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China's medium term challenges: Two keywords: fiscal and social

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Most – if not all challenges - add up to fiscal and social issues

China's macroeconomic situation is commendable:

- **Low public debt, large current account surplus and a huge buffer in terms of international reserves**
- **Furthermore, productivity is high, companies are profitable –even banks - and an enormous amount of jobs are being created**

Notwithstanding such a strong situation, China faces important challenges in a 3-5 year horizon. The challenges can be bundled in two main groups

1. **Existing and contingent <u>fiscal liabilities</u> higher than acknowledged**
2. **<u>Social unrest</u> is lingering and could increase due to income distribution/labor supply issues**

Main challenges with fiscal and social impact

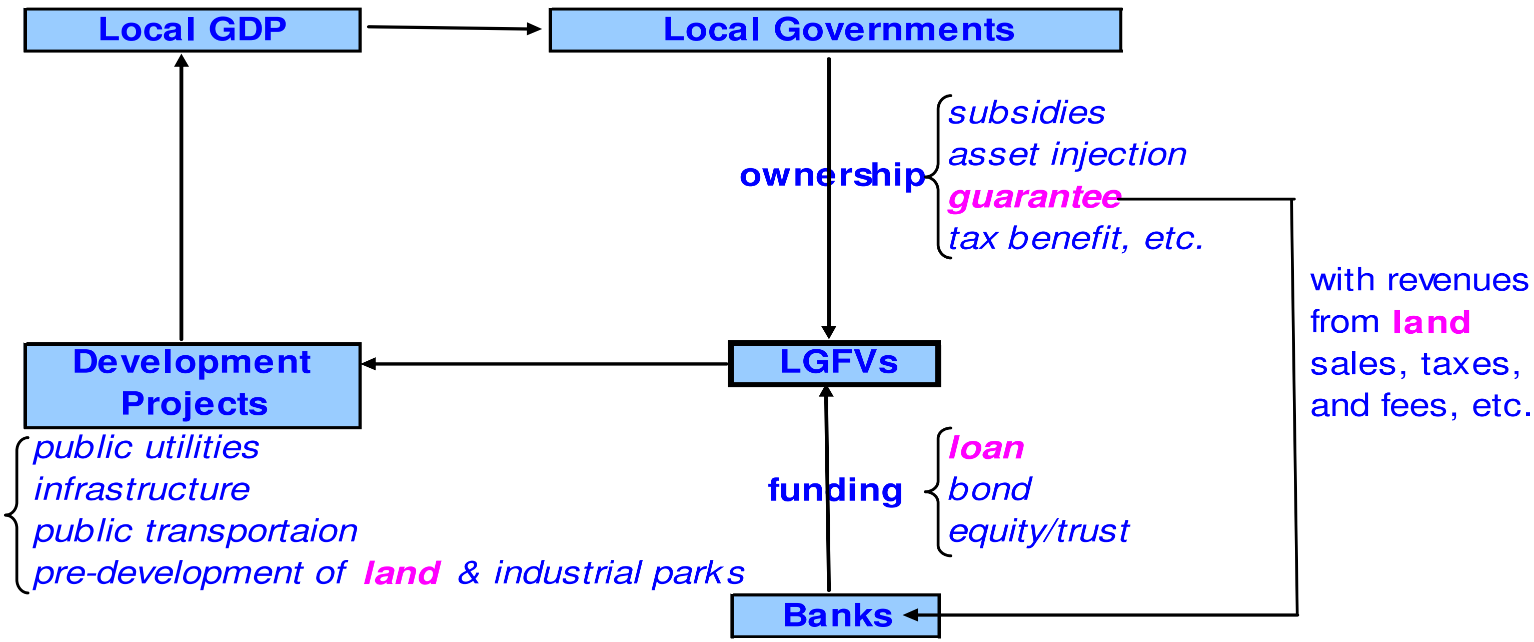
From shortest to longest term:

1. Higher than expected deficit stemming from fiscal stimulus package and concentrated on Local Government Funding Vehicles (LGFV)
2. Incomplete reform of the banking system and –on top of it – a fiscal stimulus which fosters aggressive behavior
3. Worsening income distribution
4. Ensuing labor shortages
5. Aging of population and pension issues

I. Higher than expected deficit through local government bank borrowing

LGFVs: what is the role?

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



Source: BBVA Research

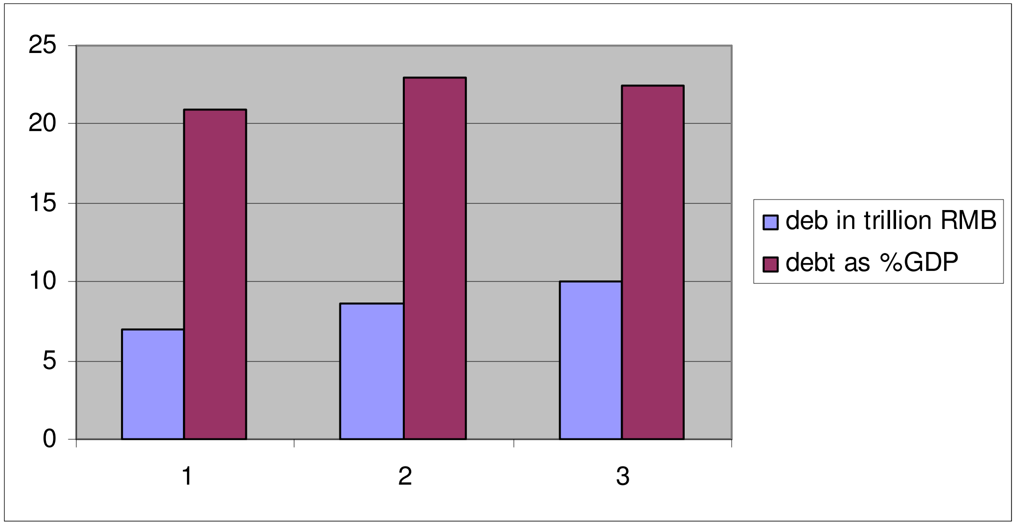
LGFVs are

- **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**

LGFVs: how big is the problem?

- Huge increase in number of LGFVs in 2009 encouraged by the central government
- It was considered as the easiest & cheapest way to finance huge fiscal package.
- PBOC estimates the total debt of LGFVs to have reached 7 trillion RMB or 21% of GDP(or 114% of annual local government fiscal revenue including fiscal transfer from central government). While it will continue growing, it should stabilize at over 20% of GDP

LGFV debt projections



LGFVs: How big is the problem?

