

# China at a crossroads: Key challenges

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# What is really the issue?

- Not even the risks of a banking or corporate crisis
  - Possibly not even a political disruption
- It boils down to **fiscal** and **social** (medium term) issues

# Is China's leadership aware?

- Fully!
- Good example is the joint World Bank-NDRC Report China 2030
  - The reformist faction of the leadership uses the World Bank to push reform ahead of November 2013 Plenum
  - Key messages in Report
    - Reform towards a market-based economy
    - Strengthening fiscal system
    - Continued globalization
    - An open innovation system linked to the global R&D network
    - Green development
    - Equal opportunity and social protection

–In line with our ideas but with clearer grouping: **social and fiscal**

# The fiscal world

- China's public debt nominally low but with huge contingent liabilities
- Which are the key sources of such liabilities?
  1. *The banking system*
  2. *Corporate debt in a "full bailout" and SOE model*
  3. *Local government indebtedness*
  4. *Pension bomb*
  5. *Environmental costs*

# The social world

- Labor factor has been under paid in a capital intensive model
- Increasing income inequality not helping to rebalance towards consumption
- Rebalancing needed a change
- Happening on the income side
  - Huge real wage increases
  - Productivity not following
- But not on the wealth side
  - Negative real interest rates on savings
- Excess labor becoming a story of the past
- Labor factor more demanding
- Aging of such labor factor increasing the collateral cost

# The bankings system

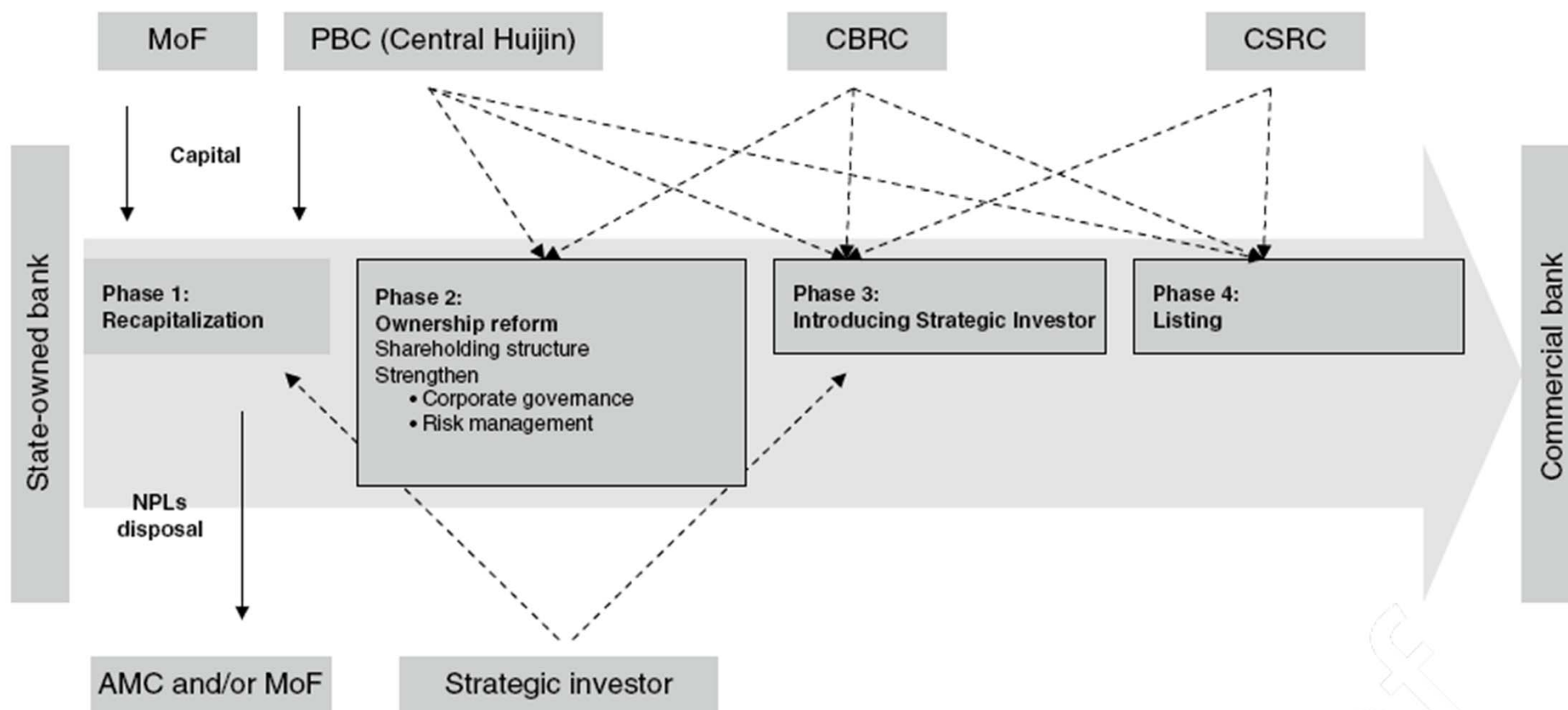
The Acheles hill in the early 2000s coming back to the forefront

# Bank restructuring before global crisis nominally successful but in a costly way

- **Large fiscal cost deluted by high nominal growth**
- **Entrenched corporate governance problems**
  - Signalling effect that the state can take care of banks' problems at no cost for its management

# Complex bank restructuring process dilutes responsibilities

- Since the 1980s, financial sector in China is a central element but trapped in stimuli-NPLs-restructuring cycles.
- In 1998, the PBC began what was meant to be a multi-year restructuring process. The SOCB restructuring was carried out in four waves, each with four sequential phases:





# And facilitates hiding the fiscal losses

- During the banking reform, the authorities have injected (mainly FX reserves) into major commercial banks around 7% of GDP in terms of capital.

## Capital injected into SOCBs

Date	Bank	Ammount			Financed by:	Currency
		RMB bn	USD bn	% GDP		
1998-1999	SOCBs	275	33	3.3	Ministry of Finance	RMB
2003-2004	CCB	186	22.5	1.4	PBC (Central Huijin)	USD (FX reserves)
	BoC	186	22.5	1.4		
2005	ICBC	124	15	0.7	PBC (Central Huijin)	USD (FX reserves)
2008	ABC	130	19	0.4	CIC (Central Huijin)	USD (FX reserves)

# But problem is repeating itself

- Moral hazard and the authorities push for the banks to intermediate the huge 2008-09 stimulus package behind's Even in our baseline scenario, banks' profit is likely to slide into a multi-year decline
- We estimate that banks need additional RMB 1.5-2.0 trillion to replenish capital over the next five years in our base scenario, which is higher than the aggregate capital of RMB 1.2 trillion raised since 2010.

