Old Problem with New Syndrome: China’s Slowing Down and Instability

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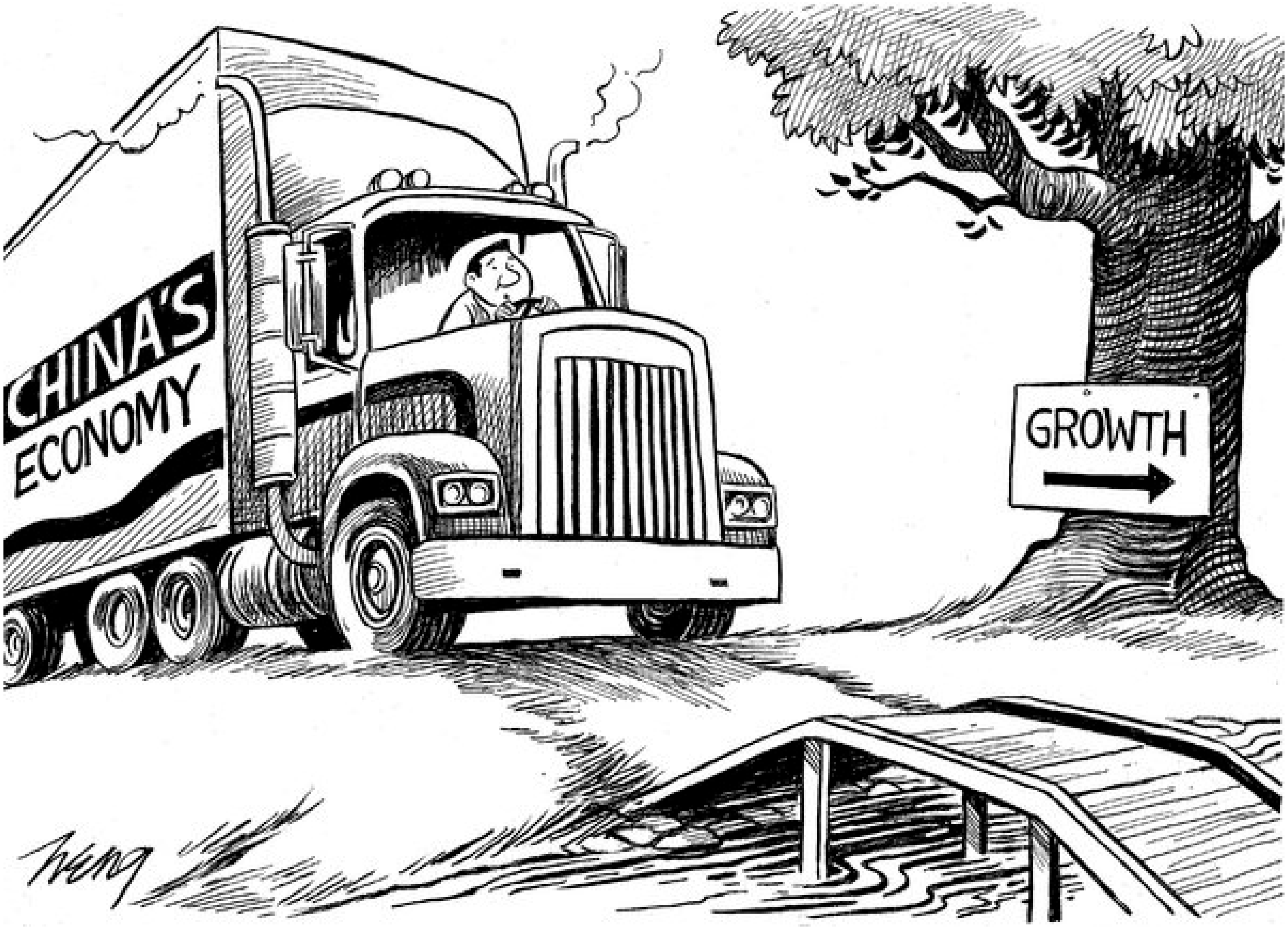
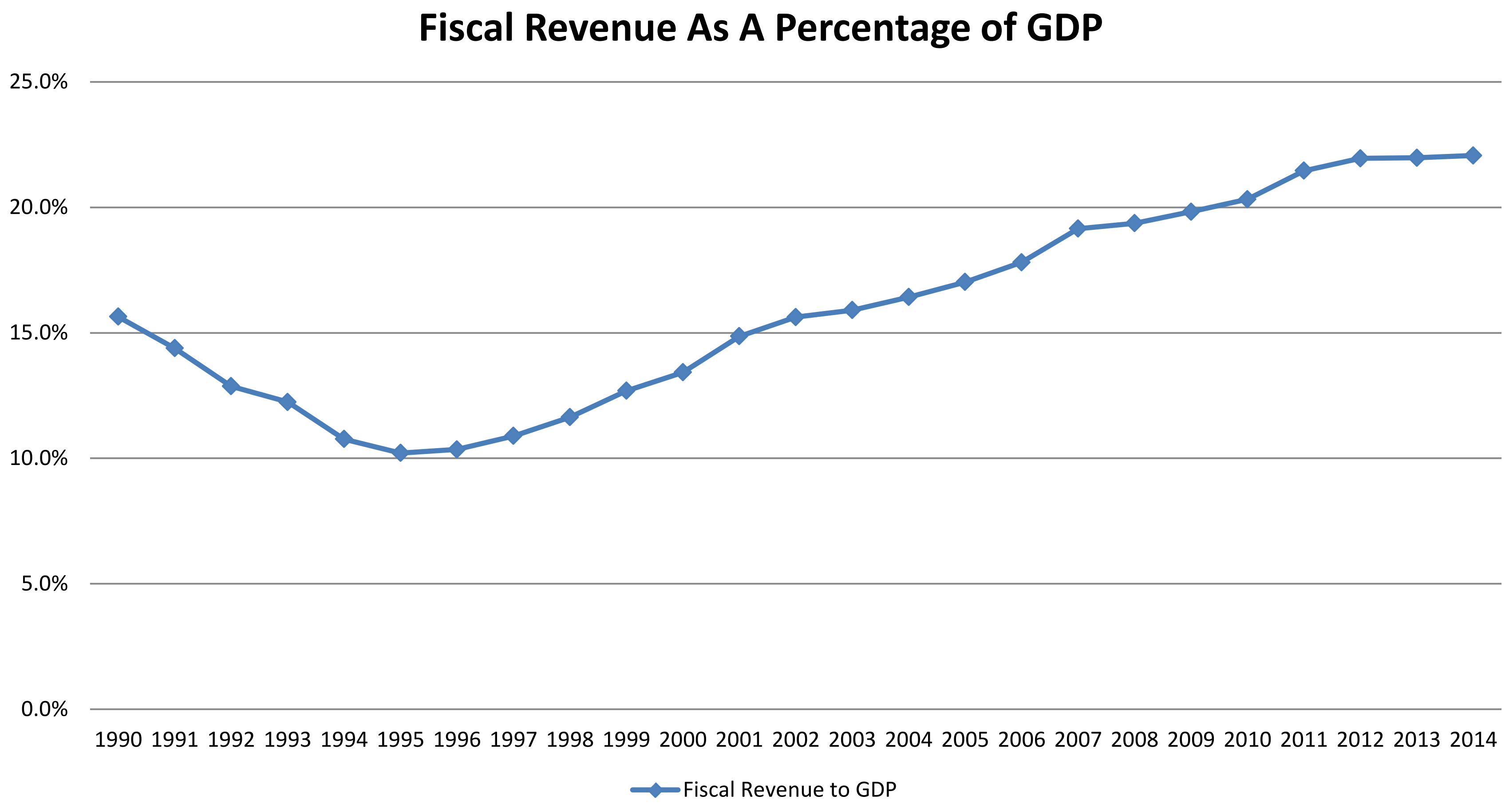
In addition to slowing down, Sustainability and stability? (NY Times, 11/13/2015)



