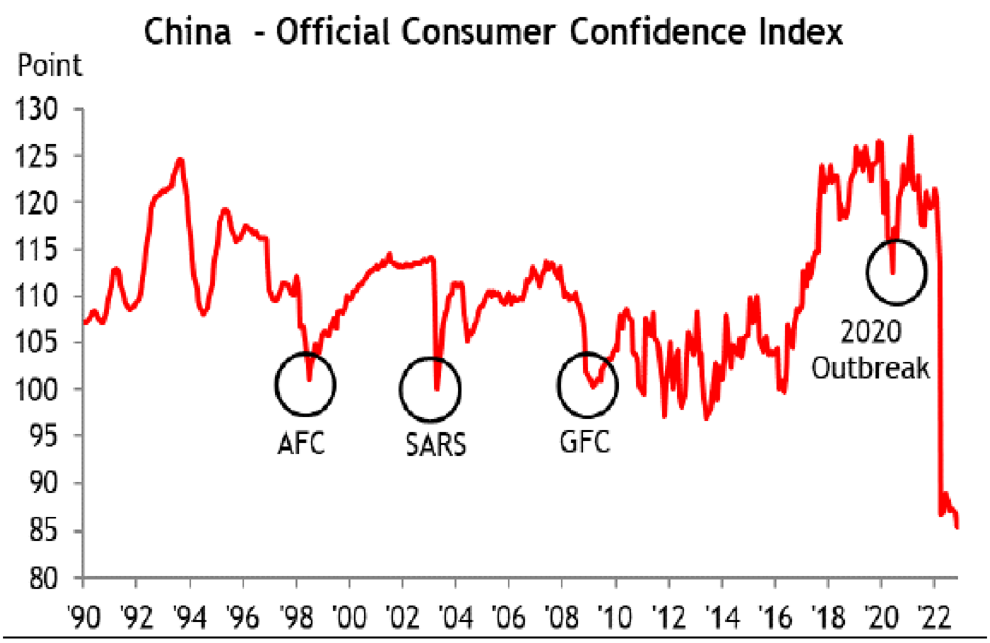
The central government's present policy appears to focus on managing the deleveraging process well, without triggering a serious economic collapse or precipitating a financial crisis. With its tremendous regulatory and administrative control over both the property and financial sectors, either crisis is avoidable.

If growth deteriorates further as the year progresses, more forceful stimulus measures can be expected. The most obvious firepower for such a stimulus plan would be to draw on the coffers of the central government. Unlike local governments, the central government still has much capacity to spend as its debt-to-GDP ratio stands at only 22%. In addition, China has the published foreign reserves of USD3.2 trillion as of July 2023 and substantial unpublished reserves hidden in the state-owned banking system.

(II) The Collapse of Consumer and Private Business Confidence

After three long years of gruelling Covid lockdowns, China is like a car left in the garage for too long — the battery is flat and Beijing needs to give the car a strong jumpstart to get it moving again.

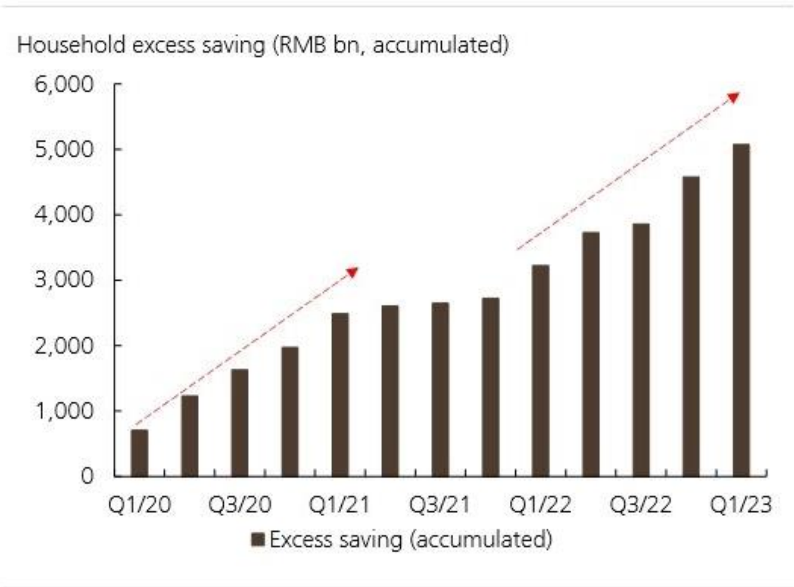
From what we can tell, the government's decisive measures are critically needed for restoring confidence in business and in consumption, which is lower than the period during the Asian Financial Crisis, SARS, and the Global Financial Crisis.