	2011	2012	2013	2014	2015	2016	2017	2018
GDP growth	9.2%	7.8%	7.7%	7.2%	7.0%	7.0%	6.8%	6.5%
CPI average	5.4%	2.6%	3.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Credit growth	19.2%	17.9%	14.3%	13.5%	13.0%	12.5%	12.0%	11.0%
Net interest margin	2.7%	2.6%	2.3%	2.0%	1.9%	1.8%	1.7%	1.6%
% of fee and investment income	33.8%	35.0%	36.5%	38.0%	40.0%	40.0%	40.0%	40.0%
NPL ratio	1.0%	1.0%	1.0%	1.3%	1.8%	2.3%	2.7%	3.0%
Provision / NPL	278.1%	296.0%	282.7%	220.0%	170.0%	150.0%	150.0%	150.0%
<b>Profit growth</b>	<b>36.3%</b>	<b>19.0%</b>	<b>14.5%</b>	<b>9.3%</b>	<b>-14.7%</b>	<b>-7.7%</b>	<b>-8.7%</b>	<b>4.5%</b>

Note: Net Interest margin assumed to decline to 1.6% due to interest rate liberalization, close to average NIM for high-income countries

However, risks to the baseline scenario coming from other quasi-fiscal challenges

# Three key pending issues

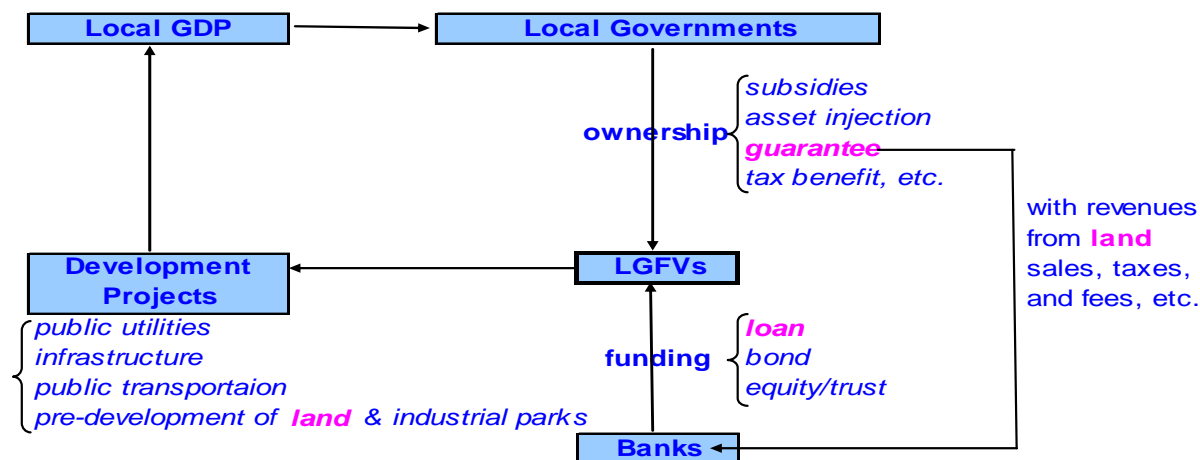
1. Local government debt: the mystery of LGFVs
2. Corporate debt
3. Shadow banking

# LGFVs: what is their role?

- LGFVs have mushroomed as a way for local governments to finance the projects approved under China's huge fiscal package.

LGFVs are:

- Owned by local governments
- Funded by banks
- Loan guarantee by local governments
- Closely connected to land and housing markets
- Closely connected to local economic growth



Source: BBVA Research

# LGFVs indebtedness adds pressure to banks' asset quality

- The latest audit of local government debt shows an increase to RMB 17.9 trillion at end-June 2013

- A clean-up of local government debt may require central government funds, and bank write-offs

Local government debt has risen

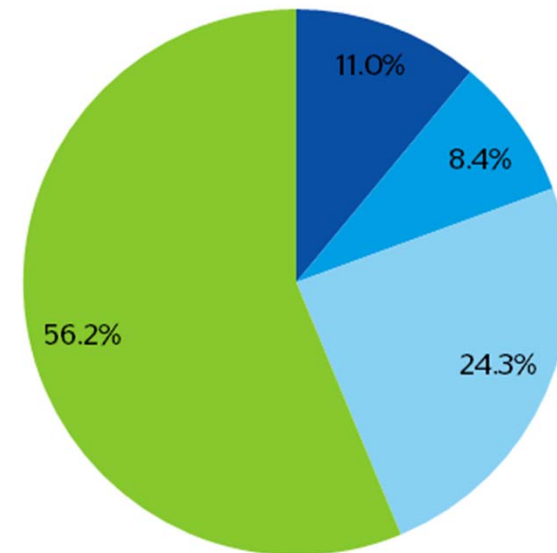
Source: BBVA Research



The government estimated around 20% of LGFVs debt at risk

Source: BBVA Research

- high risk
- moderate risk
- Low risk
- no risk

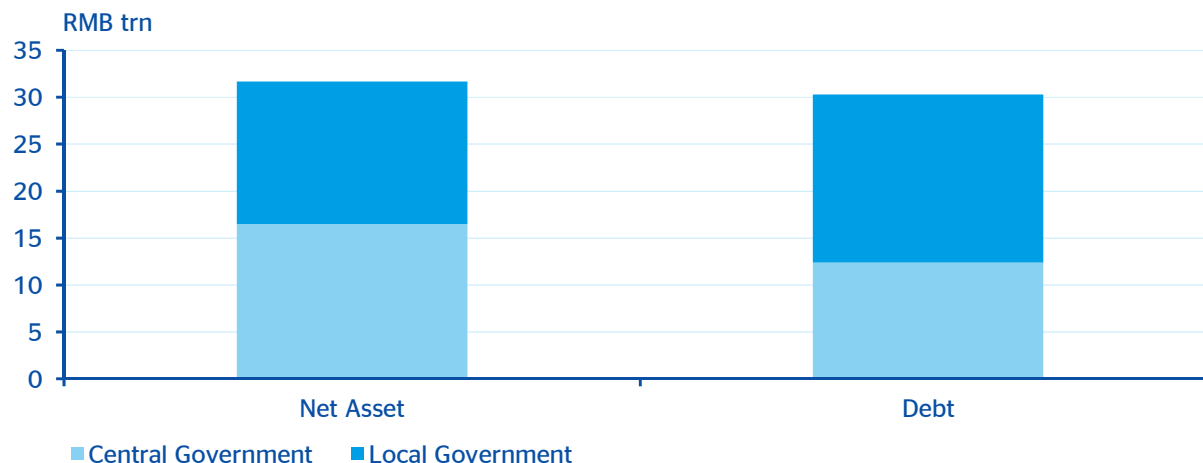


# Why LGFV's issue needs to be solved?

- Crowding out private investment, and creating fiscal and bank problems
  - How losses are going to be distributed between the state and the banks is the key question
- Since incentive is to continue to invest in infrastructure, creating social/environmental problems
  - Land sales accounted for around one-third of local governments' budgetary revenue, which makes local governments as a key player in creating bubbles in the housing market.
  - A hard landing in the housing market would affect their finance very negatively.

# How to address it?

- Scenario 1: Government bailout
  - If government assumes all local government debt, including both agency debt and problem LGFV debt, its debt would increase to 53% from current level of 22%
- Scenario 2: Bank write-offs of LGFV debt
  - Banks provision and write-off these loans in next five years
  - Banks need another RMB 1.4 trillion during the period to maintain its CAR ratio
- The likely outcome is a combination of the above two extreme scenarios.
- Local governments need to sell their assets to pay the bill.



