BBVA Research

Unmask the veil of today's China

Jinyue Dong and Le Xia

September 2021

Creating Opportunities

Summary

- Chinese economy slowed down recently after a strong rebound from pandemic. The economic structure is unbalanced, with strong exports and weak domestic demand.
- China’s long-term potential growth will gradually decline from currently 6% to 4% in 2035, depending more on total factor productivity progress rather than capital and population.
- Regarding the recent Evergrande crisis, which led to global investors’ panic and market sell-off, our bottom line is it will not cause a systemic risk to China and global economy and the company will be orderly liquidated to pay back their debt with authorities’ supervision.
- A flurry of China’s new policy initiatives and regulations have caused deep confusions and concerns, including “dual circulation” strategy, common prosperity, anti-monopoly investigations on internet giants, clampdown on after-school tutoring business etc.
- Despite the bluntness of policy promulgation and the lack of market communications, these measures or reforms are deployed to tackle a number of challenges faced by almost all the countries: tech-induced market monopoly, ever-widening wealth gap; global climate change; housing affordability; rising trade protectionism etc.
- However, it remains an open question whether these Chinese approaches will succeed. At least one consequence is foreseeable over the medium term: government interventions will become more frequent than before.
- China’s new policy direction will create new winners and losers in China.

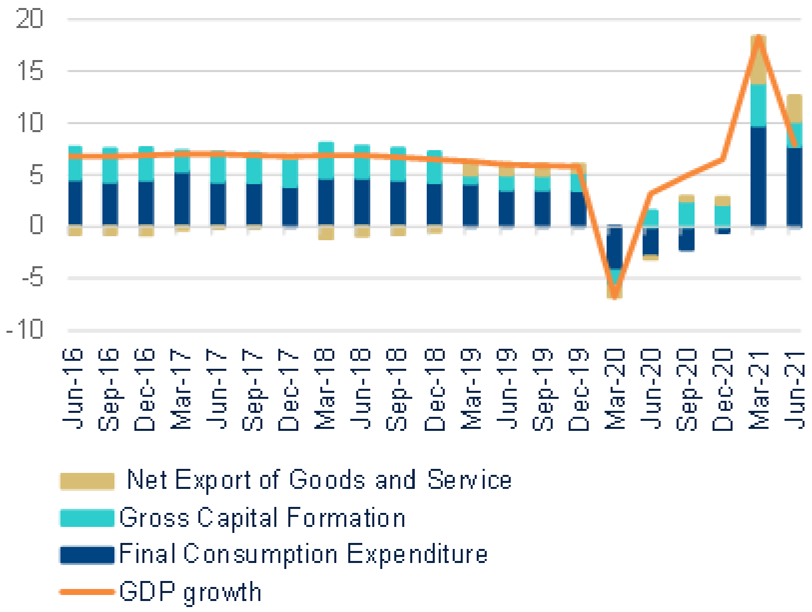
BBVA Research

01

Short-term growth deceleration while long-term potential growth depends on productivity

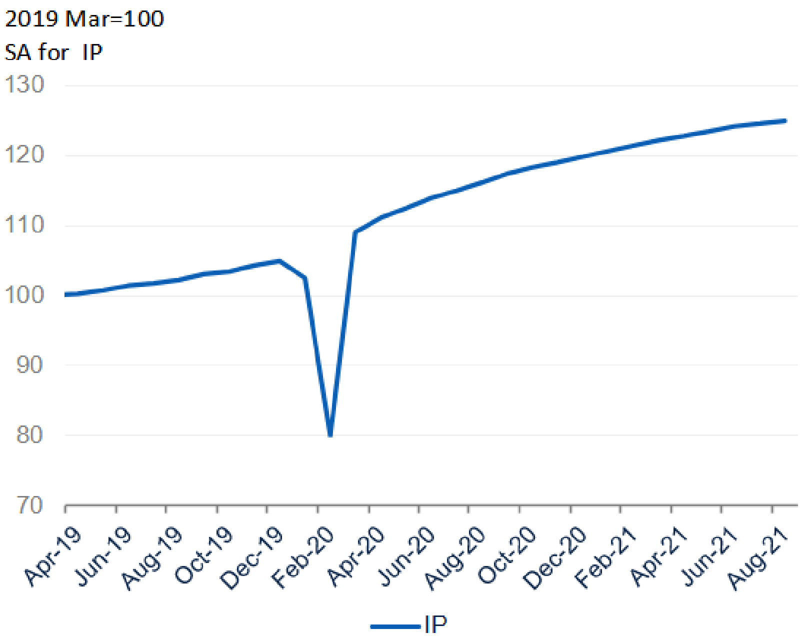
Growth slowdown after a strong rebound from pandemic