- **Even if problem seems sustainable, at least in the short to medium term, For others, like Shih(2010), LGFVs borrowing hovers around 11.4 tn RMB at the end of 2009.**
- **It is estimated that LGFVs from banks is 6 out of those 7 trillion (85% of total) but the rest are bonds for which banks tend to be the guarantors.**
- **About half of those bank loans are backed by collateral (BoA&ML, 2010) but very hard to enforce.**
  - **Those behing LGFVs – the local government - are not allowed to make guarantees**
  - **Many assets are used as collateral for many different loans**
  - **Value of collateral very volatile (specially if land)**

2; Whose is the problem? Pecking order

1. Bond interests/capital
2. Four large SOCBs and China Development Bank
3. City commecial banks (CCBs) and joint stock commercial banks in more trouble

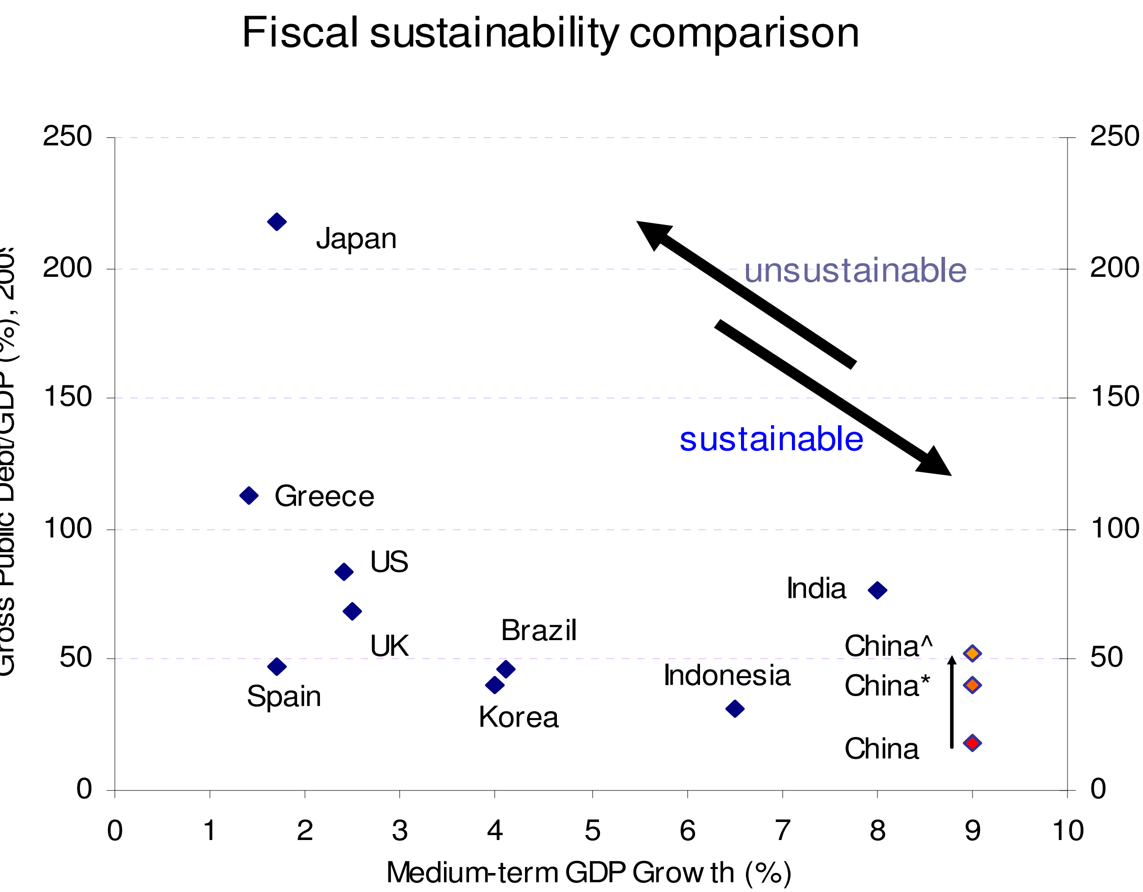
Table: Estimation of new loans for LGFVs, 2009

Unit: bn	RMB	USD
Industrial & Commercial Bank of China	720	105
China Construction Bank	646	95
Bank of China	535	78
Bank of Communications	139	20
Other banks	1,010	148
Total	3,050	447

Source: BBVA Research from various news sources

LGFVs: How much more debt for China?

Chart: International fiscal sustainability comparison



Source: OECD, WEO, CIA, Shih (2010) and BBVA Research estimates. * and ^ : incorporated 7.38 and 11.42 tn RMB LGFVs loans respectively.

So far LGFVs borrowing is not considered public debt. If it were, China's debt to GDP ratio would be:

- **41% in 2010 if their borrowing has really been 7 trillion RMB**
- **53% if borrowing were 11.4 trillion**
- **Shih argues it could actually reach 70%**

70% debt ratio would put China closer to India.

However, China's high growth and moderate (even negative) interest rates – as well as the fact that holders are virtually all residents – implies that the situation would still be <u>comfortable specially given that the debt of LGFVs will stabilize</u>

LGFVs: A key issue to solve in the coming years

- They are 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
  - In 2009, land sales accounted for 1.6 trillion RMB, or about 50% of local governments' revenue, which makes local governments as a key player in creating bubbles in the housing market.

?

Part II:

Incomplete banking reform

2. Bank reform: main messages

- **The world financial system is in shambles**
- **Meanwhile, China's banking system has not experienced major problems.**
- **Is it true?**
  - **To some extent yes**
  - **But not fully:**
    - **The root of the problem is not still fully addressed:** public interference on lending and financial repression
    - **The (mis)use of the banking sector to counteract the crisis constitute a step back;** the LGFV borrowing is a case in point
    - Finally the transformation towards retail banking to support consumption by households is proceeding very slowly

2. Fiscal costs of an incomplete banking reform

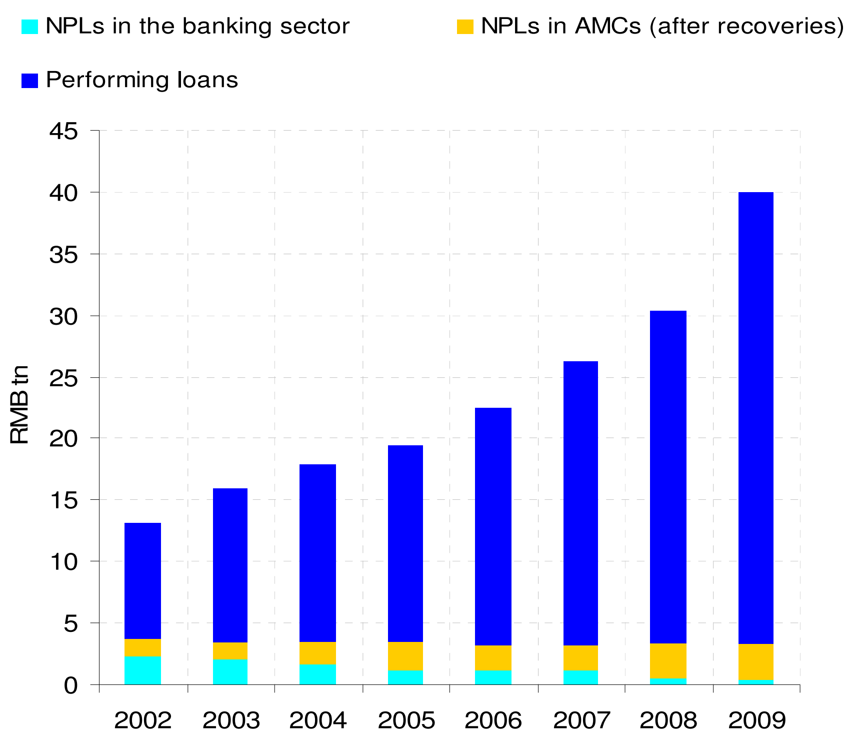
- **There are several reasons to expect a higher fiscal cost.**