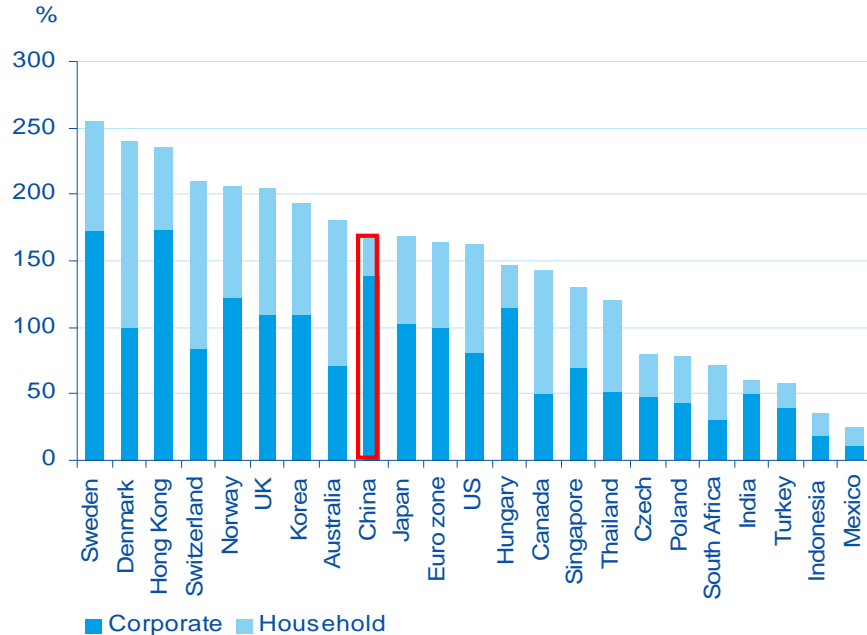


# Corporate debt: another drag for asset quality

- As a share of GDP, China's corporate debt is high by international standards.
- High corporate debt may constrain growth and weigh on bank asset quality

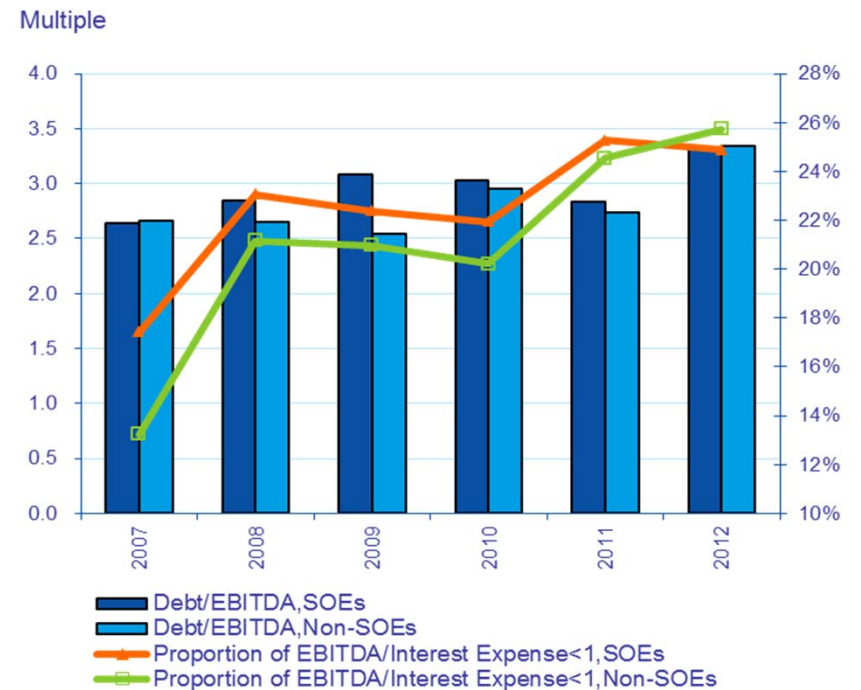
## Corporate debt level is high by international standards...

Source: BBVA Research



## ...as corporate debt stress ratios rise to new highs

Source: BBVA Research

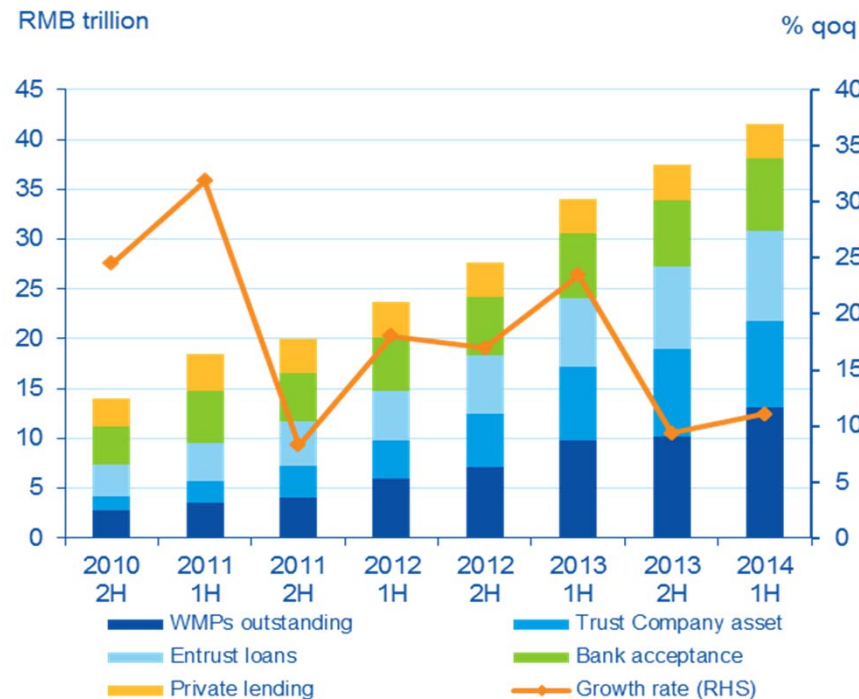


# Shadow banking first seen as a solution and increasingly as a huge problem

- Its size has grown rapidly in recent years as banks circumvent tightening regulations
- Involvement of banks in shadow banking activities could eventually impact their balance sheets.

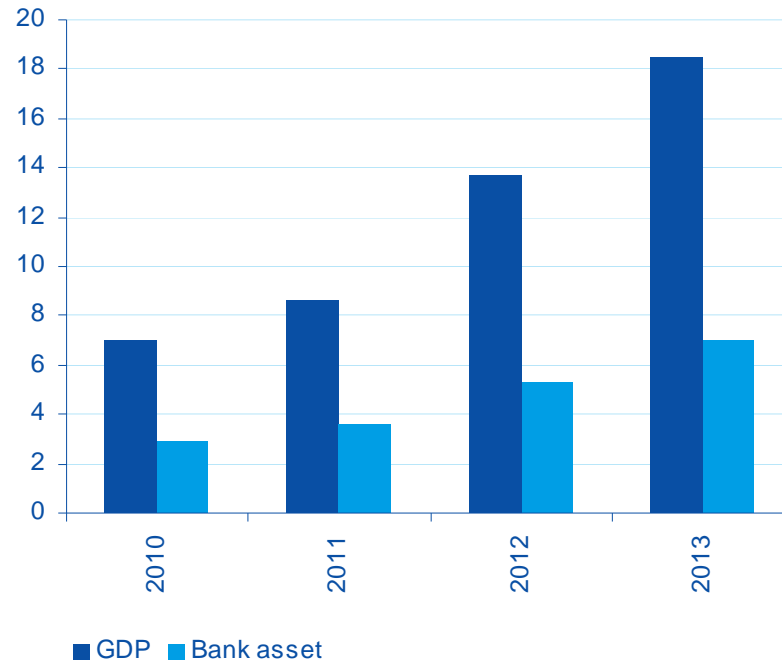
Shadow banking activities have risen...