Source: National Bureau of Statistics, CEIC, Maybank IBG Research

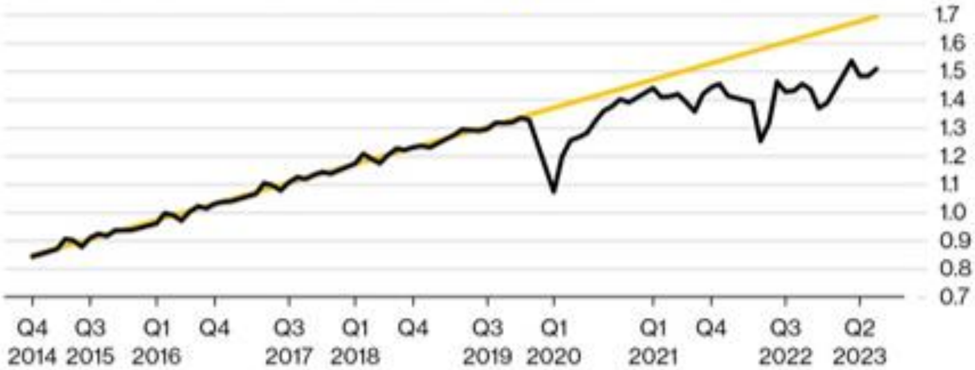
The central bank's regular urban depositor survey of 20,000 depositors in 50 cities saw its employment sentiment index softening to 37.6% from 39.9% in 1Q, while the employment expectation index slid below 50% to 47.8%, from 52.3%. As a result of weaker employment prospects and subdued income expectations, 58% of respondents showed inclinations for higher savings, same as in 1Q but much higher than the pre-Covid level of 45%.

Household excess savings continue to rise



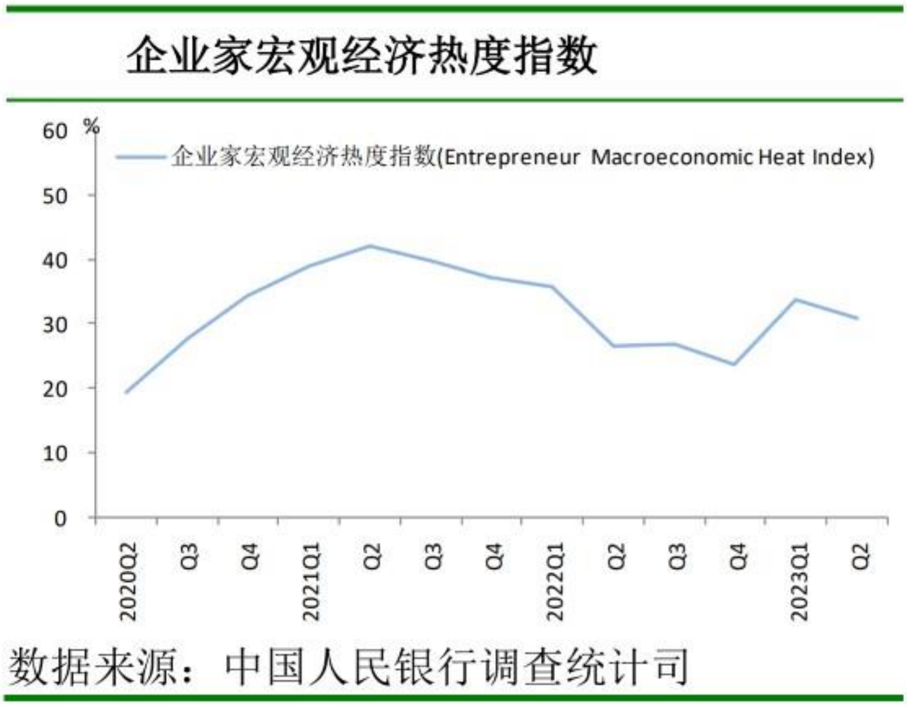
Source: CEIC, UBS-S estimates

As China's excess savings continue to rise, its consumption recovery has been significantly below trend.



Source: China National Bureau of Statistics; Bloomberg
Note: Index where March 2017=1

The central bank's quarterly survey on the confidence level of private entrepreneurs has also been weakening since the lockdown in 2022.