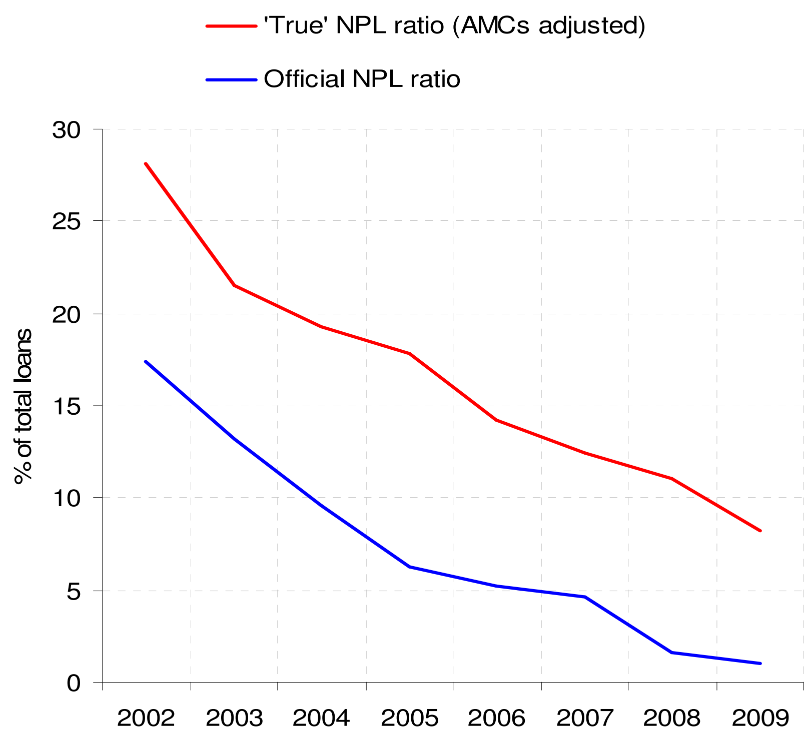
1. ***The restructuring of ABC:***
    - **NPLs stands at around RMB 800 billion.Central Huijing has injecting RMB 13 billion yuan in exchange of 50% of the capital.The remaining 50% is that from the first shareholder, the MoF.**
    - **To reduce the fiscal cost, non-performing assets may be written off on the basis of future tax rebates, dividends on MOF's shares and cash from the disposal of NPLs. In addition, MOF may sell stocks but so far fiscal cost will be large**
2. ***The clean up of the LGFV borrowing***
    - **The previous hypothesis that the whole debt of LGFVs is acknowledged by the government is extreme. Likely that one part has to be supported by the banks**
3. ***Fiscal consequences of the previous restructuring have not yet been recognized***

2. Fiscal costs of an incomplete banking reform (II)

3. The fiscal consequences of the previous restructuring have not yet been recognized

- **The transfer of NPLs to AMCs and their low recovery ratios (25% of face value) has not yet been recognized**
- **Summing htis, the "true" NPL ratio would be around 10% .**
- **Furthermore the fall in the ratio (from over 25% comes from rapid growth of credit**





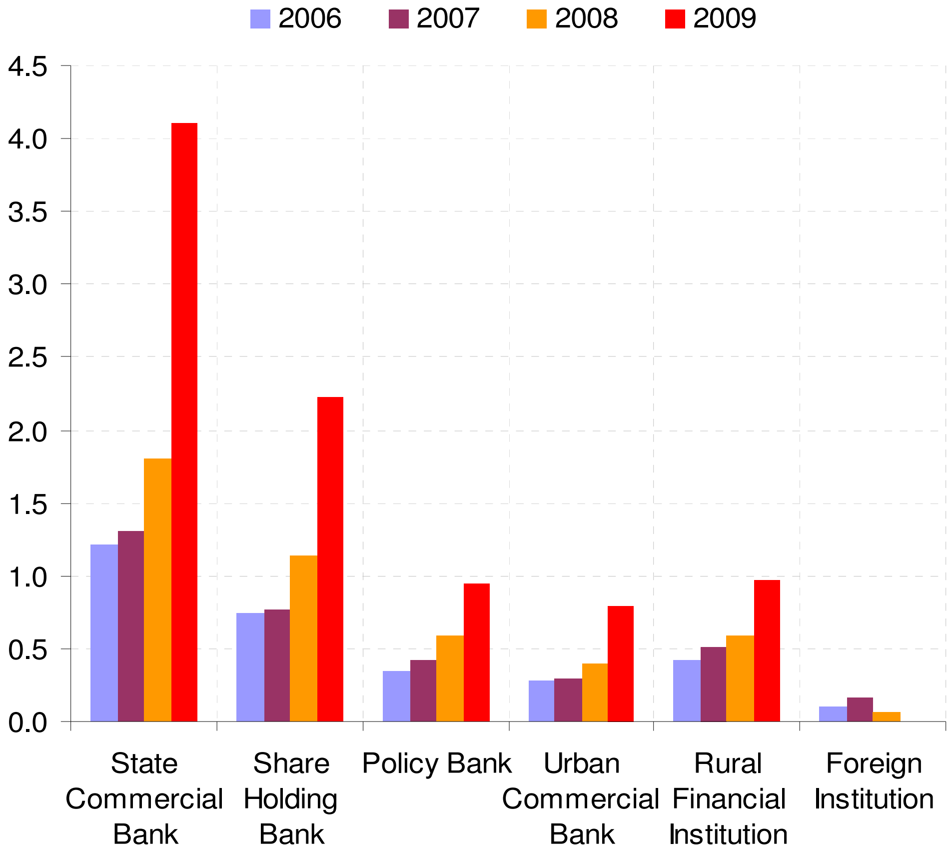
2. Fiscal costs of an incomplete banking reform (III)

ey question is thus whether *the nature of lending has changed from the past*

ctually not much: SOCBs continue to be leaders and in very similar sectors

stimates by Garcia-Herrero and Santabarbara point to about 10 pp more fiscal deficit due to new NPL flow

Changes in outstanding loans by institution
(RMB trn)



Source: CEIC. Last observation 2009.