Source: Wind, CEIC, PBoC and BBVA Research estimates



...leading to an increase in the size of the shadow banking sector in the economy

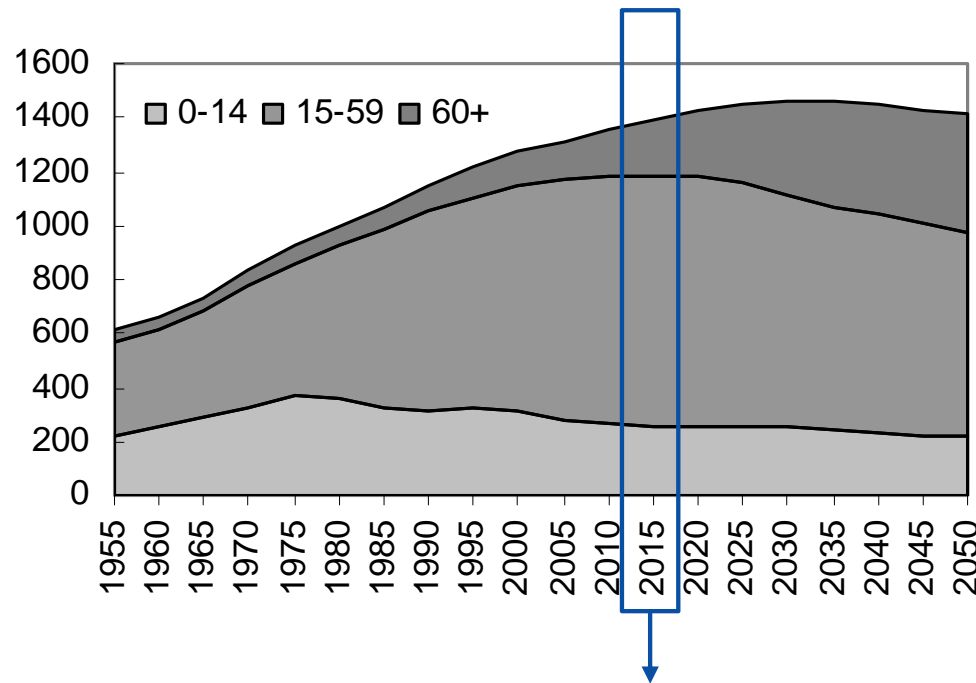
Source: PBoC and BBVA Research



# Looming pressure on China's pension system stemming from ageing population

## Projection of demography in China (Mn People)

Source: UN Statistics Division and BBVA Research



**Pension deficit?**

China's one-child policy has led to lower birth rates, which have in turn reduced the number of working-age population, putting pressure on China's pension system.

In 2010, the elderly (60+) accounted for 12.5% of total population. According to UN estimates, this figure will increase to 31.1% in 2050.

Under the current pension system, four working people support one retiree, but this ratio could change to 1 : 1.5 by 2050

According to the Chinese Academy of Social Sciences (CASS) as many as 14 provinces are currently experiencing pension deficits. On a nationwide basis, the pension surplus at the end of 2013 stood at RMB 3.1 trillion (US\$ 500 billion). Nearly a decade ago, estimated deficit already 6 trillion RMB (MOHRSS) up to 9 trillion RMB (World Bank). Probably much more now

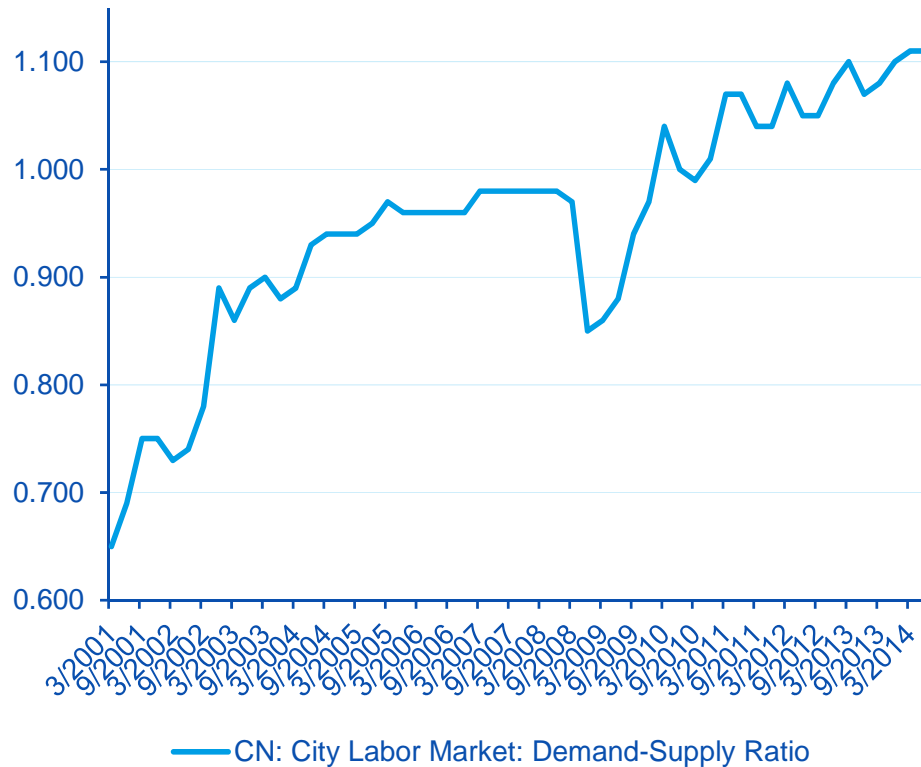
# Pension reform may help to alleviate some of the budget pressures

- Gradually rising retirement age
  - Europe's problems look moderate compared with the 55 years retirement age for men and 50 for women
  - And not revised since the 1950's despite life expectancy has risen from an average of 45 to over 73
  - The key was the limited coverage of the population but rural pension reforms opens venue for additional liabilities
- A looser stance on China's one-child policy may help neutralize some of the pressures stemming from unfavorable demographics but will increase pension bill
- Allocating part of the government-held shares of listed state-owned enterprises to the national social security network to raise its profitability but can also be a source of SOE support at a time of huge leverage (i.e., will dividends continue?)
- Resolving the urban-rural divide by unifying the various components of the pension system under one. Pension harmonization would also help to remove barriers to labor mobility.