2021 Q2 GROWTH SLOWED TO 7.9% COMPARED WITH 18.3% Y/Y IN Q1



STRONG MANUFACTURING-CAPACITY-LED RECOVERY

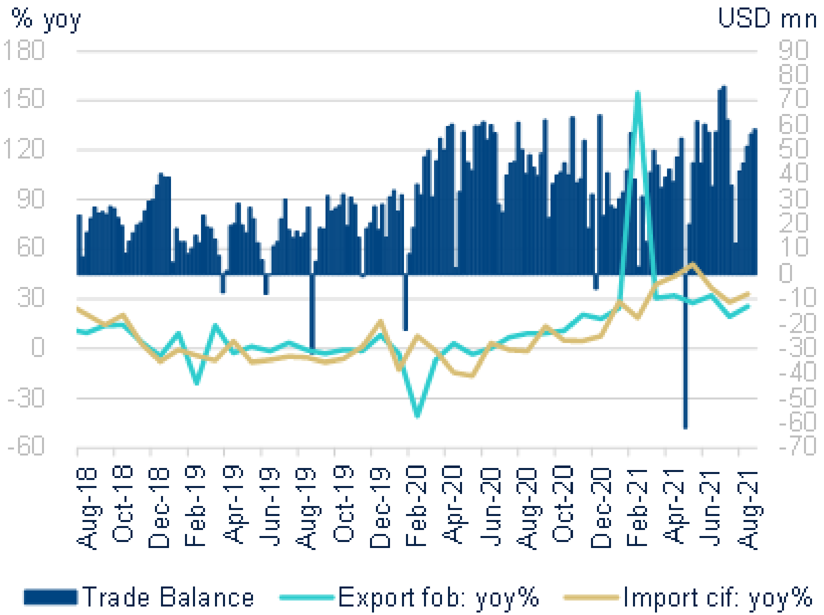
(2019 MAR = 100, SA FOR FAI AND IP)