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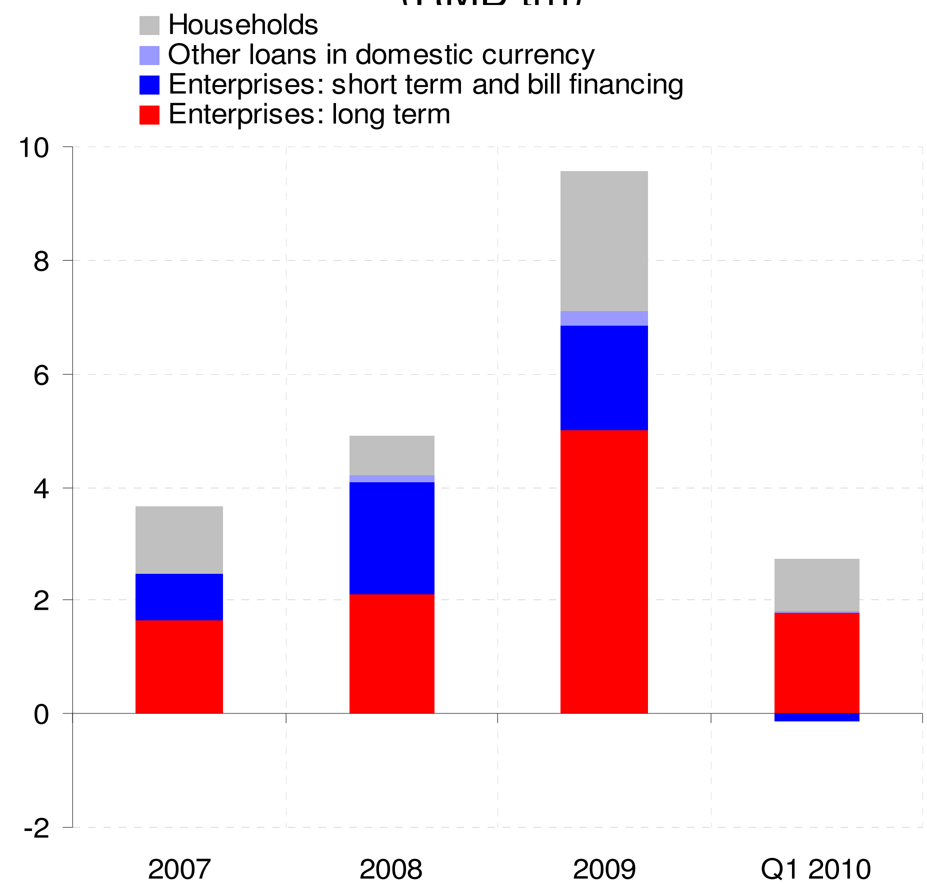


Part III:

Worsening income distribution

China Income Distribution

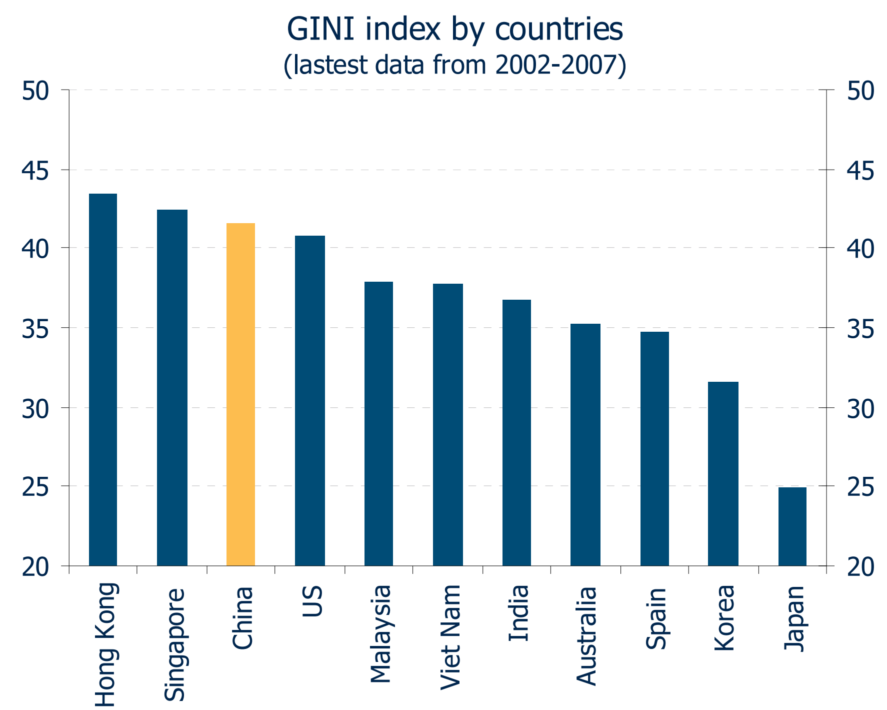
High Income Disparity in China shown as GINI Index

The rapid expansion of China's economy and of inequality in China are considered to be among the effects of the economic reforms that began in 1978. The reforms set macroeconomic growth as the first priority, and sacrificed a degree of equality in income distribution

The income disparity is mainly exhibited as:

- **Discrepancy between rural and urban areas;**
- **Income differentials across and in provinces;**

China has not published a Gini coefficient for some time but, if it were, it could look even worse than HK (45)



Source: Asia Development Bank

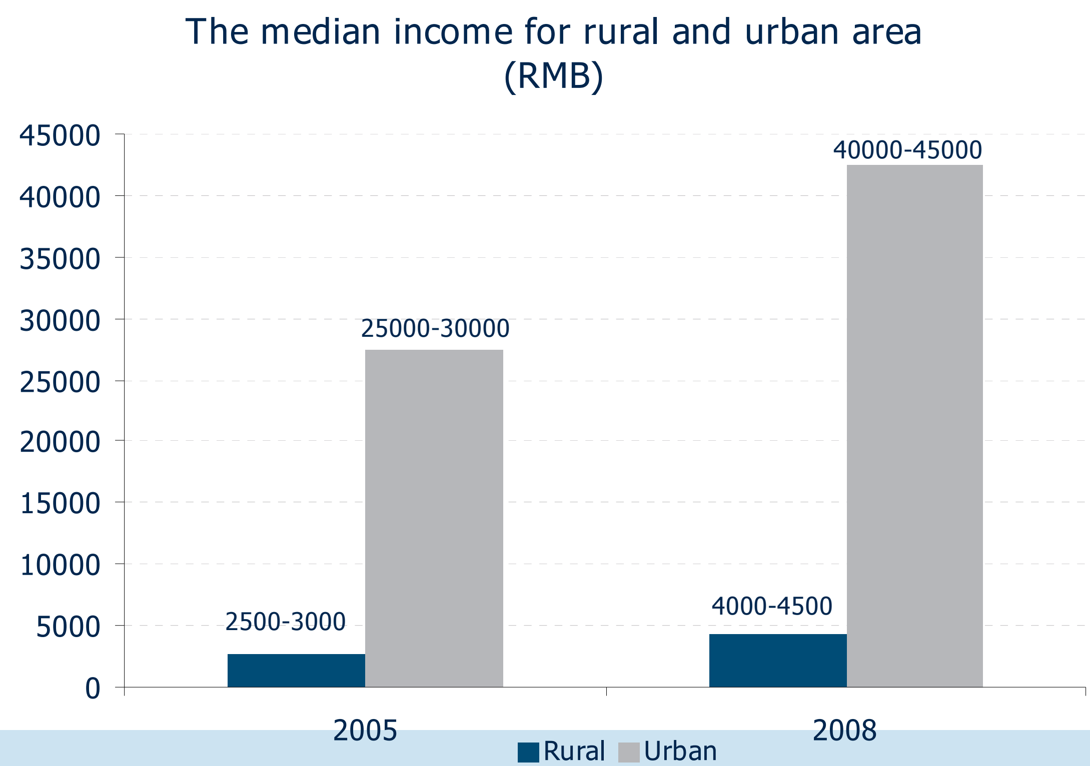
Country	Hong Kong	Singapore	China	United States	Malaysia	Viet Nam	India	Australia	Spain	Korea	Japan
GINI index	*43.4*	*42.5*	***41.5***	*40.8*	*37.9*	*37.8*	*36.8*	*35.2*	*34.7*	*31.6*	*24.9*