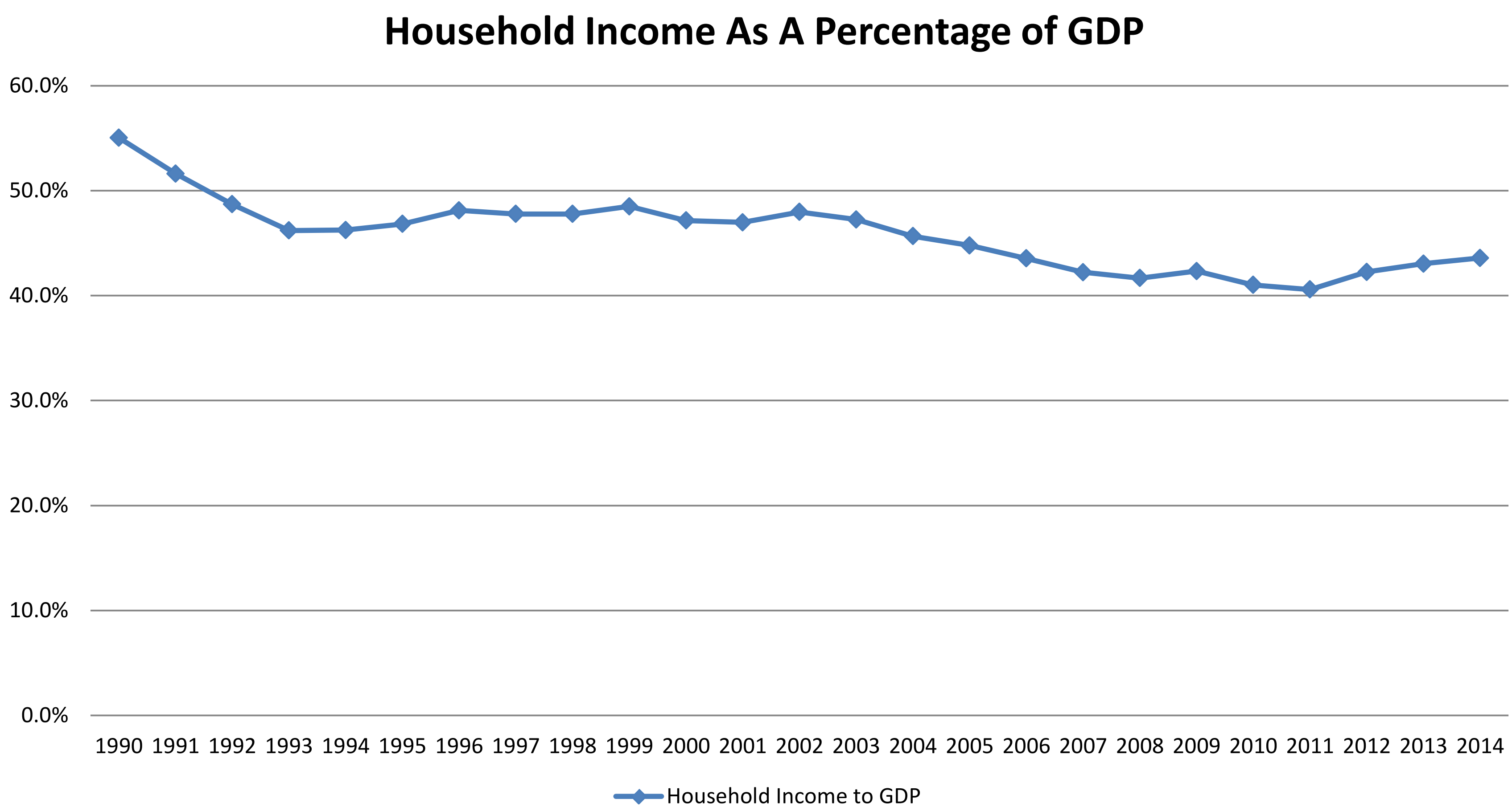
The institutional cause of China's slowing down and instability