# Ageing population leads to labour shortages and rising wages

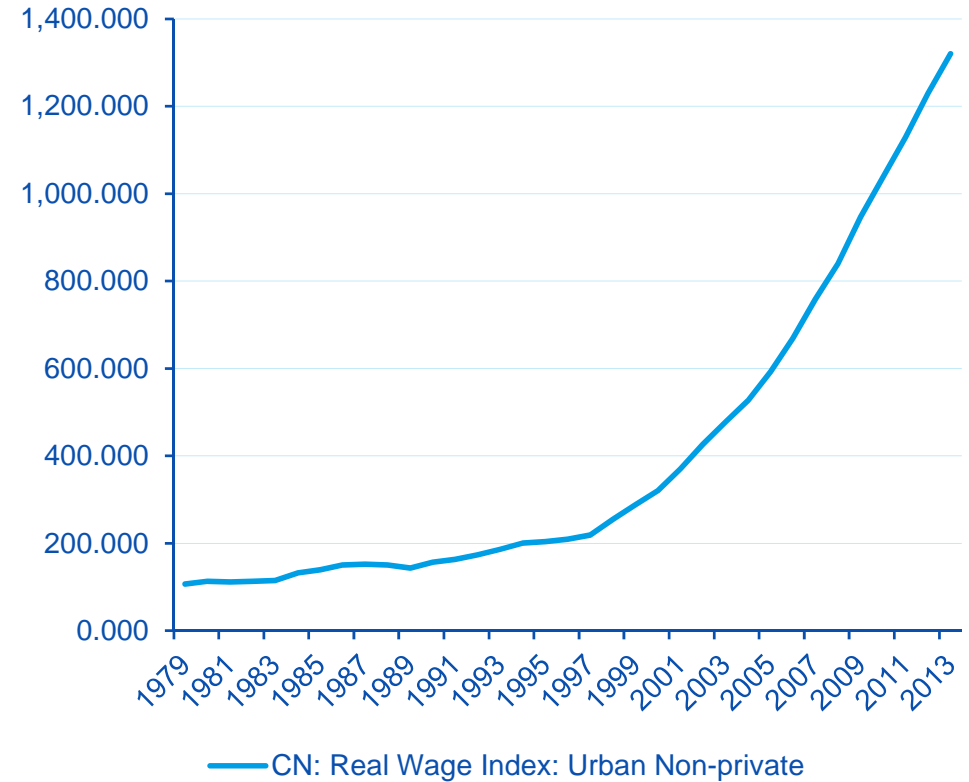
## Urban labor demand-supply ratio in China

Source: CEIC and BBVA Research



## China real wage index (1978=100)

Source: CEIC and BBVA Research



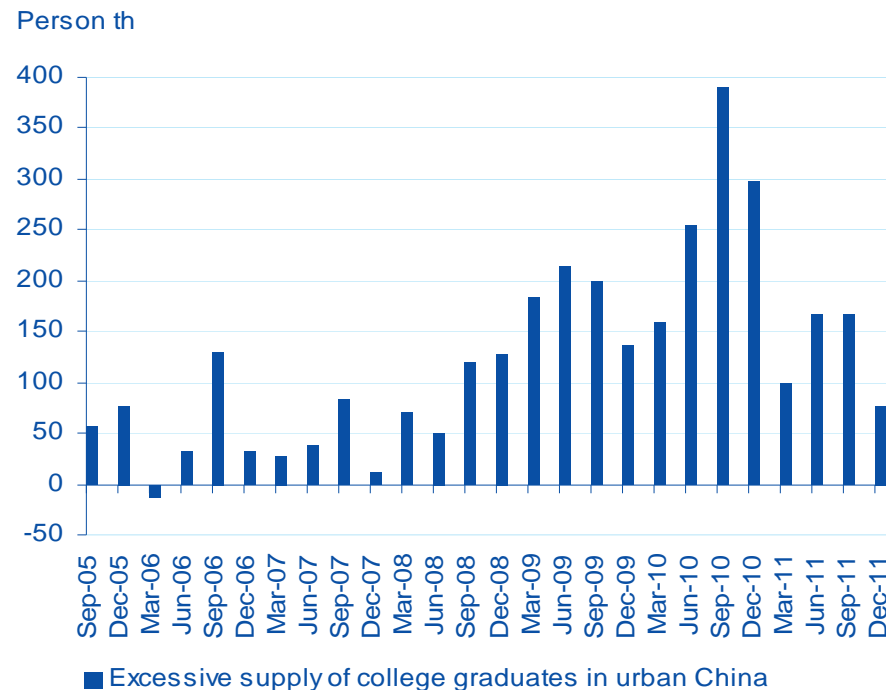
A shrinking labor pool and higher labor costs have played a role in eroding China's competitiveness as a global manufacturing hub versus its competitors

# Not only increasing labor shortage but in a dual (and costly) way

- In contrast to the shortage of migrant labor, college graduates suffer from unemployment.
- The quality of college graduates may have deteriorated due to expansionary enrollment policy. Job applicants may not possess skills desired by employers.