Source: PBOC

Reflecting this, the growth rate of private fixed asset investment, which accounts for more than half of total fixed asset investment, naturally dropped from 23.1% in 2013 to 10.1% in 2015 and fell even further to 4.7% in 2019, and deteriorated to a 0.2% contraction in the first half of this year. Having spoken to a fair number of these private businesses in both China and Singapore, their fear is understandable. Recent government actions seem to be widely perceived as being anti-business. This malaise may have been gradually building up over the past decade.

Consequently, while growth in the second quarter was 6.3% YoY due to the low base last year, it was less than 1% QoQ, due to the sharp fall in consumption to 15%, from the 33% surge in the previous quarter after Covid lockdowns were lifted.

There are, however, signs of green shoots sprouting in August.

The decline in imports had been wrongly interpreted. China's imports slumped 7.6% in the first seven months of 2023 due to lower energy and other raw material costs rather than weakened demand. Import volume has steadily recovered. In June, import prices fell by 8.5% while value fell by 2.6%, indicating an increase in volume of about 5.9%. In volume terms, imports in 2023 have been steadily rising, and actually expanded 1.0% in the first seven months, compared with a decline of 6.4% in the same period last year!

There are other signs of stabilization or improvement in August:

Growth Metric	July, YoY	First 20 days of August, YoY
Port cargo throughput	4%	8%
Port container throughput	2%	7%
Steel production	6.4%	8%-9%
Auto retail sales	-5%	5%
Auto wholesale sales	-6%	8%

Logistics continues to improve as growth of the Full Truckload (FTL) traffic index rose to 14% YoY in the first 24 days of August, from 1% YoY in July. Subway passenger turnover stayed elevated at 71 million person-times, with YoY growth largely stable at 36% YoY in the first 24 days.

Consumer confidence while still fragile, seemed to have rebounded in August, sustaining the trend since January 2023. It is however too early to decipher an uptrend.

Recovery of the Internet Platform Sector

The clampdown on internet platform companies over the past few years has shaken private sector business confidence.

"Look forward.” That was Premier Li Qiang’s message to internet platform companies at a July 2023 symposium that he presided over. According to a CCTV report, the heads of companies such as Meituan, Xiaohongshu, Haizhi Online, Huolala, Alibaba Cloud, XCMG Hanyun, Douyin, and Zhaopin successively delivered speeches at this symposium.

This was a strong signal from the Premier that the authorities' crackdown on these companies had come to an end, though it is still a rough road to rebuilding trust between the authorities and the companies.

Having brought the sector to heel, the party now needs their support in the intensifying rivalry with the US. The new thinking is: “Under the circumstances, why don't you let him go to work?”

Not surprisingly, Tencent’s revenue has registered double-digit growth in the first half of this year.

No Sign of Deflation

The media outlets have been harping on impending doom for China, that deflation in July 2023 was that start of the “Japanification" path. However, while they have been careful to highlight the need to strip out volatile food and energy prices in examining core inflation in the US, they have been less scrupulous in examining China’s inflation.

The widely noted 0.3% decline in consumer prices in July 2023 compared with a year ago was mostly due to elevated food prices in the same period last year. In particular, July’s average pork price, a big CPI component, stayed flat from June, but retreated -26% YoY from a high base. Stripping out volatile food and energy prices, core inflation in July actually rose 0.8%, up from the 0.4% increase in June.

The preliminary August data suggests that an economic recovery may have begun, though it is still very fragile. The authorities will still need to work harder to boost confidence. Actions are needed to stop weakening consumer and private business confidence feeding into each other in a downward spiral.

The present government policy under Premier Li Qiang is working diligently to help consumer and private business confidence recover. In the event of a more serious downturn, the main line of defence, apart from the central government’s robust balance sheet, the state-owned banking system will be China’s critical last line of defence.

China’s four largest banks are state-controlled, unlike the behemoths on Wall Street, as well as in London, Zurich, and Frankfurt. Their critical weakness is the distortions in the bank financing system. However, unlike Western governments and their private sector banks, it is much easier for Beijing to direct its “big four” banks to work together to forestall a systemic threat. The government also has significant leverage over the key borrowers, whether they are private or state-owned real estate companies, trust funds, as well as players in the large shadow banking system. No party would be able to shout “fire”, precipitating a catastrophic panic and a rush for the “exits”.

For this reason, plus the high downpayments of 20%-40% on mortgages that are full recourse[1] (similar to many EU countries and unlike US mortgages), China stands in stark contrast to overleveraged mortgages and strategic defaults in the 2008 GFC debacle. China is less likely to experience a Lehman moment.