China Income Distribution

Rural Vs. Urban Income Distribution: Inequality of the urban-rural dual structure

Inequality in income distribution deteriorated in both rural and urban area, but the situation in rural areas is much worse

The GINI index is 0.39 in rural area and 0.32 in urban area (lower than before)

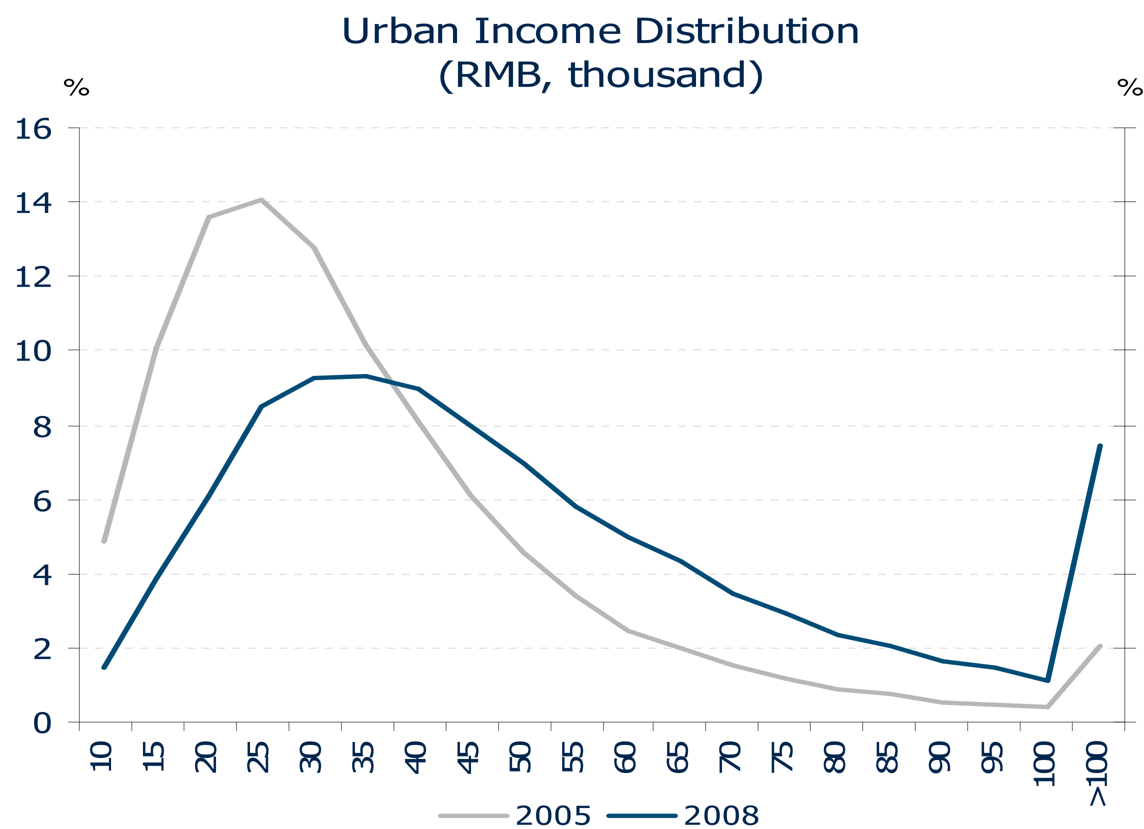


China Income Distribution

Some improvement in urban area

- More income inequality within middle class compared to 2005;

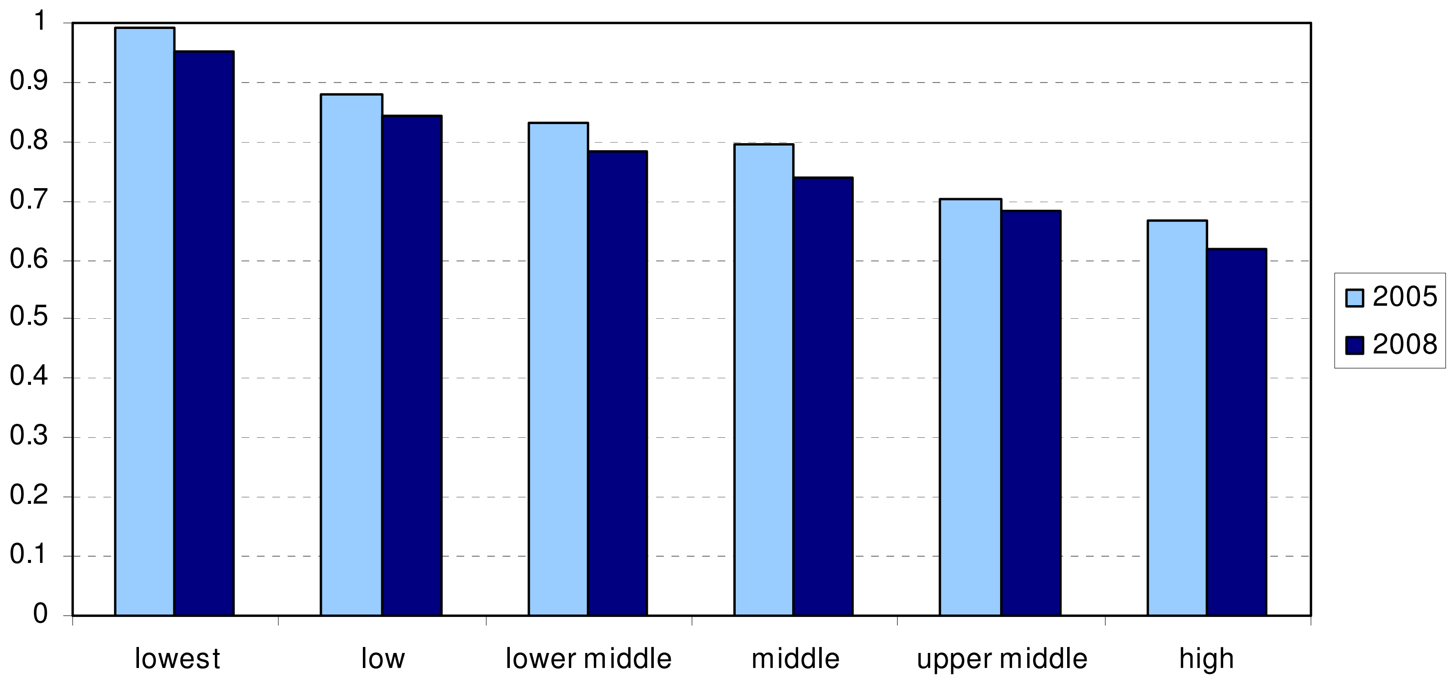
- Rich group become much richer
- There are fewer extreme poorer



Income inequality hampering domestic consumption

- **As measured by the Gini coefficient, income inequality is more severe in China (Gini=0.41) than all developed countries.**
- **Propensity to consume decreases with income level, so one way to increase domestic consumption is to reduce inequality and to increase market access to low income households.**