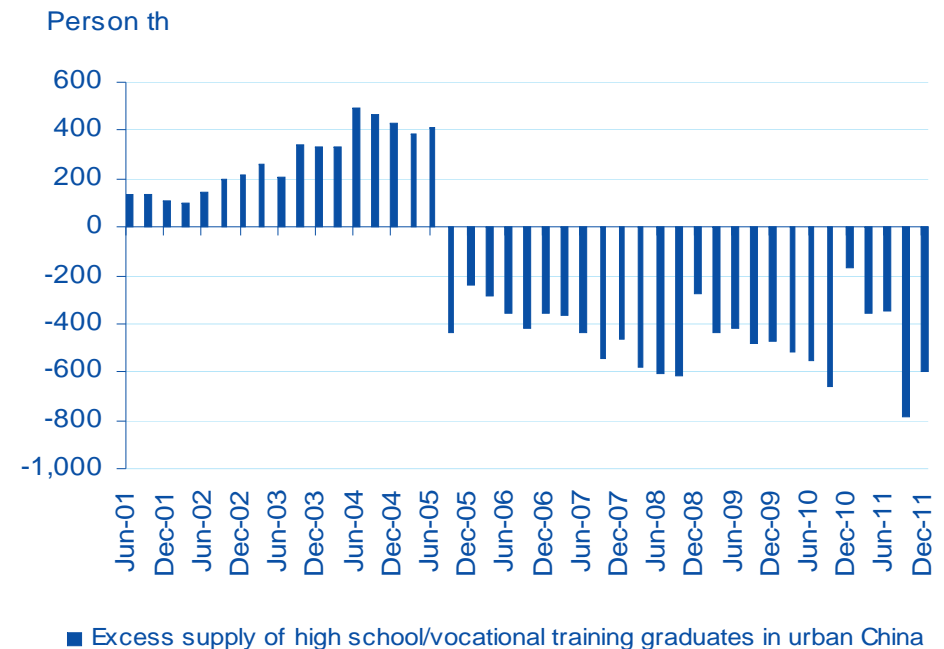
## Excess supply of college graduates

Source: CEIC and BBVA Research



## Excess supply of high school/vocational training

Source: CEIC and BBVA Research

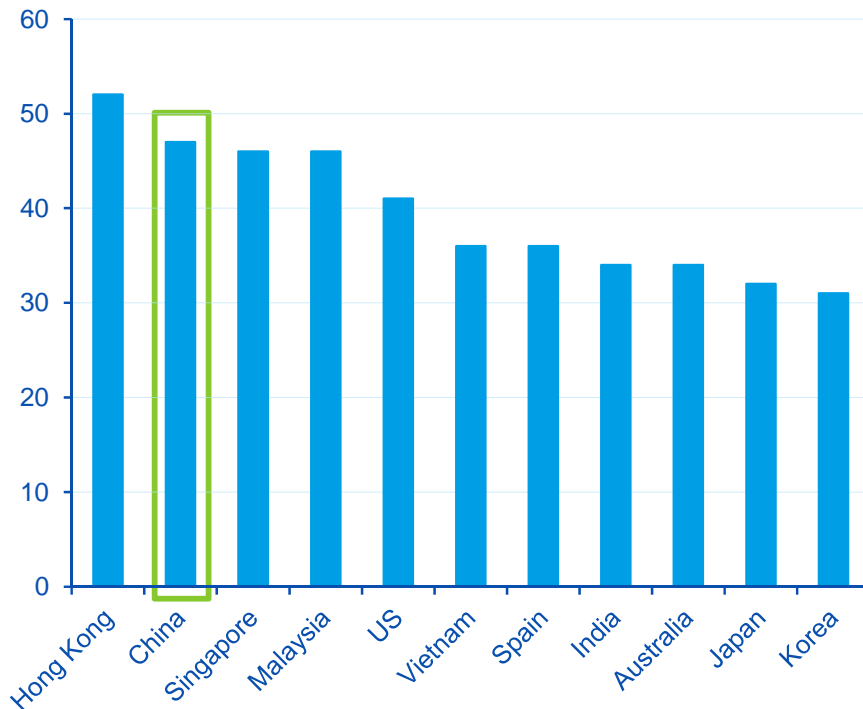


■ Excess supply of high school/vocational training graduates in urban China

# Rising income inequality to hamper domestic consumption and lead to social discontent

## GINI index by counties (2013)

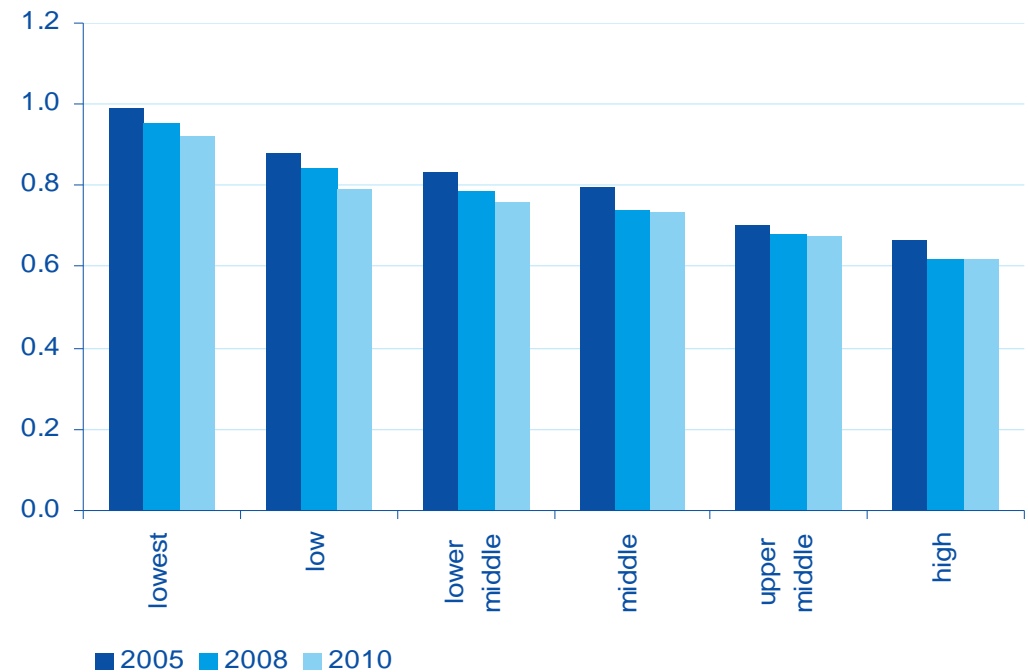
Source: World Bank, NBS, HKMA, CIA Library and BBVA Research



High Income Disparity in China shown as GINI Index. Potential undervaluation of Chinese Gini Index according to some sources

## Propensity to consume in urban China by income group

Source: CEIC and BBVA Research



Propensity to consume decreases with income level. Reducing inequality and increasing market access to low income households could provide boost to domestic consumption

# The great rebalancing project and the social challenges: what to do?

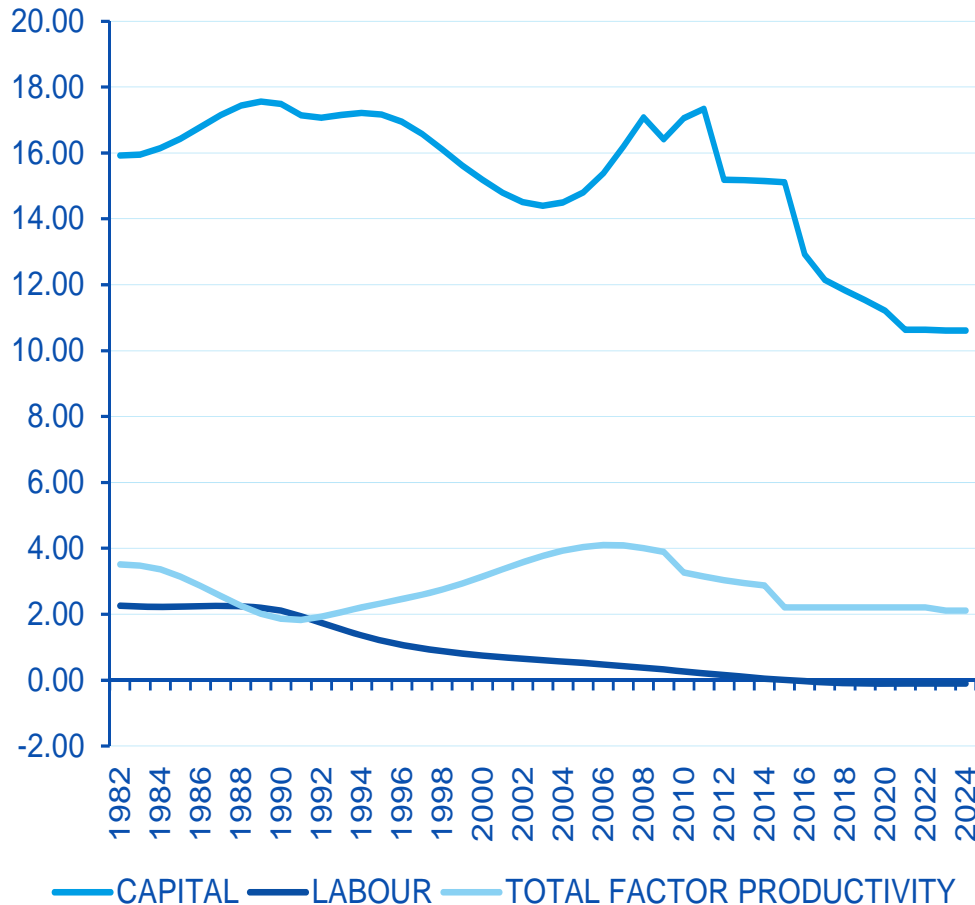
- Public spending on social welfare could help mitigate the negative effect of inequality, and therefore increase domestic demand.
- Measures taken very limited aware of the huge fiscal cost of generalizing them
  - Subsidize consumption in rural areas (specially white goods)
  - Offer minimum pension and health services (under a pilot project)
- All in all, China is lagging well behind in public spending on social welfare: 14% of GDP (which probably includes other issues) vs. 20% of GDP by OECD countries.