- Old problem: Lack of commitment to the promises
  - Institutional reasons determine the lack of commitment
  - Soft-budget constraint (SBC): a major syndrome of lack of commitment
- New: Crowding out ⇨ Low domestic demand ⇨ slowing down
  - Fiscal revenue/GDP ↑ => household income/GDP ratio↓
  - High land prices crowd-out SMEs and service industry
  - Inequality => majority Chinese households' demand is low
  - State monopoly: banking, energy, highway-railways, IT provision
- New: Instability
  - Local government finance: Real estate + local debts
  - Institutionalized Corruption; Environmental problems
- New: Unconstrained government manipulates financial market
  - Bubbles created by government's manipulative policies
  - Bailing-out the market by extra-legal means

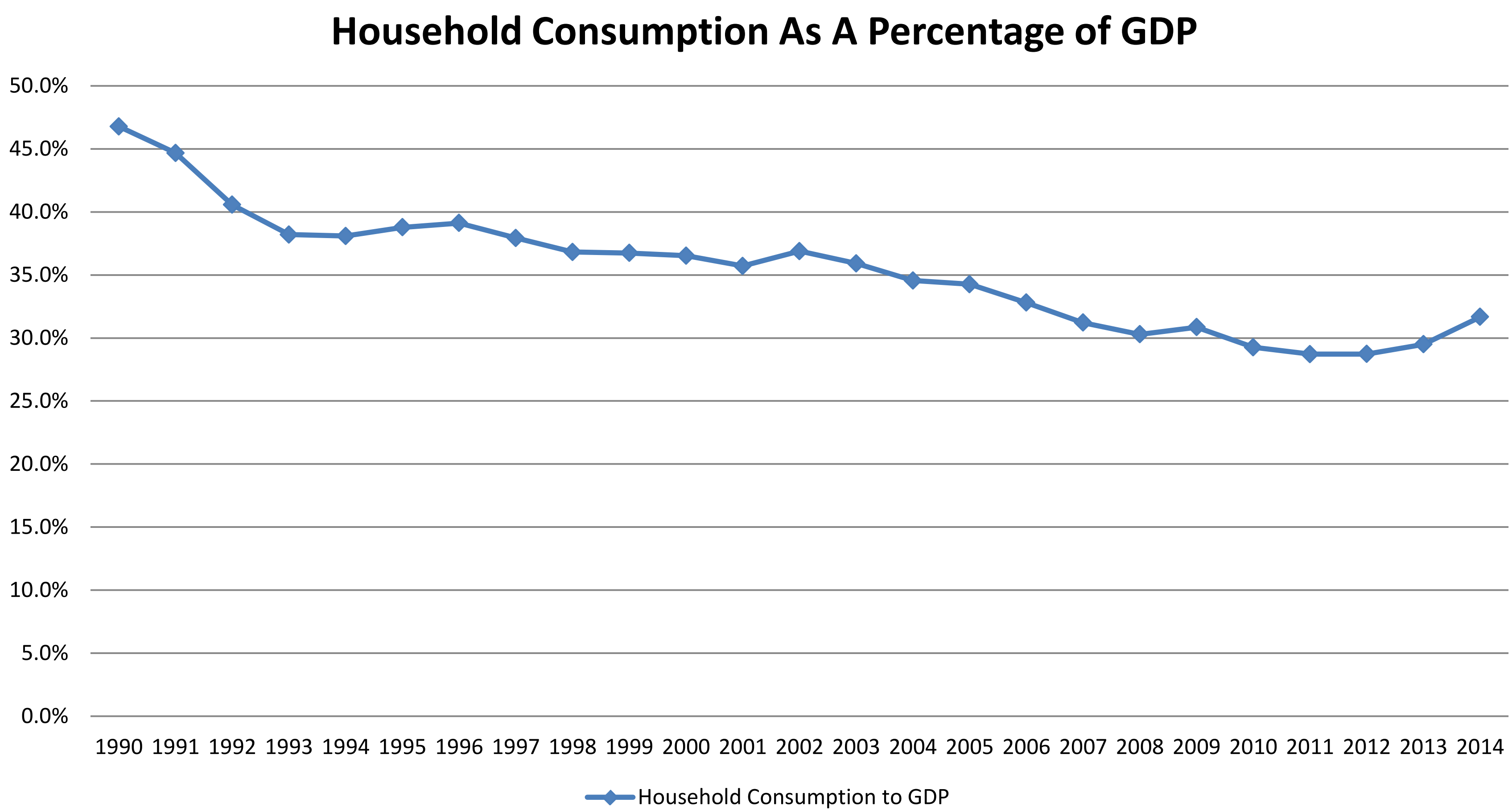
Fast Growth of Fiscal Revenue Crowd-out Household Income & Private Sector