Propensity to Consume in Urban China by Income Group



Source: CEIC

Income inequality hampering domestic consumption

- Public spending on social welfare could help mitigate the negative effect of inequality, and therefore increase domestic demand.
- Several measures are being taken, such as:
  - Subsidize consumption in rural areas (specially white goods)
  - Offer minimum pension and health services (under a pilot project)
- Still, China is lagging well behind other countries in public spending on social welfare: 14% of GDP (which probably includes other issues) vs. 20% of GDP by OECD countries.
- Two fundamental reforms seem warranted to increase consumption
  - Institutional reforms that reduces the size of the state (reallocating resources away from state-owned monopolies so as to reduce oligopolistic behavior and too high prices)
  - Increasing real interest rates so that those saving (households) do not continuously lose their wealth

Income inequality hampering domestic consumption

- Two fundamental reforms seem warranted to increase consumption
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  - Increasing real interest rates so that those saving (households) do not continuously lose their wealth
  - “Private” to welfare state through private health insurance, private pension schemes, access to consumer lending, etc
- Meanwhile social unrest will continue to increase

Part IV:

Ensuing labor shortages

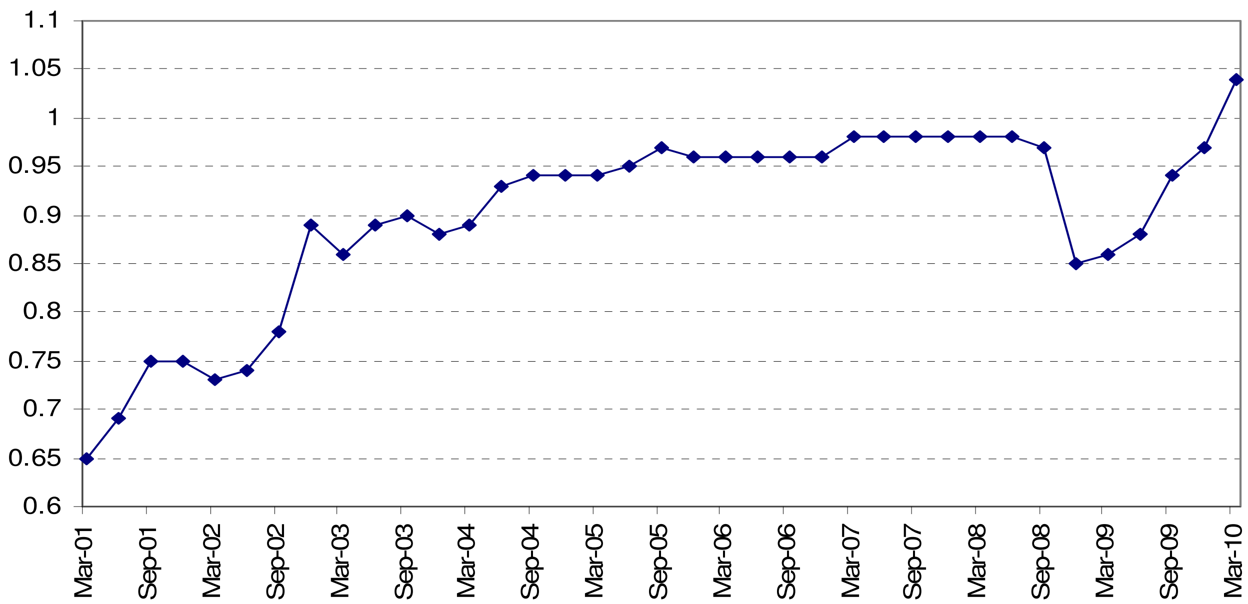
Labor market conditions : China's turning point

- Recent evidence suggests that the era of surplus labor is over under the current Hukou system (Kroeber 2010; Cai and Wang 2010; Zhang et al 2010).
- Manufacturing sector faces risks of labor shortage and losing the competitive advantage of cheap labor.
- Latest stories support this view:
  - Suicides at Foxconn and high-profile strike at Honda plant in Guangzhou resulting in significant wage increases (50% and 24% respectively)

Labor market conditions: China's turning point

- **Demand for labor temporarily dropped due to the global economic downturn, but has been increasing as the economy recovers.**
- **Wages and benefits have also been increasing rapidly. Minimum wages will increase 20% in Guangdong, 21.2% in Shandong, 20% in Beijing, 12% in Jiangsu, starting from June 2010. (Law time China June 2010)**

Urban Labor Demand-Supply Ratio in China

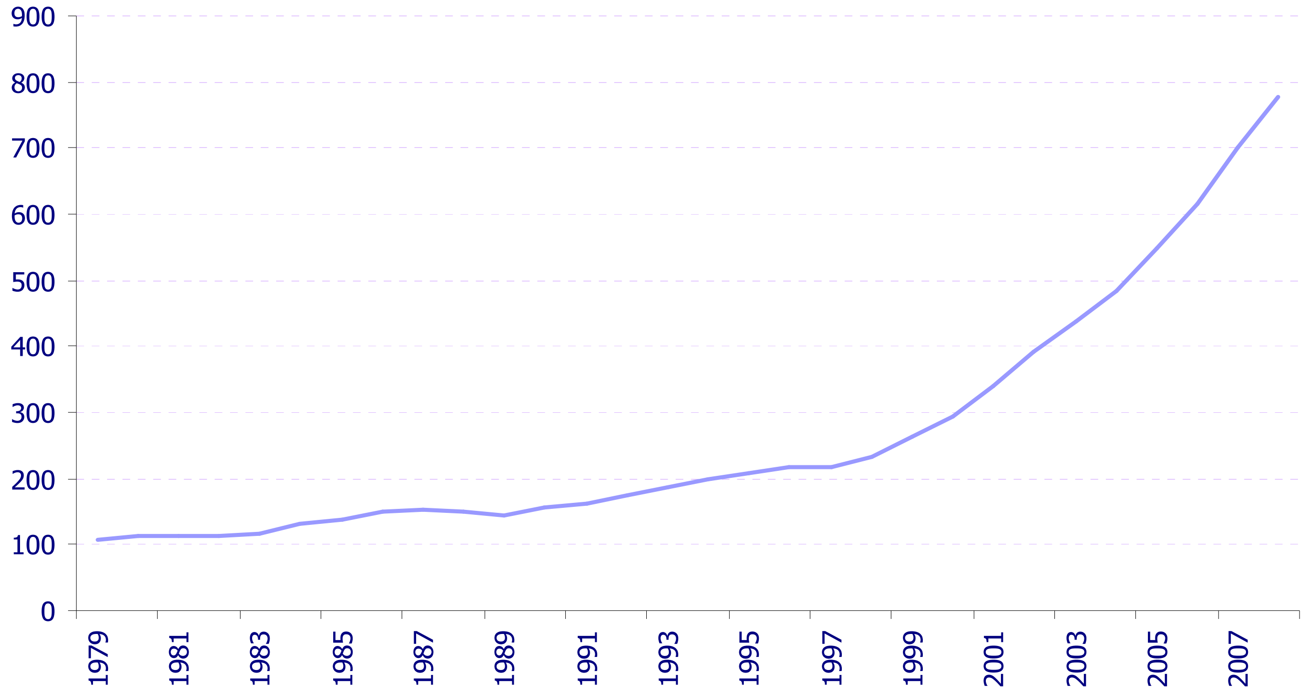


Source: CEIC

Labor market conditions: the end of cheap labor

- **As the real wage increases and living conditions in inland and rural areas improve, migrant workers choose to relocate to cities closer to home, which exacerbates labor shortage in coastal areas.**

