Economic Watch

China | Understanding the recent hot topics on Chinese economy and financial markets

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Chinese economy is currently undergoing growth deceleration and financial market turmoil. Growth headwinds are multi-faceted, among which recent regulatory storms on private after-school tutoring, high tech, medical sector and real estate, a tight monetary and fiscal policy condition and a gradual normalization of export sector should be highlighted. The authorities presumably planned to take the time-window of China's "first-in, first-out" of the pandemic to press ahead long-term structural reforms to advocate "common prosperity" and equality, which are deemed to be the foundation of Chinese socialist system. However, the economic growth deceleration seems to be worse-than-expected. Looking ahead, from the policy perspective, there will be some balance between the short-term growth stimulation and long-term structural reforms going forward, thus, monetary and fiscal easing are indeed anticipated in the rest of the year to foster the post-pandemic growth. However, the recent regulation tightening in various sectors is set to continue, together with the potential US FED QE Tapering process, continuing to create financial market volatilities.

The report is trying to help to understand the recent important hot topics on Chinese economy and financial markets, including the ongoing regulatory storms, the crucial transformation of China's industrial policy from US model to Japanese and German model, the monetary policy independency and the ultimate goal of China's financial liberalization reform.

Below are the main topics in various perspective of macro economy and financial markets that we would like to address:

1. ***Why Chinese authorities are pushing forward tightening regulations on several sectors at this post-pandemic time in a bit to advocate common prosperity and equality? Will it create systematic risks for economic growth in the short term?***

   Common prosperity and equality are deemed to be the most important characters and the foundation of Chinese socialist system by the authorities. Although for a long period of time since the beginning of China's reform and opening up policy, the nation was trying to prioritize "efficiency" in order to catch up with the advanced economies, they never want the "efficiency" to override "equality". For the past decades, the stunning development of China's tech sector, together with overheating real estate, medical sector and private after-school tutoring which are tightly linked to household wellbeing seems to accumulate too much social inequalities. Thus, the authorities, at a significant moment in the history of China's economy and capital markets, are trying to correct social inequality. That means, after a decade-long journey to conduct the non-interventionist policy on these sectors, China is shifting governance priorities from pursing "growth first" to balancing growth and social equality.

   Since May 2020, China's "first-in, first-out" of the pandemic seems like to provide a perfect time window for the authorities to press ahead the structural reforms on these sectors when other countries in the world are still grappling against the coronavirus. It is the authorities' intensions to prevent the unbridled expansion of capital by introducing a range of requirements to firms besides economic growth, chief among them is social equality;

and it is also the intensions of the authorities to rebalance the rise in corporate power and the share of labor compensation, no matter how large the scarification would be in the short-term financial markets.

Regarding the systematic risks, our understanding is that, it is the authorities' strategy to trade off between short-term pain and long-term gains. There will be indeed financial market sell-offs and corporate crackdown in the short term, but in the long run, there will be more regulated high-tech, real estate and private education sector to form a society with more social stability and common prosperity.

2. The PBoC wants to maintain the independence of China's monetary policy in terms that China would still conduct some easing measures in the rest of the year when the US FED is in the process of QE Tapering. This is quite abnormal among the emerging markets' central banks as many of them started to hike interest rate. How to solve the potential risks of capital outflows and sharp RMB depreciation?

As we mentioned above, the recent growth headwinds and economic deceleration indeed urged the PBoC to conduct some easing measures to stimulate growth. Targeted credit expansion and quantitative tools such as RRR cuts are indeed anticipated. It looks very abnormal and sharp contrast when other emerging markets' central banks are starting to hike interest rates in order to avoid panic capital outflows as the FED takes the reduction of asset purchasing in the pipeline.

However, what we need to emphasis is the special character of China's comparatively closed capital account. Although people may talk about the holes on the wall of China's financial market border, namely the continuous expansion QFII and QDII quota etc., we have to clearly realize that the volume of them are quite limited while the direction of capital inflows and outflows are still tightly regulated by the central bank and SAFE. Thus, China's monetary policy independency could be explained based on the traditional economic theory of "Impossible Trinity". That means, among the three options: independency of central bank's monetary policy, exchange rate stability and free capital flows, China chooses to maintain the first two at the current stage.

Regarding the RMB depreciation, indeed, a loosening monetary measure compounded with FED QE Tapering will certainly lead to a weak RMB exchange rate. However, it is noteworthy that the PBoC's exchange rate adjustment tools, the large current account balance and particularly the large interest rate discrepancy between China and the advanced economies could to some degree circumvent RMB exchange rate tumbling in the future.

3. How to understand China's recent industry policy transformation from consumption-oriented to industry-oriented and from following US growth model to following Japanese and German model?

Recently, amid the escalation of China-US conflicts and the technology way between the two nations, Chinese vice premier Liu He in various circumstances emphasized China's industry policy will be focusing on "profession, refinement, specialty and innovation" and will promote supply chain self-sufficiency to solve the bottleneck technology problem. From a broad perspective, it has crucial implications as this indicates China's industry policy is transferring from the previous US and UK's Anglo-Saxon type in which service sector contributes for the majority of growth to the Japanese and German type which always prioritizes the development of high-end manufacturing sector.

Under the big industry policy transformation, some sectors are joyful, some are woeful. The previous focus of consumption and service sectors might not get as much as policy support as before. While on the other hand, high-end manufacturing focusing on technology advancement, such as computer science, chips making, new energy automobile, military related industry and carbon neutrality related industry would benefit most in the long-term. This kind of policy diversification has already displayed in China's recent stock market performance as consumption and medical sectors have got significantly sell-off, while high-end manufacturing sector has been chased by capital.

4. What is the ultimate goal of the RMB exchange rate reform? And what is the ultimate goal of financial liberalization reform?

Presumably, according to the PBoC’s mandate, the goal of the RMB exchange rate reform is to conduct the managed floating exchange rate regime. However, if we again borrow from the “Impossible Trinity” theory and link the first question here to China’s financial liberalization reform, the ultimate goal of the RMB exchange rate reform should be a clean floating regime. Although this point is still arguable and ambiguous among the Chinese economist experts at the current stage, what is clear is if the ultimate goal of the financial liberalization reform is to achieve a full capital account liberalization, RMB exchange rate clean float is the only choice. That means, at that time, among the three options: central bank’s monetary policy independency, exchange rate stability and free capital flows, China’s policy mix should be: independent monetary policy, free capital account and clean float RMB exchange rate (lost RMB exchange rate stability) according to “Impossible Trinity”.

Finally, according to the outlook of RMB internationalization, we could have some hints of how the RMB exchange rate will move in the medium to long term. Based on the historical experience, when a currency goes to internationalization, there are at least two pre-requests: appreciation expectations and the large amount of the overseas assets dominated by this currency. That means, RMB internationalization will go hand in hand with current account liberation and appreciation expectation. In the future, although there will be so many international and domestic factors determining RMB exchange rate outlook in the short run, two things are certain and foreseeable, the RMB will have long-term appreciation expectation amid RMB internationalization process, and the two-way fluctuation of RMB exchange rate will be certainly anticipated.

Research

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