Reversing China’s slowdown - policy options and constraints

Insights from trip to Shanghai, Ningbo, Taizhou - January 2019

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Summary

- Impact of reduced credit growth, off-balance sheet, shadow banking de-leverage policy from government, pre-dates trade war slowdown and disproportionately hit private sector demand / consumer sentiment in 2018.

- Local business representatives see no quick fix on trade discussions and are delaying investment plans.

- Pro-growth policy moves expected but significant constraints due to already high debt ratios, and fiscal deficits running above targets. High RMB loan growth relative to foreign currency reserves limits debt driven GDP growth.

- Reform questions being asked as State Owned Enterprises appear to be crowding out the private sector.
  SOE return on capital approximately half that of private enterprises.

The content of this presentation is based on a series of meetings in China held in January 2019 with local academics, ex PBOC representatives, listed and unlisted financials, listed export manufacturing companies, Regional business representatives, Fin tech founders, Chinese technology / AI start-ups, China equity and bond analysts, Regional and global long only investors, Hedge fund managers.

Additional sources for research are FT, WSJ, The Economist, Moody's, IMF, Reuters, Bloomberg, George Magnus publication, UBS China banks research.

De-leveraging policy and trade tensions causing slowdown

1) De-leveraging policy

i. Introduced in 2017, predates the trade discussions, as PBOC reduces shadow credit supply and restrained overall credit expansion with significant impact for private enterprises. Downward pressure on consumption and household expectation of wealth shrinkage.

ii. Moody's report points out that China's shadow banking sector contracted by RMB3.6 trn in the three quarters to 30 September 2018 to RMB62.1 trn, with the broad shadow banking sector in China now totalling 70% of the country's GDP compared with 79% at the end of 2017, and the peak of 87% at the end of 2016.

iii. New 90-day delinquencies rule shift of a portion of special mention loans to NPLs (KPMG China).

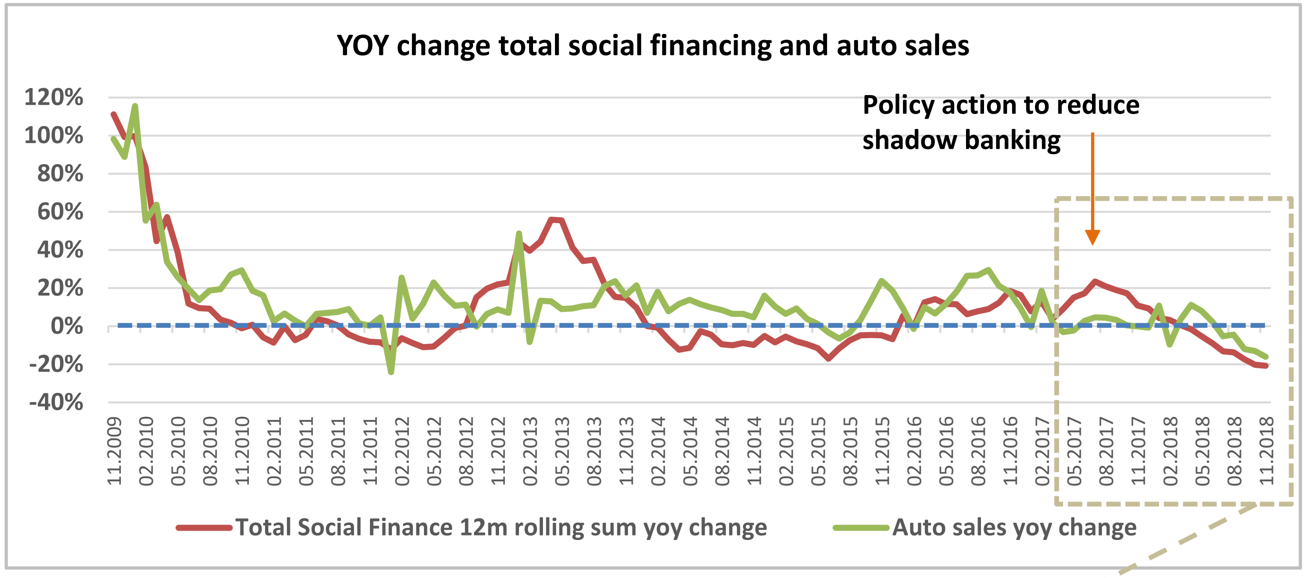
iv. Shadow banking defaults increasing, for example number of P2P lenders dramatically reduced with peak shut down in mid 2018. P2P at peak approximately RMB1.3 trn, now down to RMB0.8 trn.