Real Wage Index (1978=100)

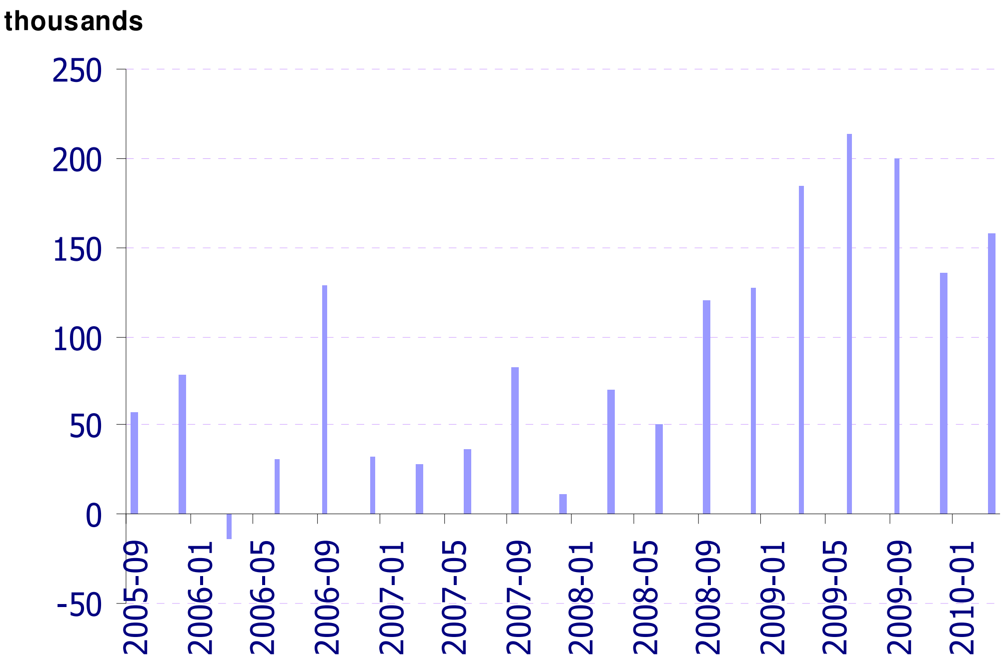


Source: Ministry of Human Resources and Social Security

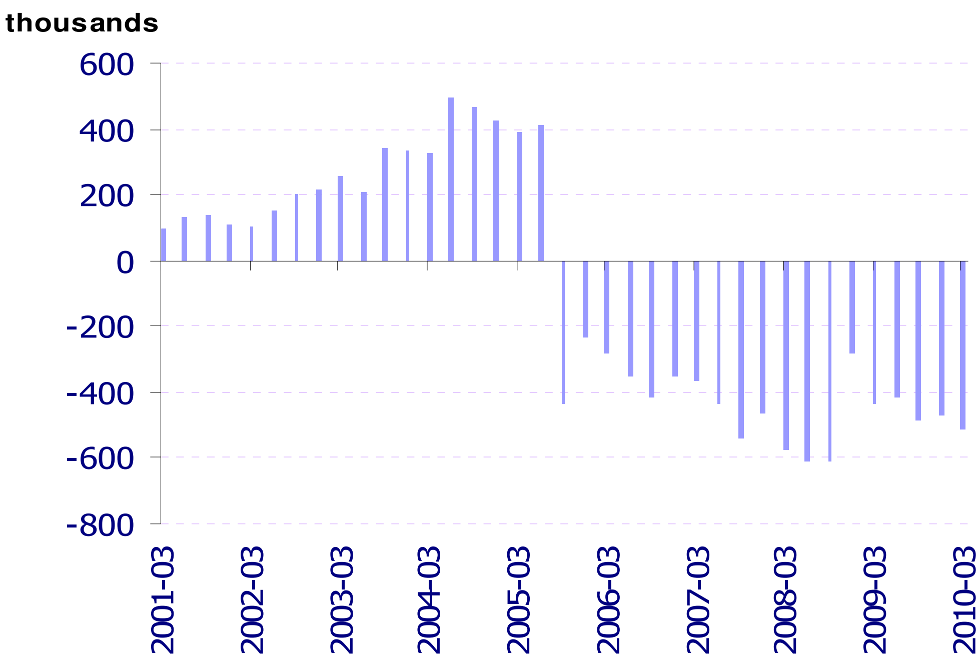
Labor market conditions: excessive supply of college graduates

- 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



Excess Supply of High School/Vocational Training Graduates

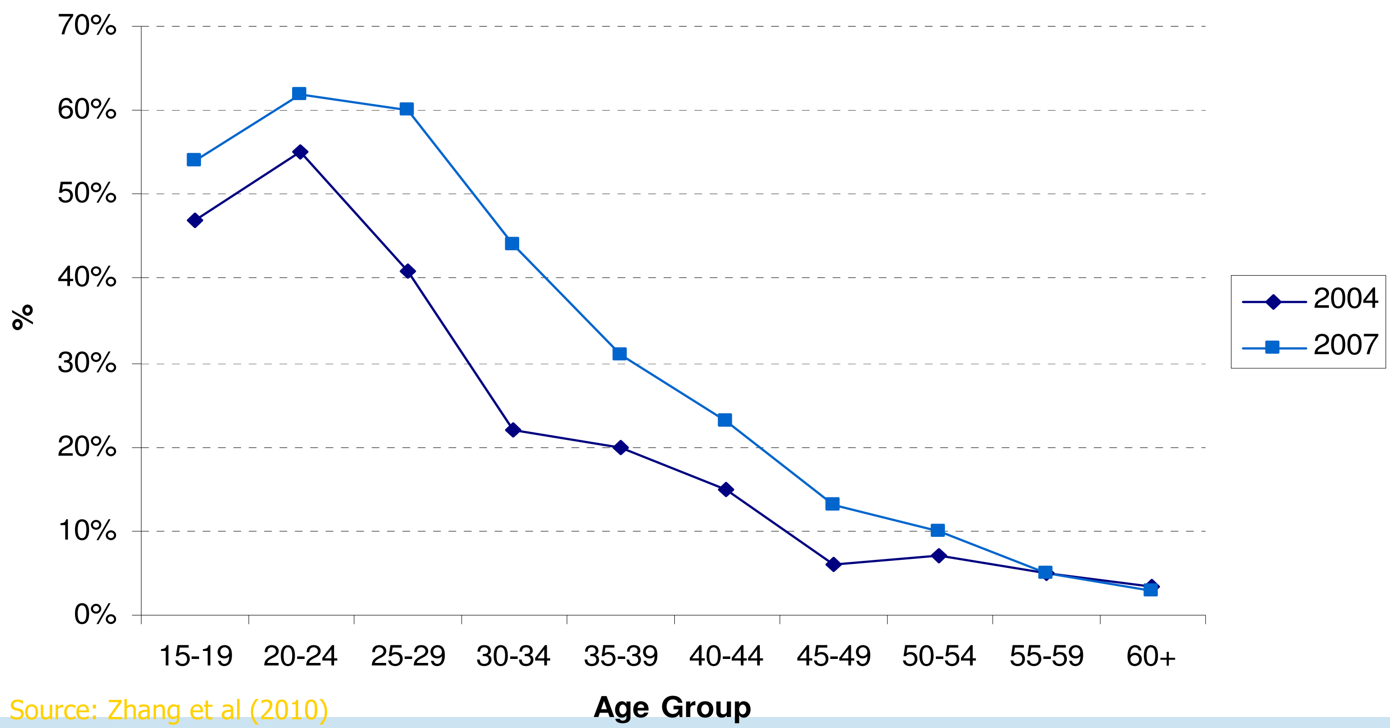


Source:CEIC

Labor market conditions: reliance on migrant workers

- **The manufacturing sector is increasingly dependent upon migrant workers from rural areas. The Hukou system and urban-rural welfare disparity impose restrictions on labor mobility.**
- **Migration rate decreases with age. There is a need to reform migration policies to facilitate permanent migration so that older migrants can participate in the work force.**