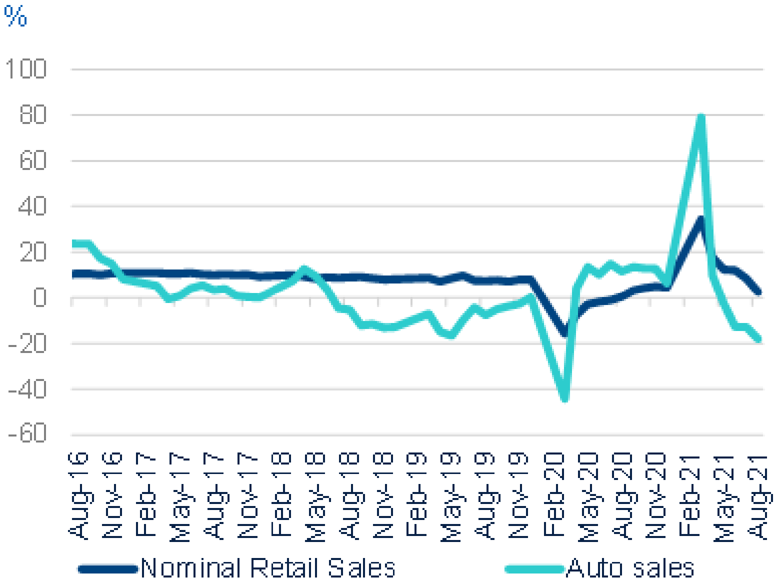
Source: CEIC & BBVA Research

Unbalanced structure: strong exports + weak domestic demand

SHIPPMENTS BENEFITING FROM PRODUCTION DISRUPTION IN OTHER COMPETITITVE ECONOMIES



CONSUMPTION IS SLUGGISH DUE TO LACK OF HOUSEHOLD TARGETED STIMULUS AND ZERO-TOLERANCE ANTI-COVID POLICY

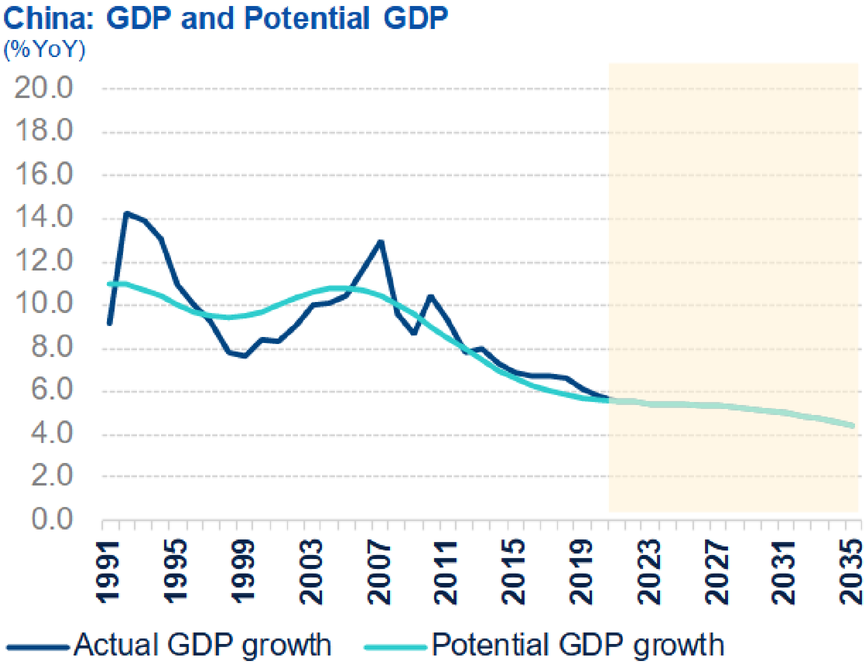


Forecast: China’s growth is still solid

	Baseline scenario			
	2019	2020	2021	2022
GDP （%）	6.1	2.3	8.2	5.2
CPI（%）	2.9	2.6	1.2	2.5
PPI (%)	-0.3	-1.8	6.5	1.7
Interest rate (LPR, %）	4.1	3.85	3.75	3.6
RMB/USD exchange rate	7	6.5	6.5	6.4

China's potential GDP and long-term growth

CHINA'S POTENTIAL GDP WILL MODERATE TO 4% IN 2035



- Potential growth will decline from currently around 6% to 4% in 2035;
- China's aggregate GDP will surpass the US between 2030-2035
- In the future, the potential GDP growth will increasingly depend more on total factor productivity progress rather than capital and population.
- We assume the Pandemic won't change the long-term trajectory of potential GDP

Research

02

Evergrande is set to drag down growth but unlikely to cause a systemic debacle

Creating Opportunities

Evergrande: a policy-induced crisis

THE BALANCE SHEET OF EVERGRANDE (RMB bn)

Assets	2301.2	Liabilities and Equity	2301.2
		Bank loans	216.3
		Overseas bond issuance	100.6
Inventory	1406.7		
Other current assets	498.2	Other liabilities	1633.9
Non-current assets	396.2	Owner's Equity	350.4

The liquidity issue of Evergrande is due to its holdings of large amount of Inventory (land and buildings under construction), which cannot be liquidated immediately to pay back its debt.

FINANCIAL EXPOSURE OF EVERGRANDE

- Evergrande's liabilities (RMB 2.3 trn) rank No.1 among real estate developers (liabilities for the 2nd Country Garden: RMB 1.76 trn; 3nd Vanke: RMB 1.52 trn)
- According to the regulation tightening policy ("Three Red Lines"), in 2020, out of 224 listed developers:
  - 51 of them failed to pass any (including Evergrande), estimated liabilities RMB 6.4 trn
  - 105 developers failed to pass one or two lines
  - only 68 developers passed all of the lines
- Foreign holdings of Evergrande's bonds:
  - Total amount of outstanding overseas bonds at USD 15.4 bn (vs USD 223.8 bn for all the Chinese developers)
  - Main holders: Allianz, Ashmore and BlackRock, UBS, HSC Royal bank of Canada

Evergrande: Why we don't think it is a systemic risk

	Potential transmission channels			Probability
Evergrande default	Banks: high NPLs Bondholders: loss	→	Bank runs; Bond fire sales	Very unlikely: Evergrande's exposure of banks and bond market is limited (in terms of the entire financial system)
	Loss of confidence in other developers	→ Developers fail to rollover debt →	Bank runs; Bond fire sales	Low Probability: 1. The authorities can effectively intervene to fine-tune their tightening against developers (ie. allowing them to borrow from banks). 2. All developers' issued USD bonds to be expired by end-2021: only 11.3 Bn USD. 3. All big banks passed the authorities' stress test (including property market stress scenario)
	Developers dump housing market	→ Steep drop in housing prices →	Financial crisis	Low Probability: 1. Housing demand has been suppressed by tightening policies (home purchase restrictions, mortgage limits) 2.Policy loosening will largely offset negative shocks. 3.Official stress test results show banking sector is resilient to housing price drops

Bottom line: the liquidity problem of Evergrande and other developers is in essence policy-induced. The authorities' intervention can effectively alleviate the situation. Evergrande has a great chance to be liquidated under the authorities' supervision. After its fall, the tightening policies against property developers is anticipated to be fine-tuned.

Evergrande: what's next and implication for growth?