(III) New Development Strategy

The Politburo of the Communist Party of China (CPC) generally holds a meeting at the end of each month, usually in the morning, with a group study in the afternoon. From January to July 2023, the CPC’s Politburo should have held seven such meetings, but party media only reported on five of them, and reported on only two afternoon group study sessions.

[1] In full recourse mortgages, a lender can pursue the borrower's other assets and income sources to recover the remaining debt, should the collateral property's value be insufficient.

A close reading of media reports on official pronouncements in the first three months of 2023 indicates that the Politburo was not focusing on the economy and might not have been aware of economic difficulties.

On April 28, the Politburo held a meeting and finally focussed on economic headwinds.

It admitted that the 4.5% year-on-year GDP growth in the first quarter was "mainly restorative"; “facing new resistance"; but still believed that "…the triple pressure of demand contraction, supply shock, and weakening expectations has been eased, economic growth is better than expected, market demand is gradually recovering…”.

The tone was still confident, with regards to the economic recovery’s prospects, indicating that the Politburo did not anticipate a serious economic slowdown.

From June, there was a visible change in the Politburo’s tone.

On July 19, following several weeks of meetings by Premier Li Qiang and several government agencies with private industry, the Central Committee of the CPC and the State Council jointly released an opinion on supporting the private sector.

Whenever these two bodies release a joint document, one should pay attention. This is because they are far more authoritative than those released by lower-level state and party bodies.

On July 21, President Xi Jinping presided over a symposium for non-Party members in Zhongnanhai and delivered a speech. Xi asked people outside the party to "further unify their thoughts and actions with the analysis and judgment of the CPC’s Central Committee on the economic situation." He also asked them to "actively offer advice and suggestions for the political leadership".

At July’s monthly NDRC press conference, an official said China’s economic recovery is still facing tepid demand, weak momentum, and low confidence. The NDRC said it would promptly formulate and roll out policies to restore and expand consumption, mainly aimed at stabilizing consumption of bulk commodities, increasing demand for automobiles and electronics products, expanding rural demand. The NDRC also aims to stabilize the job market, in particular to address youth employment.

China's Ministry of Commerce followed with the announcement of an 11-point plan to boost the consumption of consumer goods and services. The 11 measures set out how companies will be encouraged to develop online platforms for the provision of household consumer services such as furniture leasing, how local governments should step up the renovation of old homes, and how financial institutions should increase credit support for household consumption.

Premier Li Qiang had spent many years in Wenzhou earlier in his career. There are numerous modern private sector firms there, hence his close relationship with private enterprises. In March 2023, he mentioned the indomitable "four thousand spirits" of Zhejiang merchants, who are no stranger to "traveling through thousands of mountains and rivers, speaking a thousand words, trying thousands of means, and suffering thousands of untold hardships" (走遍千山万水、说尽千言万语、想尽千方百计、吃尽千辛万苦) to do business. He gave the assurance that future policies to support the private sector would not change and urged local officials to continue supporting the private sector.

Li Qiang's relationship with Xi is by no means ordinary, otherwise he would not dare go off-script with his remarks. On the one hand, Li Qiang always defends Xi in his remarks and says things to strengthen Xi's position. On the other hand, he had not shied away from sharing his inner thoughts.

What Type of Capitalist Does Xi Want?

On 13 November 2020, President Xi sent an unmistakable signal to the private business community. Xi made the remarks while visiting Nantong Museum during his inspection tour in eastern China's Jiangsu Province. Xi viewed exhibits introducing Zhang Jian (张謇), founder of the museum and a Chinese industrialist and educator in the late 19th century and early 20th century. Xi learned about how Zhang ran businesses that benefited the nation, developed education, and took part in public welfare activities. Xi praised the late Chinese industrialist as a model of all Chinese private entrepreneurs.

Xi himself has often said that private companies should be "rich and loving," be "patriotic", and share the fruits of their growth with employees more equitably.

No Stimulus Deluge

With the benefit of hindsight, the government took on too many vested interests at the same time. The "three red lines" policy for the real estate market was closely followed by the attack on the internet platforms and private after school tutoring (AST). Together with the harsh and prolonged Covid lockdown, serious damage was inflicted on the confidence of consumers as well as private sector business leaders.

The slowdown in growth has caught the attention of the authorities, but they are as yet still short of launching an all-out stimulus plan. Clearly, they are constrained by the excessive build up in the real estate and infrastructure sectors. Rather, the July 2023 Politburo meeting on economic work reiterated the "Proactive fiscal policy and prudent monetary policy" phrase already included in the report of the Central Economic Work Conference of December 2022.