Low Household Income Leads to Low Domestic Demand



Low Household Consumption Leads to Low Domestic Demand

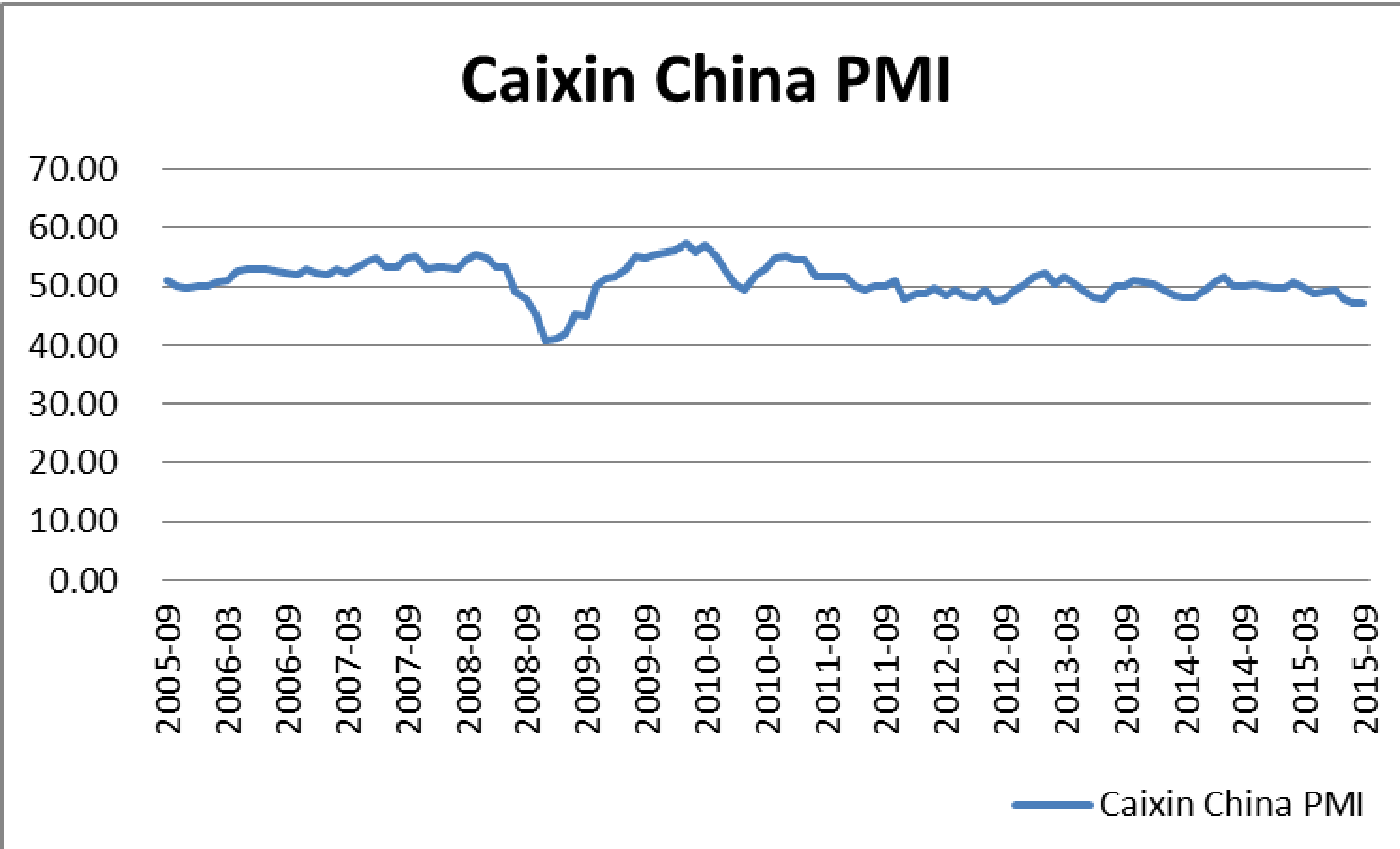


Consumer spending declines since 2012

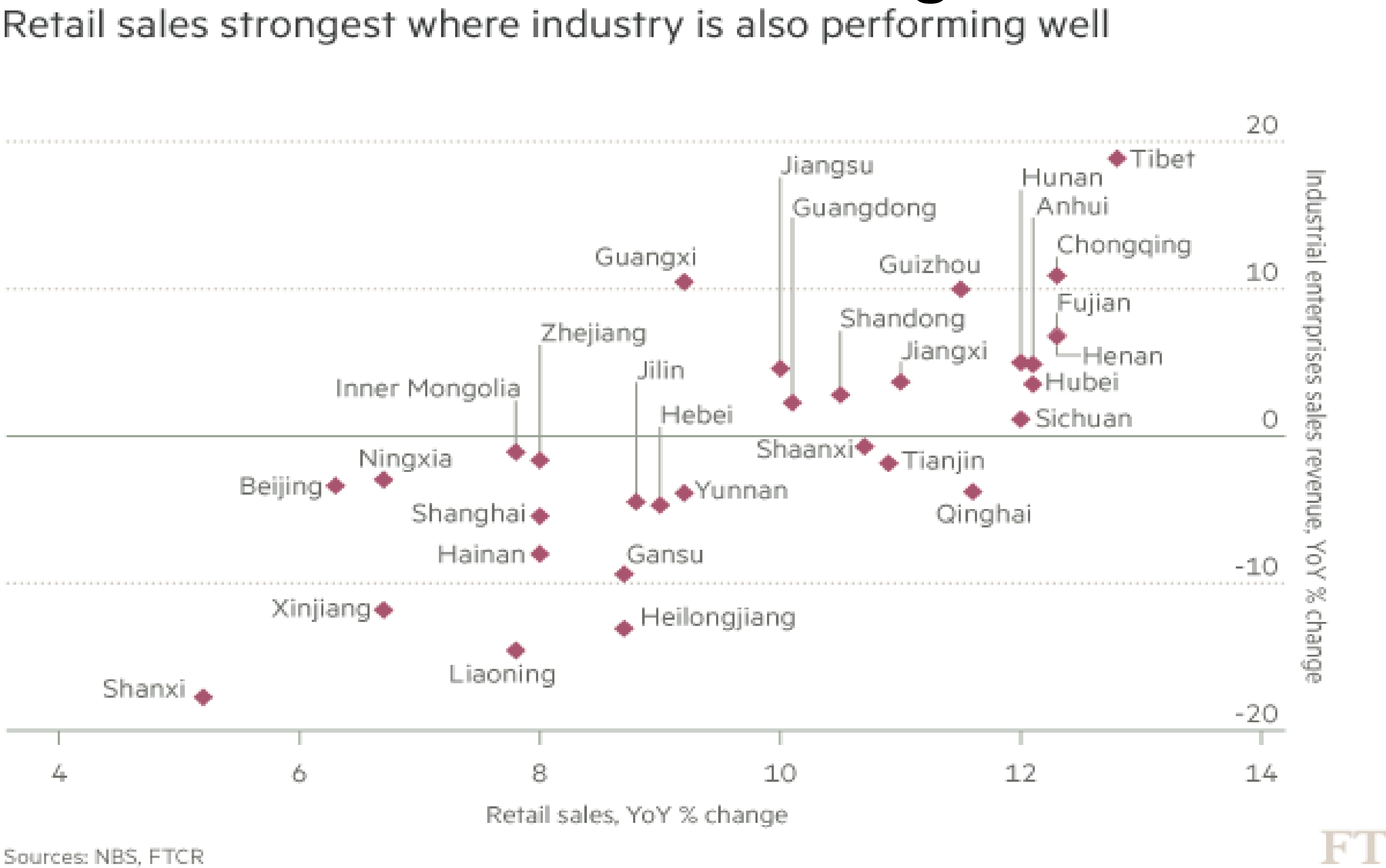
FT-Chinese 13/11/2015

- China UnionPay Index: consumer spending data from UnionPay bank cards
  - 100 = 2011 level
- FTCR Index: FT Confidential Research survey data on Chinese consumers discretionary spending
  - 50 = no change