# Before the fiscal and social costs surface fully, China's growth model slowly wearing down

Diminishing returns on capital investment (y/y %)

Source: BBVA Research



China's diminishing returns on capital point towards a loss of competitiveness

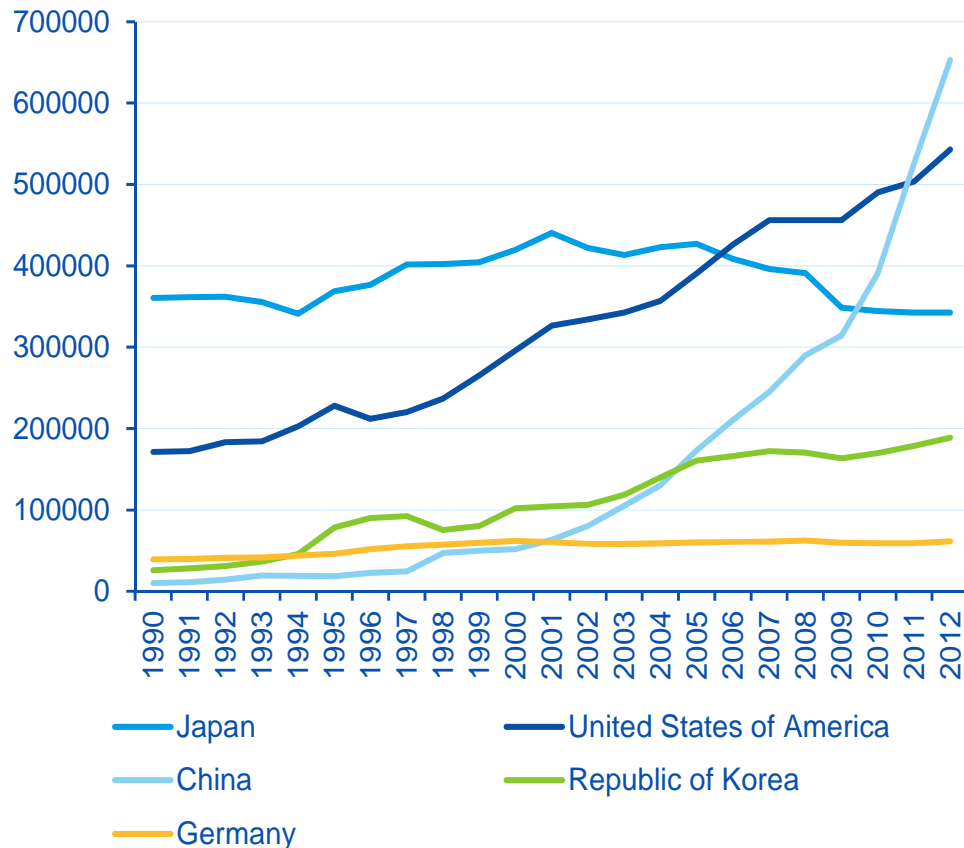
Every extra dollar in capital investments leads to decreasing GDP gains

In order to sustain growth in the long term, China will have to implement deep reforms that promote technological innovation

# Neither rebalancing not technical innovation seems to be taking over

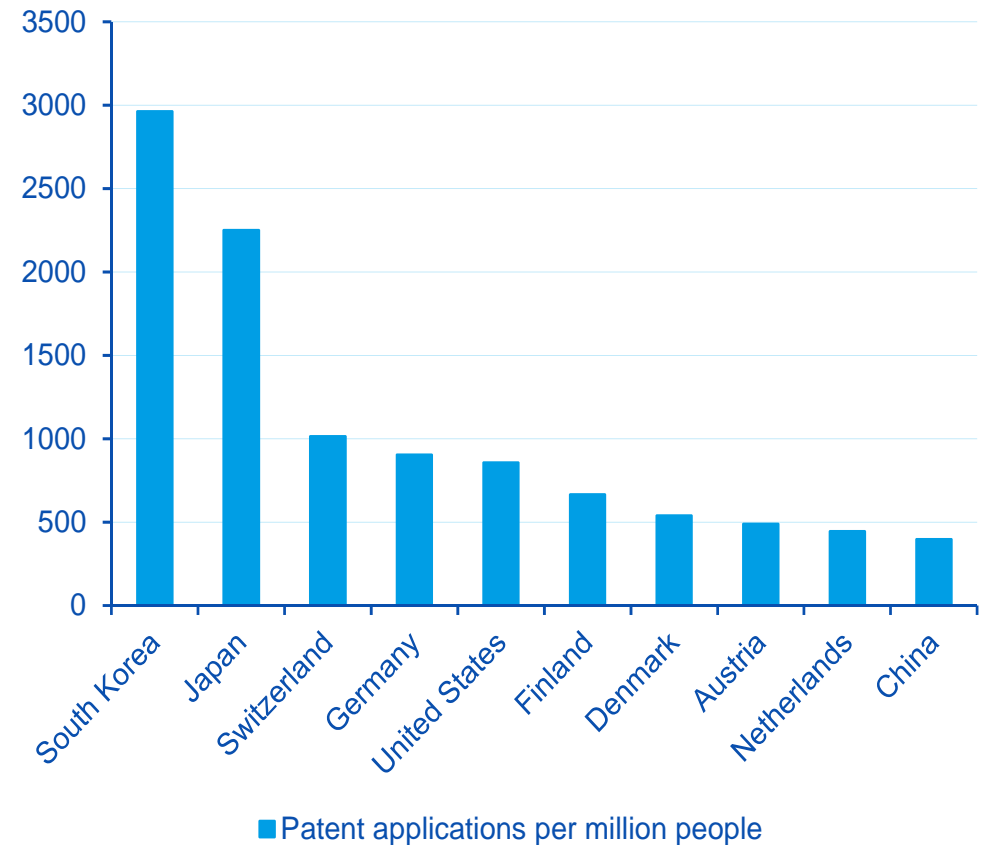
Patent registrations have increased significantly in nominal terms ...

Source: WIPO and BBVA Research



...but patent registrations per Mn ppl (2012) reflect relatively lower technology levels

Source: WIPO and BBVA Research



Increased investments have not translated into significant technical advances

China is posed to take over the US in terms of GDP in 2014, but technology levels remain low versus other advanced economies

In order to sustain growth in the long term China will have to implement deep reforms that promote technical innovation

# Overall, both fiscal and social issues and the model's waning call for bold changes

- **More market based economy**

- SOE reform (dismantling oligopolies)
- At least transfer of dividends from SOEs to State (improvement in public finances freeing space to finance larger welfare state).
- Privatization and opening up to foreign competition needed

- **Plenum announces more competition between private and public corporations but not a revolution**

- No larger role for foreign investors
- No privatization

- **Government shifting towards providing intangible public goods**

- Some measures during global financial crisis but very limited
- Not much more announced in 2013 Plenum
- Rural pensions
- Affordable housing

- **Financial reform (specially liberalizing the deposit rate) key for savers not to lose purchasing power**