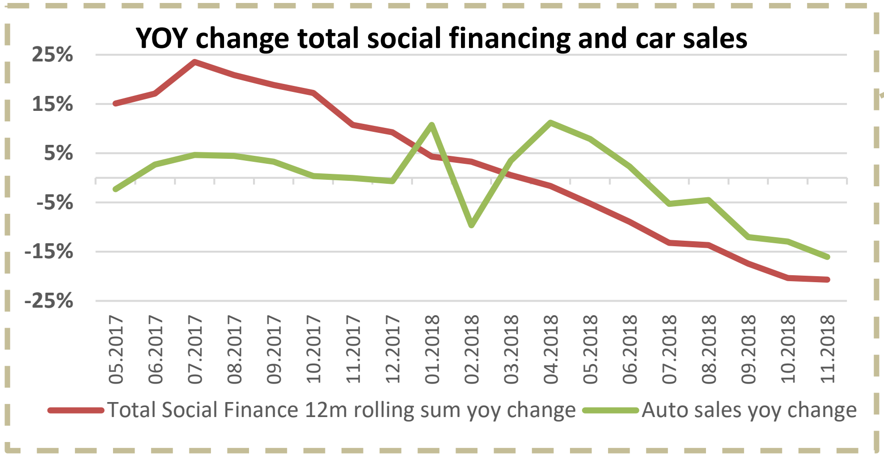
2) Trade tensions

i. Inventory cycle exaggerating current negative trend of trade flows.

ii. Psychologically, individuals and corporates see trade war as major issue that cannot be solved easily. Postponement of Capex and reduced consumption of significant purchases (e.g. cars, apartments). US China Engagement on a new path, it is not just a trade story.

iii. Supply chain effects much broader and impacting global investing and global Capex, which again will impact Chinese exports to Europe. Substitution by South East Asia production facilities being considered by manufacturers.





Global feedback loop from China slowdown

Germany's Sharp Slowdown Fans Fears That China Woes Are Spreading

The impact of the cooling Chinese economy is a particular concern: Germany, a maker of high-end cars and capital goods, is one of only few Western economies to have cracked China as a big export market. If that source of growth goes, economists fear Germany could become a conduit for the Chinese slowdown to infect other economies.

China is a particular concern because it is Germany's biggest trading partner and a key driver of German corporate profits. Growth in German exports to China slowed to around 4% in November year-over-year, from double-digit levels earlier in 2018. Germany's main stock-market index, the DAX 30, has fallen more than 15% since the middle of last year.

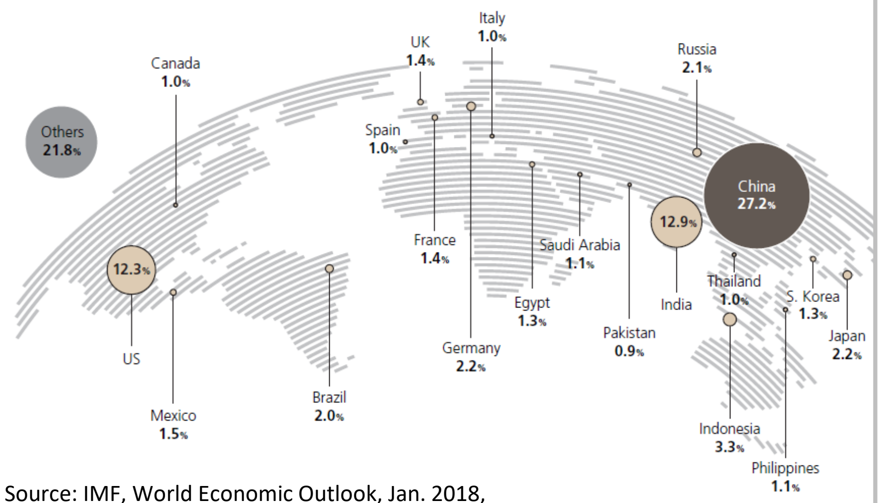
"The German economy rises and falls with China," said Joerg Kraemer, chief economist at Commerzbank in Frankfurt. He warned of a toxic cocktail of risks in China, including high debt at state owned companies and uncertainty linked to a trade war with the U.S.