Continuous contraction indicated by Purchasing Managers Index



Correlated Contractions between industrial sales and retailing sales (FT, 11/13/2015)



SBC: High leverage, over-capacity

- Reasons of persistent deceleration of Chinese economy
  - Over-capacity fueled by high leverage
  - High leverage threatens stability of the system
  - Why over-capacity and high-leverage issues keep worsening？
- The mechanism of high-leverage: SBC
  - SOEs + local governments: expect government bailing outs when becoming insolvent
  - Moral hazard problem created by the lack of bankruptcy threat: no discipline, “investment hunger”

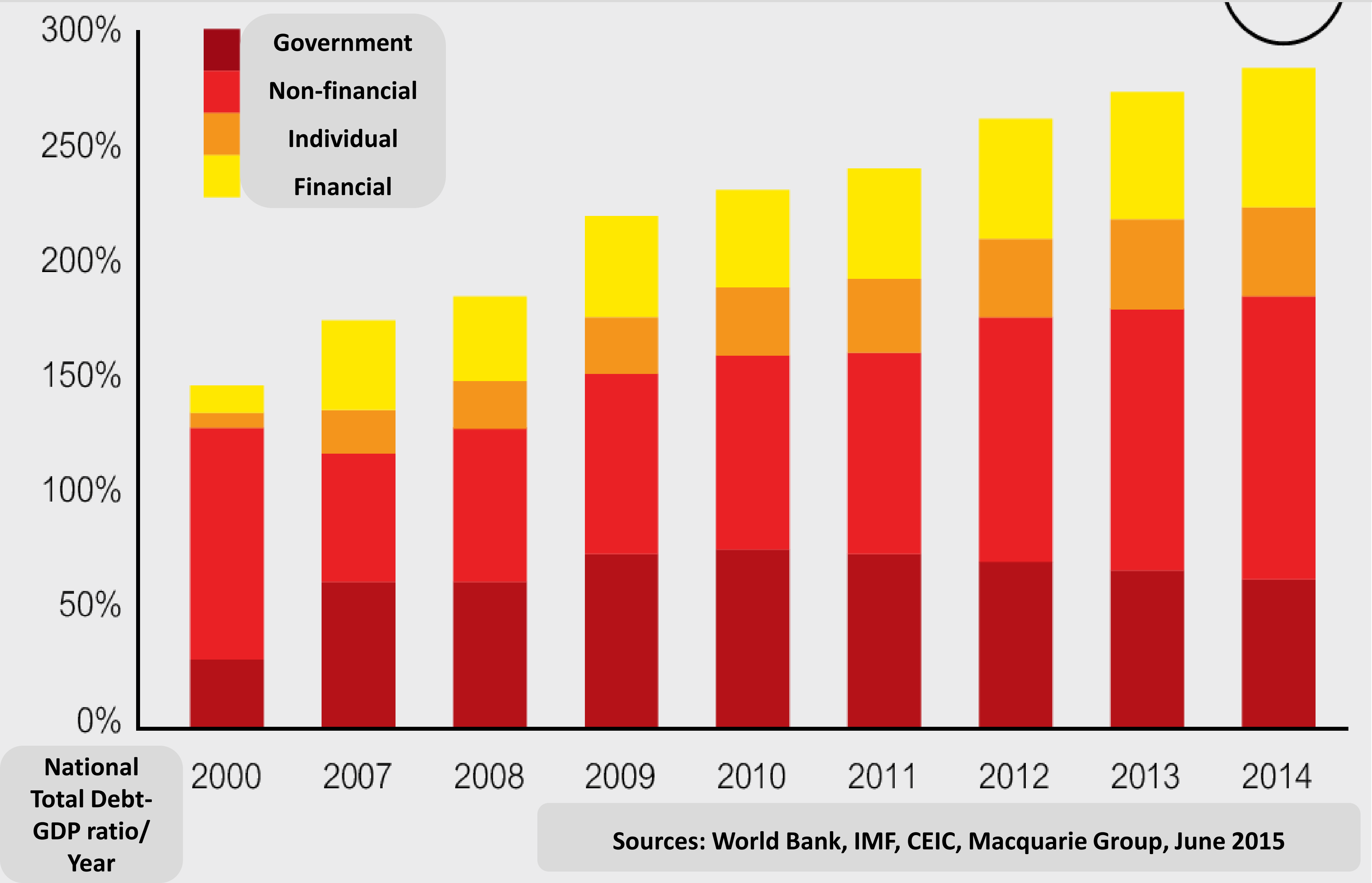
China’s temporary remedies of the SBC

- Hardening budget constraints in the 80s-90s
  - The private sector becomes China’s largest sector
  - Large scale privatization of small-median SOEs
- Easing SBC syndrome at beginning of the 2000s
  - Stripping non-performing loans from state banks
  - Large scale capital injection to state banks
- But the institutions for SBC find new ways to grow
  - Large SOEs become larger and stronger
  - Local governments directly control lot more resources via land
- Effects of the remedies in dealing with the SBC
  - Laid down foundations for rapid growth
  - The pressure from SBC to the economy was greatly reduced during 2000-2007
- The disease of SBC worsened rapidly under-noticed when the “China model” was promoted confidently
  - Particularly driven by local governments and large SOEs