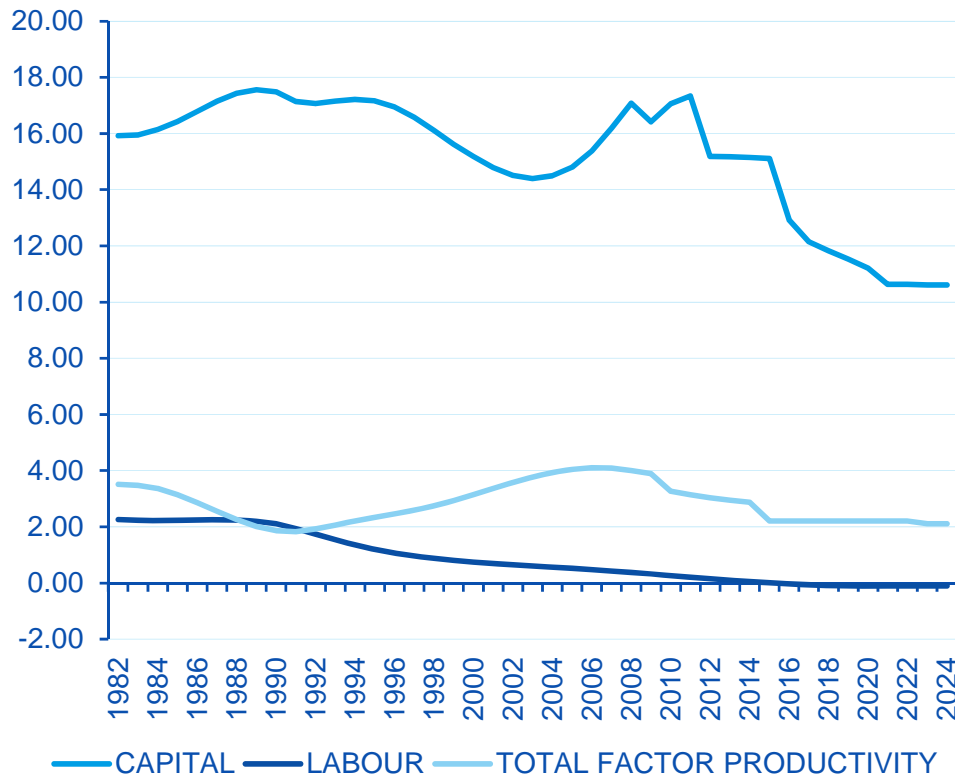
The leadership is aware  
but the boldness to act shiftly might  
not be there

Challenges remain challenges  
but for how long?

# The return on capital has started to decline

Diminishing returns on capital investment (y/y %)

Source: BBVA Research



China's diminishing returns on capital point towards a loss of competitiveness

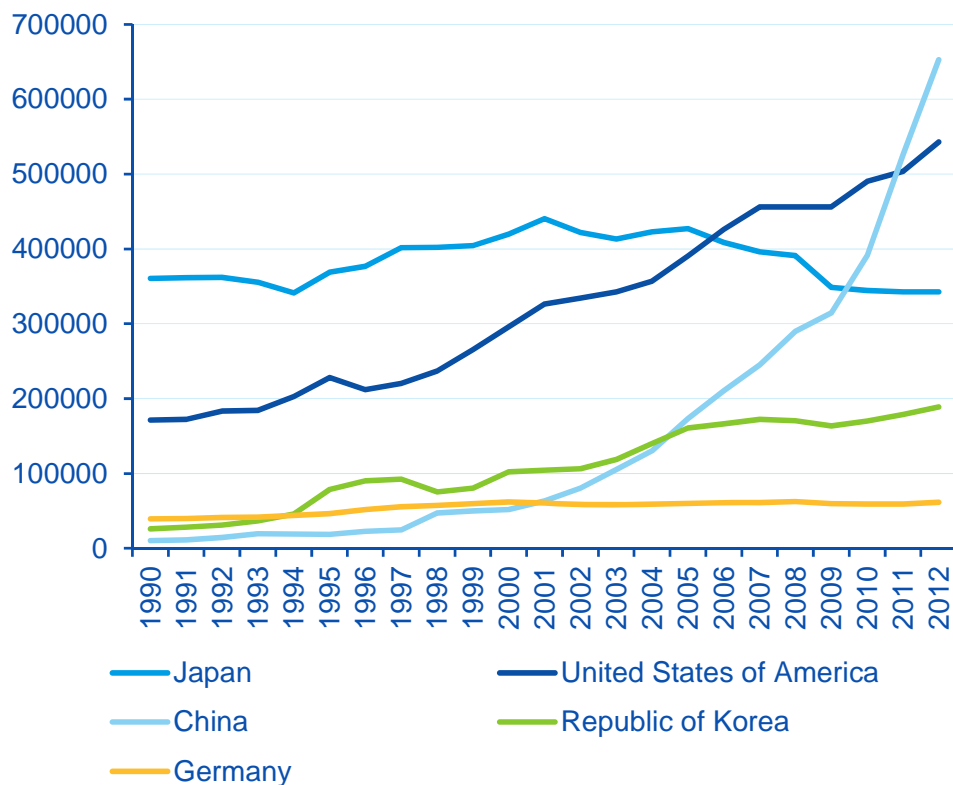
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# Technical innovation remains relatively lower than that of regional competitors

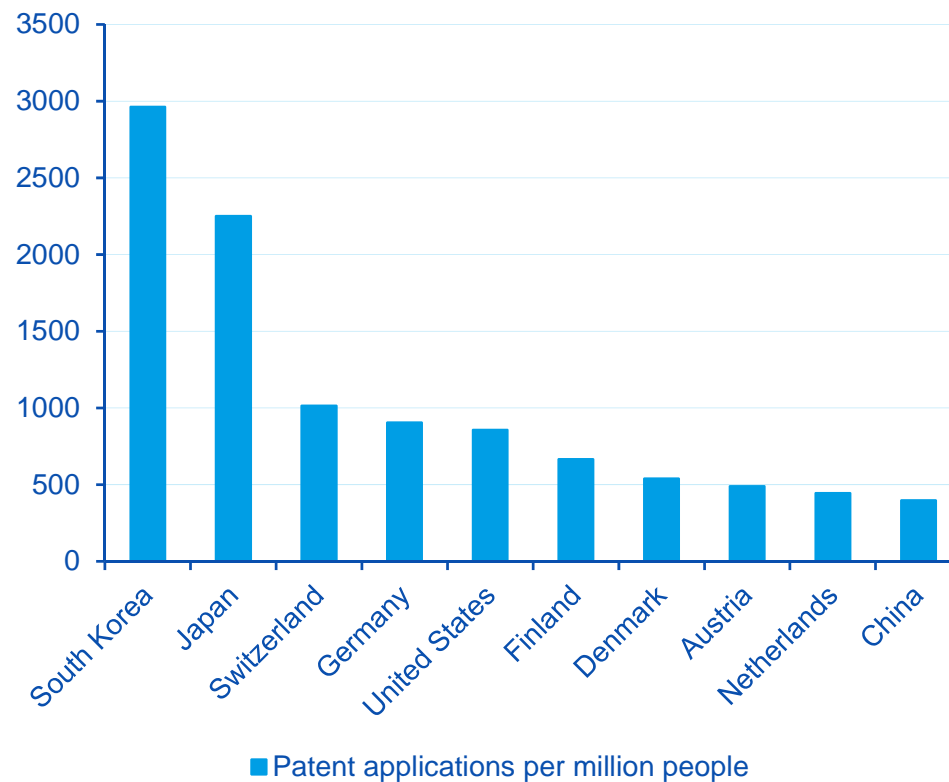
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For comments and questions [\*alicia.garcia-herrero@bbva.com\*](mailto:alicia.garcia-herrero@bbva.com)