The euro fell almost half a cent against the dollar to its lowest level in more than a week after the figures were published Tuesday, settling around $1.143, while Germany's main stock-market index slipped.

Germany's auto industry has been hit by falling demand in China, which last year posted its first decline in new car sales in nearly three decades. While luxury-car makers such as BMW AG and Daimler AG's Mercedes-Benz were able to buck the trend and sell more cars in China, big mass-brand makers such as Volkswagen AG suffered a big drop in sales. Continental AG , a German auto-parts maker that supplies Volkswagen and many of the world's biggest auto companies, said Monday that orders from car manufacturers had nose-dived over the past few months in part because of weaker sales in China, causing the company to lower its earnings and sales outlook for the year.

Source: WSJ, Jan. 15, 2019

Contribution to global GDP growth, 2018-2019 (f)



Source: IMF, World Economic Outlook, Jan. 2018, published by UBS Asset Management 2018.

Negative feedback loop from China slowdown on global growth

China expected to contribute 27% of global GDP growth in 2019
(Source: IMF, World Economic Outlook)

German exports of goods and services make up a higher proportion of gross domestic product than in any other big economy, at 47.2 per cent
(FT, Jan. 15, 2019)

Indicators

1. China	Indicator	Change since end Q1 2018
FX reserves	WIRACHIN Index	-2.2%
Total Social Finance	.TSF12SUM G Index	-12.8%
Chinese Auto sales	CNVSPSGY Index	-19.3% points (down from +3.5% to -15.8% in Nov 2018)
China Li Keqiang Index (Electricity + Freight)	CLKQINDX Index	- 0.8% points (down from +9.2% to +8.4% in Nov 2018)

2. Global spillover	Indicator	Change since end Q1 2018
German industry (47% of GDP from exports)	DAX Index	-10.0%
Global Automobile sector	S&P Global Automobile Index	-12.4%
Global Semiconductor sector	Philadelphia Semiconductor Index (SOX)	-6.3%
Commodity prices	Copper price	-11.5%

Policy options for reversing slow-down (I) – Monetary policy

Monetary policy

- Liquidity injection by central bank, flooding markets before Chinese New Year

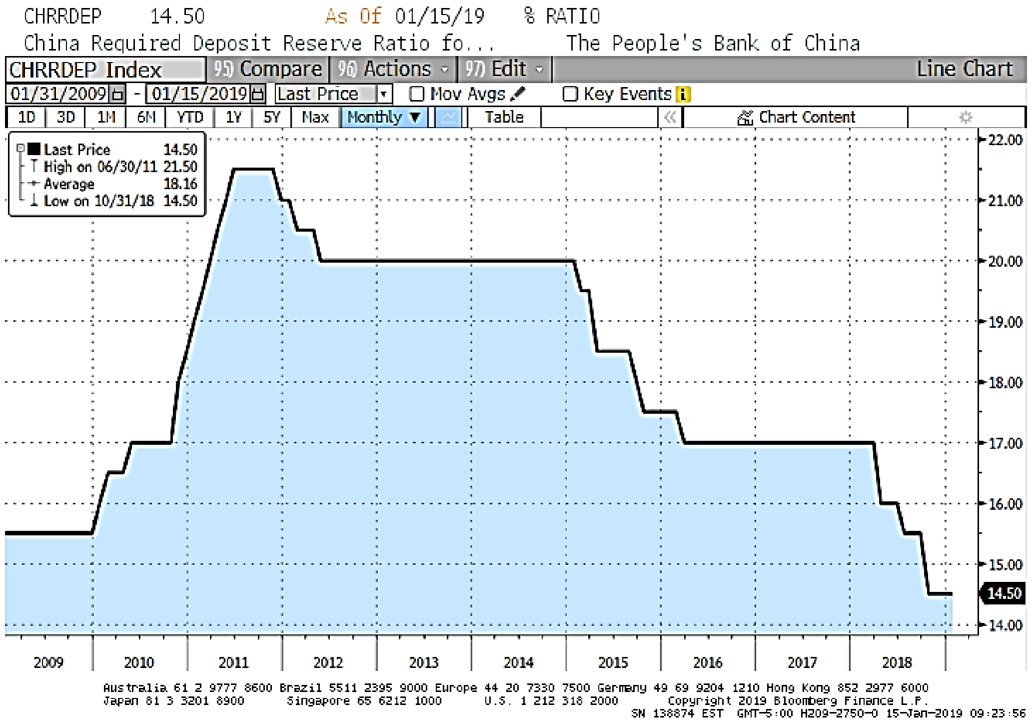
- Unwinding legacy sterilisation with reserve requirement ratio (RRR) cuts