Old problem with new syndrome: SBC

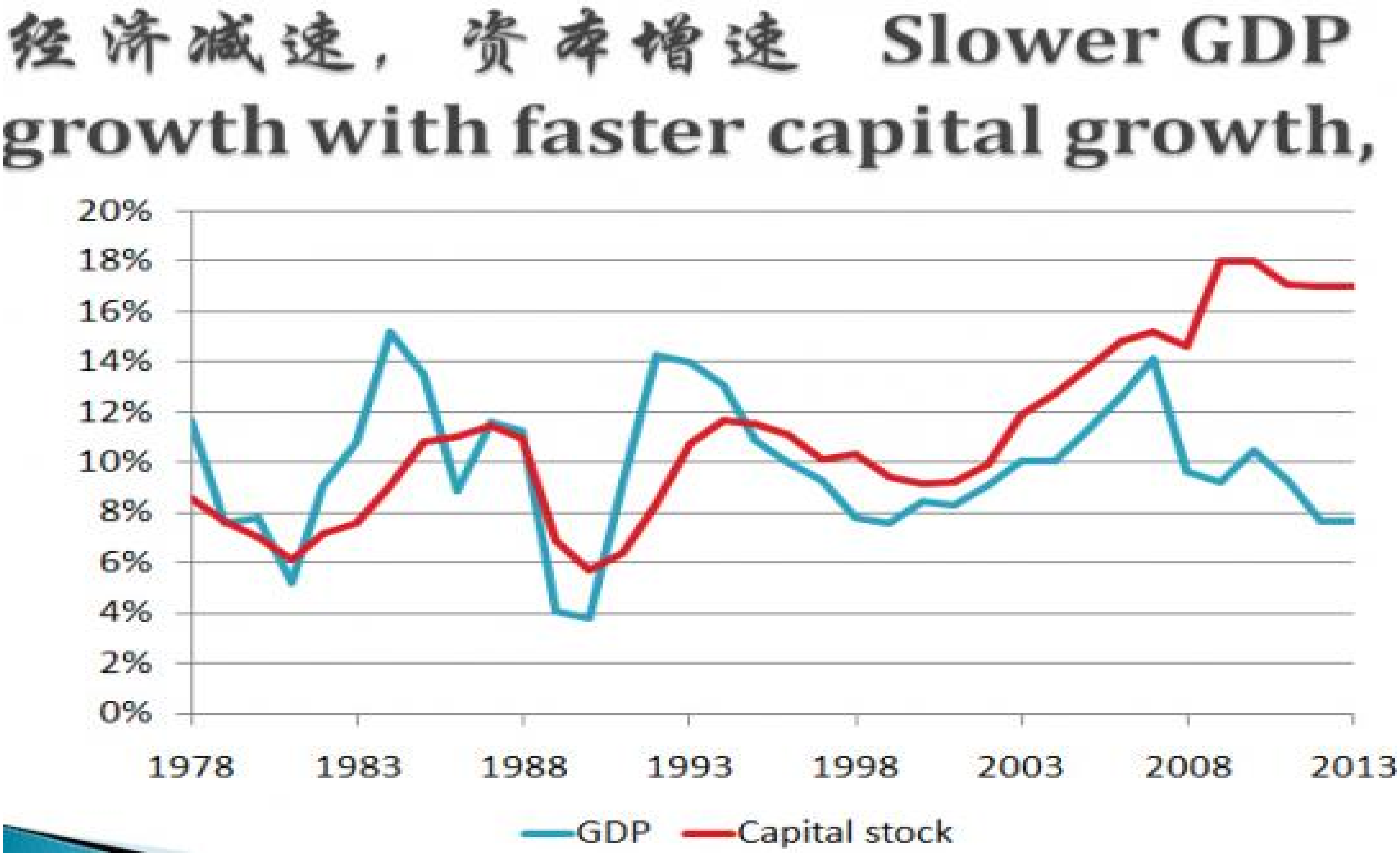
- Triggered by the 2009 fiscal stimulus policy, expecting helps from the central government, local governments (LGs) and SOEs invented new ways of accelerating leverage
- LGs borrowed bank loans > 3 trillion RMB
  - Backed by land collaterals
  - Financial innovation: Government Financing Platform (GFP), SOE
- SOEs' fast expansions supported by debts
  - Also government supported non-SOEs
- In mid 2014, the total national debt exceeded 172 trillion RMB, the total debt over GDP ratio reached 282% (McKinsey, 4/2015)
- Over capacity is an outcome of the leveraged expansion
  - By 2014, China contributed 37% of the global over-capacity (OECD)
  - 2012-14, 41% of the increased production capacities are from China (*WSJ)*

China's Total Debt-GDP Ratio(%)



Sources: World Bank, IMF, CEIC, Macquarie Group, June 2015

Growth rate divergence between investment and GDP since 2007 (Wang Xiaolu, 2015)



Declining Capital Productivity (Wang Xiaolu, 2015)