The solution lies, according to the Politburo, in restoring confidence, promoting domestic demand, stimulating innovation, speeding up the construction of a modern industrial system and "high quality" growth, and focusing on emerging industries such as electric vehicles (EVs).

The policy priority is to shift away from the old development path of excessive investments in real estate and infrastructure, to investments in hard tech, EVs, investments in advanced manufacturing, new energy and materials, healthcare and medical equipment, as well as life sciences. At the opening ceremony for new cadres in the Central Party School in March 2022, Xi admonished: “Some people believe that development means investing in projects and scaling up investments,” while warning, “you mustn’t walk the old path with new shoes.”

Eventually, the future growth model will continue to mobilise savings but divert them away from over-investment into real estate and infrastructure. One example is automobile manufacturing, where China overtook Japan as the world’s largest car exporter in 1Q 2023. In 2015 China exported under 375,000 cars a year, fewer than India, and about as many as Germany and Japan shipped in a single month, according to The Economist.

Bad debt from the real estate sector as well as infrastructure projects would need to be handled, either as bad debt on banks’ balance sheets or carved out to asset management companies. This settlement of bad debt will eventually have to be paid for indirectly, through a lower return on bank deposits.

With the enduring slogan of “common prosperity”, there is also a clear policy focus on income redistribution measures and improving household welfare. In terms of policy, this would mean addressing the underlying causes of such a high household savings rate, by strengthening the country’s social welfare system, enhancing the pension system, widening unemployment insurance, increasing healthcare subsidies, and bolstering health insurance. Since 2000, the government had increased its share of health care spending from the mid-teens to almost 30% a decade later, reducing the burden of the population in their out-of-pocket payments, which had fallen from 60% at the turn of the century to 36% by 2018. Social and commercial insurance accounted for the remainder.

However, compared to less wealthy countries like Argentina, Brazil, Mexico, and Turkey, China’s spent a smaller share of its GDP on domestic general government health expenditure in 2020, according to the World Bank’s data. Hence, there is still substantial scope for China to increase healthcare subsidies to make households feel more secure, trimming savings rates and boosting domestic spending.

These improvements in China’s social safety net could be financed through more effective personal income tax collection, which in China is equivalent to only around 1% of GDP, compared to 12% in Canada, over 10% in Italy, and around 7% for Spain, due to rampant under-reporting of income and tax avoidance. A revamped social safety net would effectively put more money in the hands of middle-class people who are more likely to spend it. That would be effective, sustainable redistribution, to moderate China’s savings rate and boost its long-term consumer demand.

The old growth model served the interests of corrupt local officials and their cronies, private property developers, foreign private-equity investors, as well as members of the wealthy, urban, upper middle class and some private business owners who own multiple properties and did not pay their fair share of income and wealth taxes.

This new development model envisages a more inclusive growth model and a new growth path for China. During this three-to-five-year transitional period of deleveraging, annual growth would likely be more moderately paced at 3.5%-4.5% as China sheds the drag from its bloated real estate sector and over expansion in infrastructure. This transition will be painful and fraught with risks, particularly at a time of global geopolitical challenges. Deft policy skills would be needed to manage consumer and private business confidence, as well as financial sector stability.

As these excesses and distortions are gradually flushed out, confidence will steadily recover, and return to a more sustainable pace of around 5%.

I had travelled throughout all the 31 provinces, and after visiting hundreds of cities and villages over the past 30 years, I believe I have a good feel of the thinking and sentiment of the Chinese. For about 75% of the Chinese population, especially young people who are currently priced out of the property market, the lower and middle class in the coastal, central, and western regions, and the peasants in the vast rural areas, this post-Covid economic model would benefit them far more than the previous distorted and unbalanced development model. The upshot is that it would not only strengthen the legitimacy of the Party but would create a more stable and fairer society.

Dr. Tan Kong Yam is a founding member and Deputy Chairman (China) of APS Asset Management. He is also professor of economics at the Nanyang Technological University. He serves as a board member at the Changi Airport Group (2015-present). From 1985-88, he was the chief assistant to Dr. Goh Keng Swee, the late Deputy Prime Minister of Singapore who was invited by Mr Deng Xiaoping to advise China on economic development strategy. From June 2002 to June 2005, he was a senior economist at the World Bank office in Beijing. In 2004, he was a member of the World Bank expert group on the eleventh five-year plan (2006-2010) for the State Council in China. He served as the chief economist of the Singapore government (1999-2002).