China will not resort to "flood-like" stimulus in monetary policy next year, although it will consider more cuts as needed to reserves held at commercial banks, local media quoted a central bank advisor as saying in a report on Tuesday. The Chinese economy will face downward pressure in 2019, while the pace of growth will gradually stabilize, the 21st Century Business Herald quoted Sheng Songcheng, an advisor to the People's Bank of China (PBOC), as saying.

To ward off a sharp slowdown, China has unveiled a raft of policy measures this year, including four rounds of reserve requirement ratio cuts to boost lending, along with lower taxes and fees, and moves to fast-track infrastructure projects. The PBOC has so far refrained from cutting benchmark interest rates, which would undermine its efforts to rein in high indebtedness and pressure the yuan currency.

(Reuters, Dec. 24, 2019)

China Required Deposit Reserve Ratio



Policy options for reversing slow-down (II) – Fiscal policy

Fiscal policy

Tax and fee cuts

BEIJING (Reuters) - China will cut company taxes and fees further this year to support economic growth, Finance Minister Liu Kun told state television in an interview aired on Friday. Chinese officials have pledged more aggressive reductions in 2019, after cutting about 1.3 trillion yuan ($192.8 b) in taxes and fees last year.

Liu also said the government was studying a plan to lower social security fees to reduce the burden on small companies. He said China’s proactive fiscal policy would send a clear signal to companies.

Tax policy ratification subject to National People’s Congress decision

The ministry agreed the proposed deficit target of 2.8% of gross domestic product at its annual work conference in December, two people familiar with the matter said. The figure, which compares with 2018’s target of 2.6%, will be presented for approval at the National People’s Congress, China’s legislature, in March. The final number could still change. Officials can use so-called special bonds, which don’t affect the overall budget, to finance local government projects and spur infrastructure investment.

Policy options for reversing slow-down (III) – Government spending

Infrastructure investments in China account for 20% of GDP (The Economist)

China steps up fiscal spending as it approves $125bn of rail projects (FT, Jan. 6th 2019)

China has approved new rail projects worth more than $125bn in the past month as it steps up fiscal spending to counteract a slowdown in its economy, a move that could give Beijing more breathing space in its trade confrontation with Washington.

The National Development and Reform Commission, China's top planning agency, has approved urban rail projects in eight cities and regions worth a total of RMB860bn ($125bn) since December 5, according to official statements.

Beijing has signalled an easing of its deleveraging drive in recent months, after investment growth in fixed assets fell to the lowest rate on record, and retail spending growth slowed to its slowest pace in 15 years.

But some economists argue that there is room for accelerated infrastructure spending. "China has over-invested in industrial infrastructure, but I do not think it has over invested in infrastructure overall," said Bo Zhuang, China economist at TS Lombard in Beijing. "It is under-invested in urban and consumption related infrastructure, urban metros, sanitisation, and anything to do with urban services."

Is China's infrastructure boom past its peak? (The Economist, Sept. 20th 2018)

(…) A sharp slowdown in investment this year points to a more subdued future. The infrastructure boom has lost steam this year. After expanding at a double-digit pace for much of the past three decades, investment in it has slowed sharply. Since May spending on projects ranging from railways to power plants has fallen compared with a year earlier, the longest weak patch on record. Both economic growth and the pace of urbanisation are tailing off. Spending on infrastructure still accounts for a fifth of China's annual output, far above the level of most other countries.