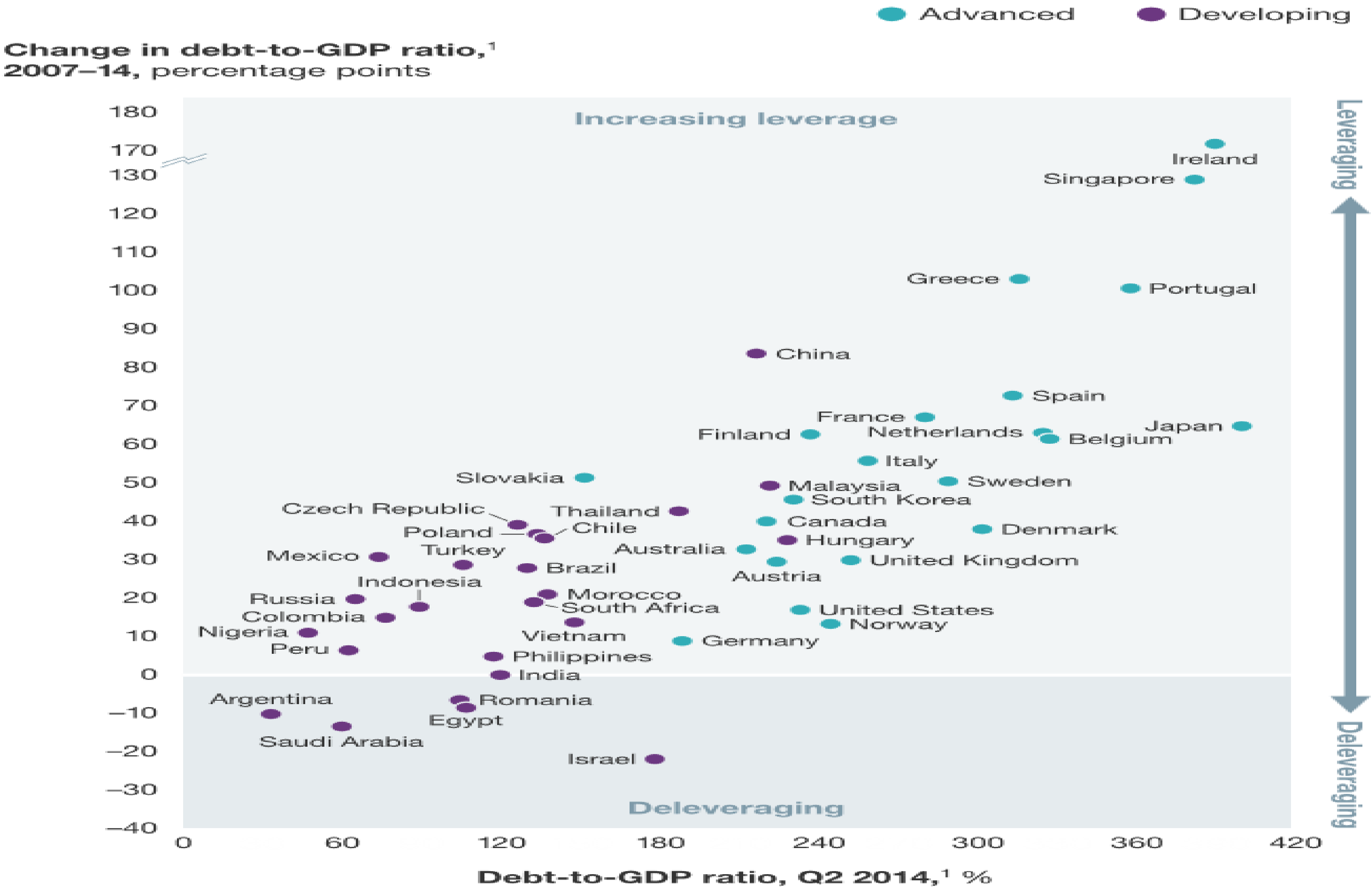
资本生产率下降 Rapid drop of capital productivity

	APK	MPK
1980	0. 454	0. 499
1990	0. 480	0. 328
2000	0. 505	0. 468
2010	0. 376	0. 234
2013	0. 297	0. 146

Alarming: The accelerating rate of the leverage and the nature of the debts

- Leverage has been rapidly accelerating since 2008
  - The debt-GDP ratio increased from 76% to 282% in 6 years
  - Leverage has been accelerating regardless deleveraging policies in recent years
    - 6 trillion new debts by SOEs in Sept 2015 （10%）
- The nature of the majority debts are fragile
  - Most of the debts are bank loans backed-up by collaterals
    - When collaterals’ values decline => banks’ balance sheets
  - Different from the US subprime mortgage: majority borrowers are municipal governments and SOEs
- When profits/asset-value decline, how to repay debts?
  - SBC: government will bailout by lending more
  - Municipal debt-swap scheme as a rescue
    - Issuing new debts in bonds to repay old debts

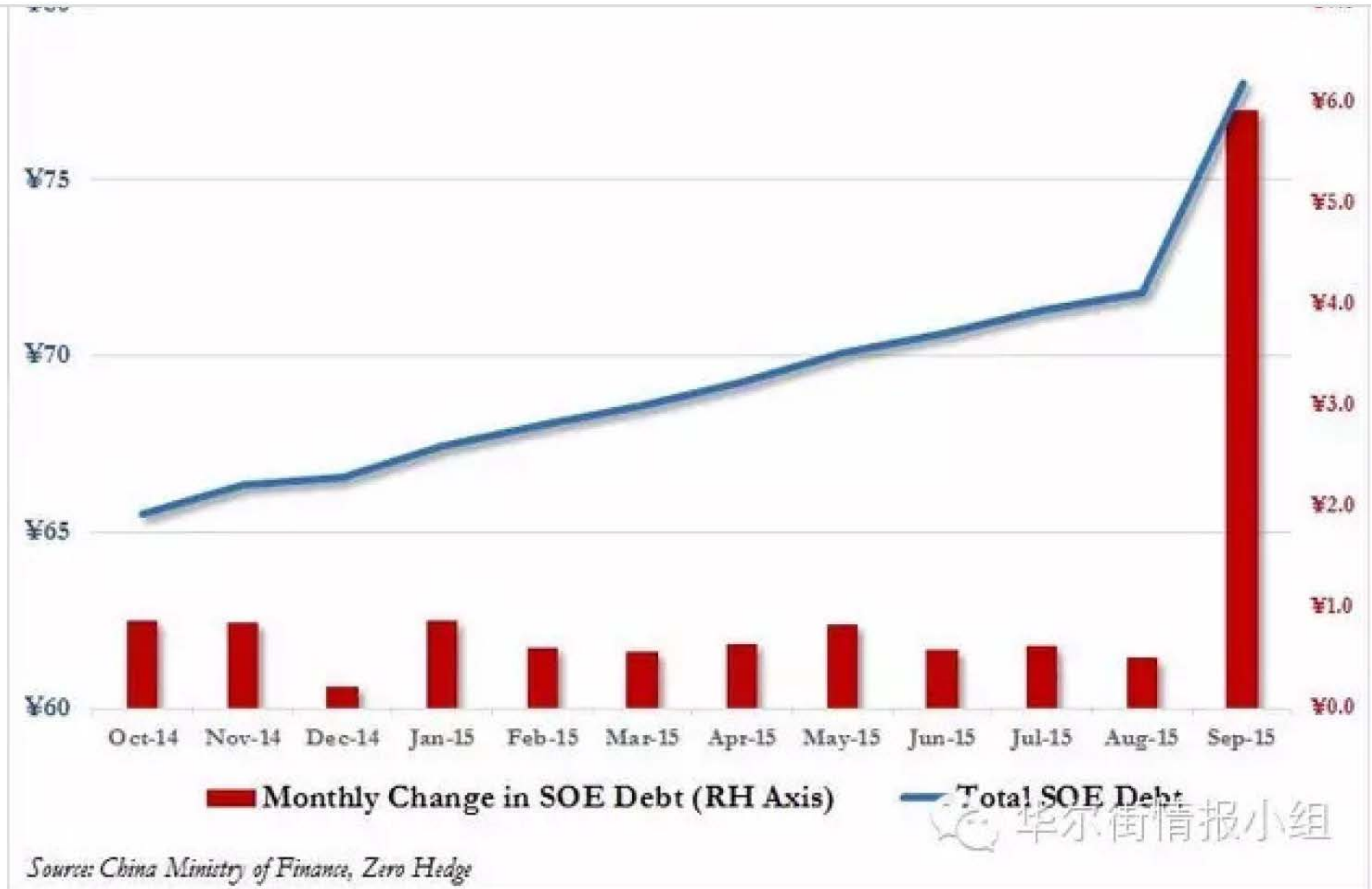
Leveraging speed vs. debt-GDP ratio (McKinsey, 2015)