THE AUTHORITIES´ LIKELY REACTIONS

1. The authorities will not bailout Evergrande directly:
    a. Less systemic risk (a property developer not bank)
    b. Still hold valuable assets (land reserves)
    c. It's private rather than state-owed company
2. The most likely reaction would be following HNA model
    a. Form a debt-payment committee composed of government representatives and important debt holders
    b. Liquidate good assets to pay back debt
    c. Equity holders take the final loss, likely being wiped out
    d. Institutional debt holders share the loss not covered by equity part, trying best to protect individual debt holders (home buyers paid in advance)

ECONOMIC CONSEQUENCE

- Evergrande's liabilities (RMB 2.3 trn) is equivalent to 2% of Chinese GDP.
- Real estate sector counts for around 29% of Chinese total GDP.
- In our baseline scenario, Evergrande crisis will lead to around 1% decrease of GDP; in the risk scenario, it will lead to 2.5% drop of GDP.
- The authorities will likely fine-tune its tightening on the property market and developers to stabilize the economy in the coming months. More pro-growth fiscal and monetary policy.

Research

03

Targeting inclusive growth and green economy with tighter government controls

New Role Model of Growth: Germany not the USA

German Model: what appeals to Chinese	Policy implications
Strong manufacturing capacity	“Hard tech” (5G, chips, NEV) not only “Soft tech” (Fintech)
Policy emphasis on climate change	Carbon neutrality by 2060 More support for Green tech
Good solution to housing affordability problem	Tightening on housing market (fine-tuning but no turnaround)
Less income inequality and equal opportunity	Tax scheme reforms Crack down on internet giants

(unnecessary) New concepts and misunderstandings

Common Prosperity = Nationalization of private enterprises?
Dual Circulation = Closing the door to the rest of the world ?

	Headline individual capital gains tax rate (%)	Property tax rate (%)	Inheritance tax rate (%)
China	No	No	No
US	20%	Varied across states, e.g. New Jersey: 2.13% New Hampshire 1.89%	No inheritance tax. However, there is an estate tax with a top rate of 40% .
UK	Range from 10% to 28%	28%	40%
Germany	25%	No taxes on wealth or capital employed, only minor local authority tax on property, but could be offset by an additional trade tax deduction.	50%
Spain	26%	3%	34%
France	30%	3%	60%

- In terms of tax scheme, China is more capitalist than many other countries! The "common prosperity" should and will be achieved through tax scheme reforms, rather than clamping down private enterprises.
- Dual circulation strategy is not closing the door to the rest of world. It's more like a reaction to US high-tech embargo. China needs to have their plan B for advanced technologies and products in the worst case. It's a malleable framework, pending on the geopolitical and international factors.

Regulatory storm is progressivism in nature, aiming to address long-term challenges to all the countries

Clampdown on Ant Finance and other Fintech companies reflects China’s efforts to shadow banking activities

Tightening regulations on monopoly behaviors of internet giants are in essence not different from US and Europeans actions on Google, Facebook etc.

Eliminating after-school tutoring business and limiting adolescent time of video game are leveling the playing field and enhance human capital

These policy initiatives are progressivism in nature, attempting to tackle a number of challenges to all the countries: tech-induced market monopoly, ever-widening wealth gap; global climate change; housing affordability; rising trade protectionism etc.

Chinese government need to do more and do better

Reasonable doubts

These are very ambitious goals, which are challenging to the entire human society. It remains an open question whether we can overcome them or not.

The Chinese approach is too blunt. There is lack of transparency in policy making and lack of communications in announcement. As a result, these policy initiatives, albeit with good intention, could lead to market confusion and even panic.

These policy initiatives are at the cost of growth. However, China cannot abandon growth. The communist regime legitimacy is based on continuous economic prosperity. The competition with the US requires for a remarkable performance of the economy. China needs to walk on a fine line.

Potential side effects

Frequent governmental interventions could expand the size of public sector and crowd out private sector. It is set to increase the government's debt level.

Domestic entrepreneurs will feel discouraged and confused when they are unable to tell which sector will be the next clampdown target.

Ever worse is that many of them could feel threatened if they (mis)interpret that China's authorities will nationalize their enterprises.

By the same token, international capital could shun China's market or require for a higher premium for their investment return in China. Even more clash with other countries could be possible.

Brain drain and capital exodus could take place if the country fails to retain its talents, in particular entrepreneurs.

The authorities are aware of associated risks but the jury is still out

- Better market communications to clarify policy intentions (from President and other top officials)
- More support for strategic industries (Huawei) and SMEs
- More liberalizing measures to attract international capital (shortening negative list and opening more free-trade zones)
- Opening domestic financial market to foreign capital

It will make winners and losers

Potential Winners	Potential Losers
High-end manufacturing, including new energy, electric vehicles and green economy	Polluted and energy consuming sectors
High-technology, including cloud computing, digital economy and 5G	Shadow banking activities and high leverage ones
National security and defense industries	Sectors with national security concern and data privacy risk
Pharmaceutical, biotech and services related to aging	Entertainment, housing, education for adolescents