Policy options for reversing slow-down (IV) - Reforms

	SOEs	Private Enterprises
Share of GDP	25%	75%
Credit Growth (including Off-Balance Sheet)	80% of all new loans	20% of all new loans
Share of employment	20%	80%
Innovation	30% of techn. innovation	70% of techn. innovation
Return on capital	3-5%	8-10%
Share of stock market cap	40%	60%

Sources:

Stratfor Worldview (Nov 2018),
Economist (March 2018),
Vanguard (July 2017)

Xi's turn away from the market puts Chinese growth at risk (FT, Jan. 16, 2019)

(…) Even after receiving various direct subsidies, the Chinese ministry of finance acknowledges that more than two-fifths of these state companies persistently rack up losses. They are kept afloat with massive increases in bank credit that are almost entirely responsible for the increase to record levels of leverage in China's corporate sector. Because of Mr Xi's repeated admonition that state-owned companies should be bigger, the government has organised multiple mergers of large enterprises in particular industries. This ill-advised consolidation has reduced competition, weakening the incentive for innovation and cost control.

Predictably, the return on assets of the largest state-owned companies has fallen by more than half since the merger mania began. At the same time, the productivity of private companies has increased, and in the industrial sector is now almost three times that of their state-owned counterparts. While these unwieldy state behemoths soak up a larger and larger share of bank credit, they are doing so mostly at the expense of more productive private companies. The share of bank lending to the private sector has shrunk by 80 per cent since 2013. Despite the rapid growth in credit overall, the absolute amount of bank lending to private companies has also fallen sharply.

This has reversed a long-term trend — the share of investment undertaken by private companies first plateaued and then fell in recent years. Similarly, whereas private industrial companies had previously expanded their output at twice the pace of their counterparts in the state-owned sector for more than a decade, since 2017 the situation has reversed.
This reflects both the squeeze on the bank credit accessible by private companies and the more recent crackdown on the shadow banking system, which had previously been a source of credit as bank loans started to dry up. The failure of the state to protect private property rights has also played a significant role, undermining the trust and confidence that many entrepreneurs have in the system. The combination of the precipitous decline in the return on assets of state-owned enterprises, which control about $30tn in assets (the equivalent of well over twice last year's gross domestic product), and declining investment by private companies is dragging down China's average annual growth by an estimated two percentage points.
Perhaps Mr Xi accepts this as the price of maintaining a state sector that he believes is an important element in sustaining political control. But without a return to a more marketed-oriented economic policy, even if bilateral trade disputes with the US are resolved, the likelihood is that China's growth will slow further — with unpleasant consequences for the global economy.

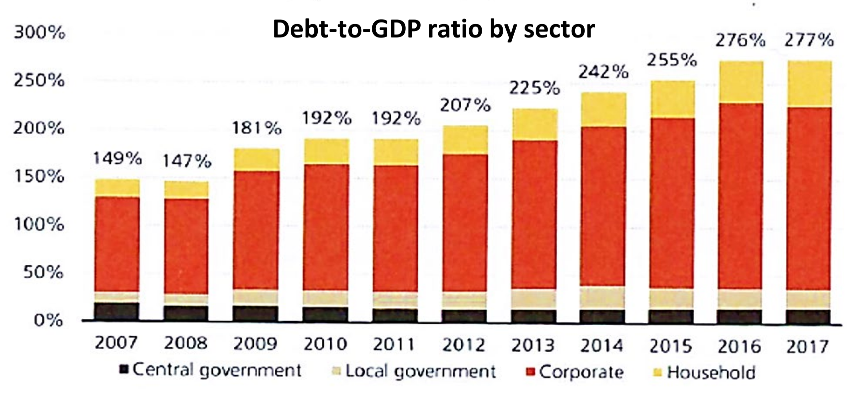
Policy constraints (I) - Credit growth exceeding FX reserve growth

Controlling exchange rate, credit growth, GDP growth and currency reserves… will be difficult.