[1] Debt owed by households, nonfinancial corporations, and governments; Q2 2014 data for advanced economies and China; Q4 2013 data for other developing countries.

Source: Haver Analytics; national sources; McKinsey Global Institute analysis

Drastic increase of SOE debts in 9/2015



SBC in China's Securities Markets

- A new type of SBCs
  - Insolvent listed state-firms do not go bankruptcy, are not delisted
  - Government inject capital to lossmaking listed state-firms
    - Capital injection via government organized merger/acquisition
    - Using SBC approach to mislead market
  - Non of "the Shanghai Old 8 Stocks" (the earliest listed companies) was delisted although many of them run into deep financial problems (Li, FT-Chinese 2015/11/3)
    - After many rounds of government organized merger/capital injection, their businesses have been substantially altered
    - Using capital injection and policy promises the government push up their stock prices
- HBC is a necessary condition for securities market
  - Market discipline: share prices of loss making firms go down => bankruptcy
  - Shareholders' rights: the majority of the listed firms have to be profit making firms

Understanding the SBC: No commitment to ex ante promises

- Lack of a promise on HBC at the first place
  - No credible promise in reform plans that insolvent SOEs and local governments will go bankruptcy
    - Insolvent local governments never go bankruptcy
    - Insolvent SOEs very rarely go bankruptcy
  - CCP 18th Congress reform plans do not concern SBC problem
    - But concerns on losing of state assets
- Commitment problem is determined by institutions
  - Necessary condition: the separation of powers; and the separation of property rights
  - Without a reform in this direction implies no commitment

Commitment problem at large: from SBC to Financial Regulation

- The state has to commit not to use financial market as its political or policy instrument
  - SBC is only part of the syndromes
- Independent judicial system is the fundamental commitment for the state to protect private property rights
- Finance is legally constructed (Pistor, 2013)
  - Financial assets *are* contracts that their values depend on their legal vindication (Bradley 1902)
  - Legal rules, their enforcements by courts and regulators determine which financial assets will be vindicated
- Under independent judicial systems **without state regulation** LSE and NYSE etc. supported industrial revolutions
  - The legal base of later introduced state regulation is private law
- Financial market without judicial independence

No commitment => destabilize the Market Failed "Financial Reform"

- The economic reform plan of the 3rd Plenum of the 18th Congress of the Chinese Communist Party tried a "financial reform" without touching judicial independence issue
- Institutional problem (legal infrastructure) of financial development is missing in the plan
- No commitment to the statement "respecting markets"
  - Financial market is a policy target and an instrument
  - A misdiagnose on the fundamental of the economy
- Moreover, the reform plans overlook low household income-low domestic demand issue
- focus on supply side, e.g. finance, innovation, "one road one belt", …

Financial Market Crash with China characteristics

- The same as any financial market crash: bubble burst
  - But the creation of the bubble has China characteristics
  - The way to rescue the market shows China characteristics
- The financial market regulator is part of the executive branch of the government
- The executive branch of the government is not constrained by the court and by the law
- The government tries to use financial market as policy instruments with comprehensive plans for many purposes
  - They thought they can control/manipulate the market
- Since the late 2014, the government coordinated manipulative efforts aiming to push up market performance: a man-made bubble

An Orchestrated Policy Bull Market 政策牛

- Coordinated propaganda by Party mass medias, examples from *People's Daily*
  - Announced in Dec 2014 that "the reform bull" is arriving, and the SSE Composite Index will be far higher than 4,000
  - Published two influential articles on 30 Mar 2015: stock market is entering the bull market regardless of pressures from the fundamentals; stock market booming will create huge bonus to the economy
  - Published an interview to an authority on the front page on 25 May 2015: the fundamental is good; the bull market will at least last for 3 years
- The policy's impacts to individual investors and net-citizens
  - Baidu search keywords "人民日报 牛市"：15+ million results
  - Baidu search keywords"政策市"：1 + million； "炒股要听党的话"：0.64 million； "暴力救市"：2 + million

The Failure of the Great leap forward in Stock Market

- Regulations are greatly loosened to encourage margin trading and leverage facilities are provided
- Margin trading dramatically increased
  - About 1 trillion products in the stock market are highly leveraged
- During the crash, after failures in manipulation and control, the government relies on violence to bailout the market
  - The Chinese call it as Violence bailout "暴力救市"
  - Send police head to Shanghai Stock Exchange
  - Invention of a crime called "hostile short" (恶意做空)
- Financial regulation becomes farther away from law enforcement

Institutional solution to commitment problem

- Any institution that concentrate all powers into one body creates commitment problem
  - Without institutional constraints to his power, even a benevolent dictator will often breach his promises “for the better”
- Separation of powers and dominance of secured and dispersed private property rights are the necessary institutions to solve the commitment problem
  - Institutional constraints to the government imposed by separated mutually independent powers force the government commit to its promises
    - It is also a condition for security of property rights
  - Dominance of secured and dispersed private property rights determine HBCs
- Centralized financial regulation alone will NOT solve SBC and commitment problems

Thank you！