A(nother) Window for Reform Opens in China

We would argue that the current widespread and heightened concerns about capital flight and imminent severe economic and financial dislocations in China are likely overstated. While its economy has slowed down, and will continue to do so, the current financial stress primarily reflects the impact of financial sector reforms, especially the premature opening of the capital account in bringing the underlying imbalances to the fore.

As such, these developments and stresses have greatly amplified the urgency of structural reforms—especially in the state-owned enterprise (SOE) sector. Therefore, the upcoming National People’s Congress (NPC) meeting in March 2016 is a litmus test to initiate a more robust SOE reform agenda; considering the elevated and clear risks of sticking with the status quo, we consider it likely that these reforms will indeed commence.

Together with recent moves to regain monetary policy independence—by de-pegging the currency and re-tightening capital controls—and to raise fiscal deficits, the authorities are building in macroeconomic policy space to cushion and absorb the adverse impacts of capacity cuts on domestic demand. Looking ahead, these impacts may include those that come via further flexibility of the exchange rate.

Given the considerable time that has passed and the rising costs from a lack of action, this paper puts forth some benchmarks for reform in China that investors may find of interest over the coming months.

A recent trip to China triggered some cognitive dissonance: for once, the skies over Beijing were clear, the air was fresh, and even key macroeconomic data had stabilized or even rebounded. Yet, the gloom deepened among investors; the equity market sold off, and widespread concerns about the exchange rate and imminent “hard-landing” frequently appeared on the front pages of many foreign newspapers. Just as a clear January sky does not mean an end to Beijing’s air-quality concerns, poor stock market performance and investors’ sullen moods may not signal an impending crisis. While the following points recognize China’s challenges, we lay out a constructive view for the year ahead. We close the circle by noting that the obvious challenges now could imply less resistance to critical structural reforms going forward.

In many ways, rather than a sharp turn for the worse in the underlying economic situation, we are instead witnessing the results of the particular Chinese approach to economic reforms. In the past, outside observers, ourselves included, had stressed the importance of proper reform sequencing, i.e., undertaking financial liberalization—especially the opening of the capital account—only after key structural reforms were completed, particularly those in the SOE sector. Otherwise, improper sequencing could give rise to a substantial increase in the risks to financial stability and material capital outflows.

As it happens, the Chinese authorities have chosen the opposite sequence, liberalizing financial markets and increasing the openness of the capital account before embarking on meaningful structural reform. To some extent, this was a conscious choice, counting on the resulting heightened pressures, especially from capital account liberalization, to galvanize politically difficult reforms, particularly those within the SOE sector.
In our opinion, we have now reached the point where the political difficulties of SOE reform may be comparatively less than the costs of staying with an unreformed growth model, exemplified by sharply falling stock prices, rapidly declining international reserves, and indeed, what looks like a slow-burning balance of payment crisis. Our baseline scenario is thus that SOE reforms are now able to proceed considering the alternative of further delay simply seems too onerous.

SOE reforms, especially cutting excess capacity in the sector, are so important because they are a key driver of very high (and still rapidly rising) debt in China—which in our view is the country’s most important vulnerability. In particular, the need to finance loss-making capacity in large SOEs, such as those in the coal, steel, cement, and aluminum sectors, has resulted in the simultaneous occurrence of rising debt and falling GDP growth and is the reason why the effectiveness of past stimulus attempts has been decreasing. Cutting capacity will therefore be an essential element in curtailing the need for additional leverage and the further accumulation of bad debt.

While this is not a novel observation and investors’ expectations for substantial SOE reform have not been met so far, we think this situation is different given the now obvious pressures from an unreformed growth model. That said, sufficient progress will depend entirely on Chinese leadership’s commitment to launch on-the-ground structural reform after years of preparation. We are hopeful and expect that the upcoming NPC will launch a comprehensive SOE reform program.

Of course, immediate, dramatic progress in SOE reform remains unlikely. In the initial stage, there may be attempts to solve excess capacity via mergers and acquisitions, or centrally planned and ordered competitiveness programs, which are unlikely to work. However, over the subsequent months, we expect greater acceptance of direct capacity cuts, be it via bankruptcy or closures.

While this reform scenario appears optimistic at the current juncture, in addition to the heightened pressures to proceed implied by poor sentiment and capital outflows, it is also in line with Chinese history. In particular, the three most recent major reform drives in the late 70s, 80s, and 90s were undertaken after similar significant growth slowdowns that also involved large scale job losses.

Clearly, the most important constraint to reform is unemployment, especially given the fact that industries with excess capacity are not evenly distributed geographically, but are concentrated in regions with less economic heft. Thus, any indication that the authorities are providing measures to buffer the fallout from large-scale layoffs (e.g., via funding mechanisms for unemployment or early retirement transfers) would be an early, positive sign. In this regard, it should also be kept in mind that China is not the first country that has had to trim excess capacity, especially in sectors such as coal and steel; the experience of Western European economies in the 1960s and 1970s offers some useful lessons, e.g., with respect to the design of social safety nets.

Successful SOE reform would subsequently permit the economy to initiate a needed deleveraging phase, allowing productivity to rise as resources are more efficiently allocated. This would be the cornerstone of alleviating concerns about the sustainability of China’s growth.

**Conclusion**

With that backdrop, it is fair to say that our essentially constructive view outlined above is not in line with investors’ currently elevated concerns about a hard landing for the Chinese economy in 2016. When discussing hard-landing scenarios, however, we think it is important to clarify the concepts involved. To the extent that the term implies a significant growth slowdown, this is already happening, driven largely by the difficulties of the Chinese manufacturing sector. While official statistics may struggle to pinpoint the actual numerical extent of the structural shift and slowdown in Chinese growth, we think lackluster global demand, particularly the sharp slowdown in global trade, is strongly indicating that Chinese growth has already slowed substantially.
So, in addition to this slowdown, a hard landing would require an additional trigger, e.g. large-scale disruptions of asset prices, uncontrolled exchange rate depreciation, and/or significant financial and banking system instability that could result in a further leg down in growth and a consequent increase in global risk. From our perspective, this is still very much a tail risk for 2016 that the authorities can avoid with their policy buffers at hand.

Indeed, we continue to view the authorities’ permitting of higher headline fiscal deficits and attempts to rebuild their macroeconomic policy arsenal—by decoupling from a FX-peg regime and re-tightening capital (as well as some current account) controls in order to regain monetary policy independence—as incrementally helpful in building flanking support for reform in the context of the ongoing slowdown. Even so, the case for progress is urgent, and structural reform is key in staying clear of the risk of a hard landing beyond near-term stabilization with traditional macroeconomic policy tools. As laid out above, given the obvious urgency expressed in sentiment, financial prices, and capital outflows, we believe that a window has now opened for reforms to begin in earnest in 2016—the alternative is becoming too dire.
Source(s) of data (unless otherwise noted): Prudential Fixed Income as of February 2016.

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