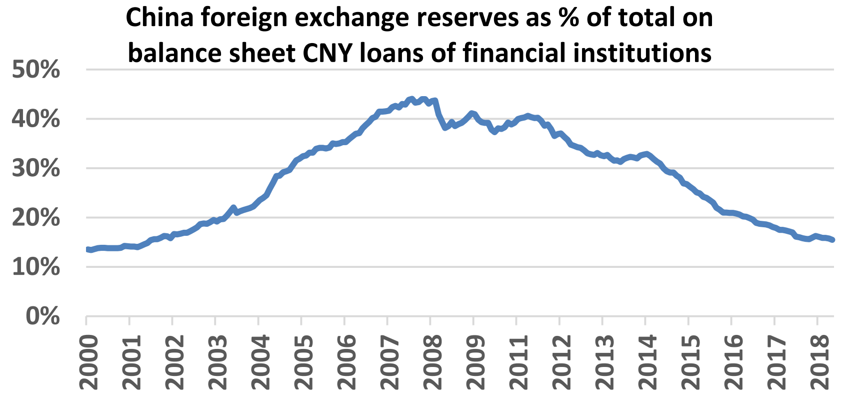
- ‘It will not be possible for China to sustain a stable exchange rate and stable reserves, if banking system assets continue to grow significantly faster than reserves and GDP. The currency’s fortunes are linked to the manner in which China eventually resolves its debt and deleveraging problems.’

- ‘If Renminbi assets grow substantially faster than USD reserves, excess liquidity in the home market leak overseas unless the capital controls are watertight.’

(George Magnus, Red Flags 2018)



Source: CEIC, UBS estimates



Source: Bloomberg

Policy constraints (II) – Fiscal Deficit

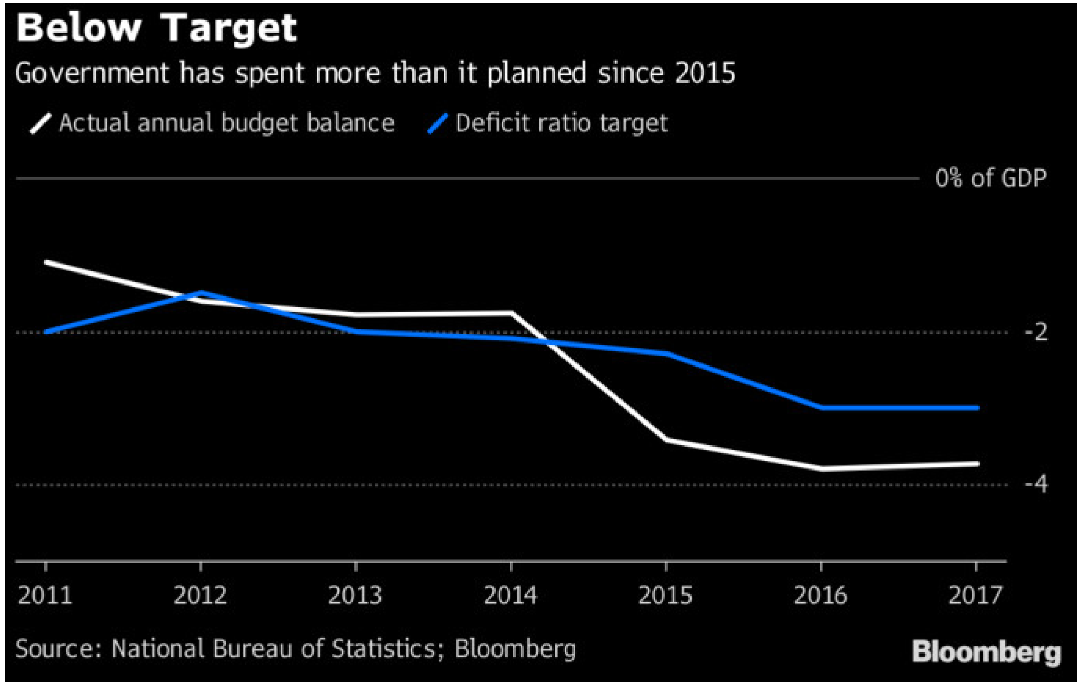
Fiscal deficit to GDP

Expectations of aggressive fiscal policy and tax cuts in China may be misplaced, leaving monetary policy a greater role in supporting the economy, according to Barclays Plc.

We expect most of the extra fiscal stimulus will be reflected in reductions in personal income and corporate taxes. A 2.8% deficit target would be a calibrated policy response aimed at combating continued weakness in domestic demand, flagging external demand and uncertainties associated with a trade war with the U.S. — David Qu and Chang Shu, Bloomberg Economics

"China's fiscal space is constrained by legacy issues arising from the extraordinarily expansionary policy in the last downcycle, a deteriorating fiscal position, and elevated contingent liabilities, including future pension costs," economists led by Hong Kong based Chang Jian wrote in a note.

(Bloomberg, Jan. 9th, 2019)



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