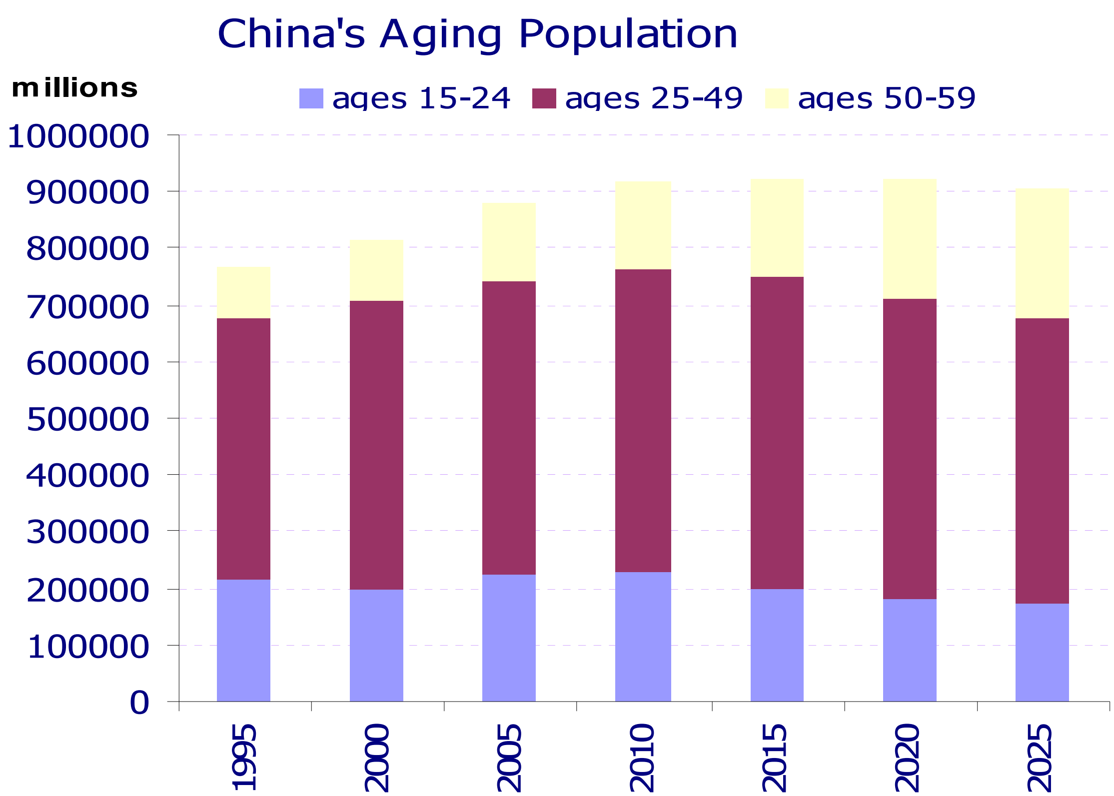
Share of Migrant Workers for Rural Males



Source: Zhang et al (2010)

Labor market conditions: reliance on older workers

- **The government still has leeway through reforming the Hukou system. However, with China's population aging, the number of potential labor force entries will decline over time (Kroeber 2010).**
- **China will need to rely on an older workforce (Zhang et al 2010). There is a need to reform social welfare policies, especially those for migrant workers.**



Source: United Nations Populations Division

Labor market conditions in sum

- Such a structural shift in China's labor force will have several different consequences
  - Social unrest in as far as others will clearly demand the same wage increases
  - Possible different treatment of SOEs and private (specially foreign) companies, with potential negative consequences for China's FDI
  - Increase in inflation although not major blow to competitiveness as there is a shift towards provinces with lower wages and productivity continues to increase
  - Such high productivity increases will not continue for ever, though, specially as the labor forces ages

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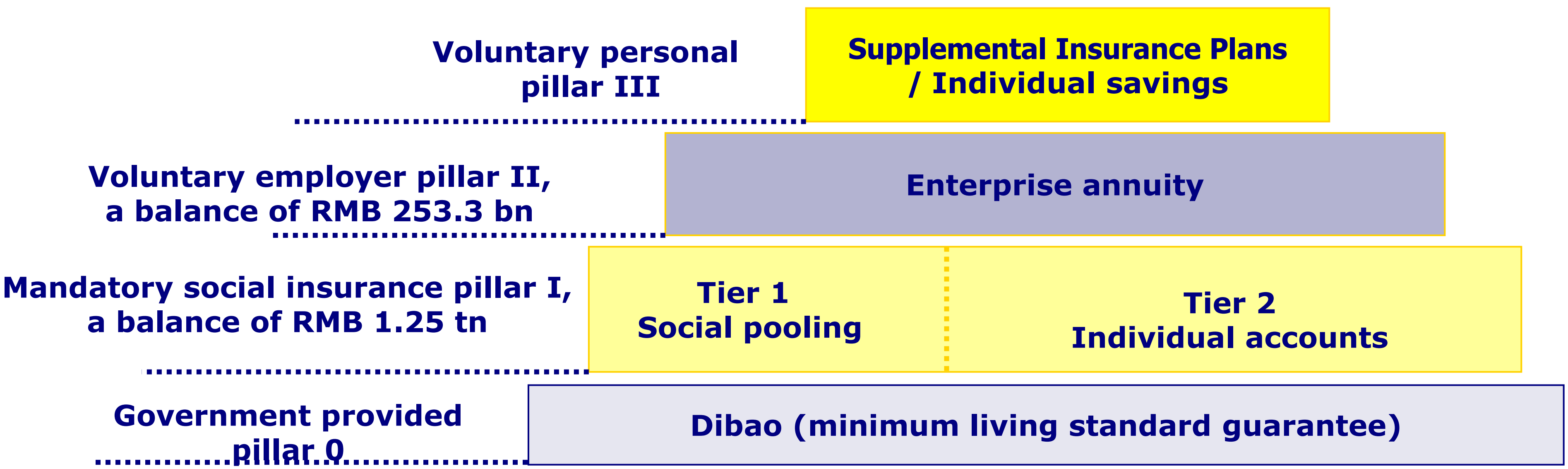
Part V:

China pension system:
A time boom unless there
is a reform

The three pillar system which was to be introduced but hasn't

Three Pillars System



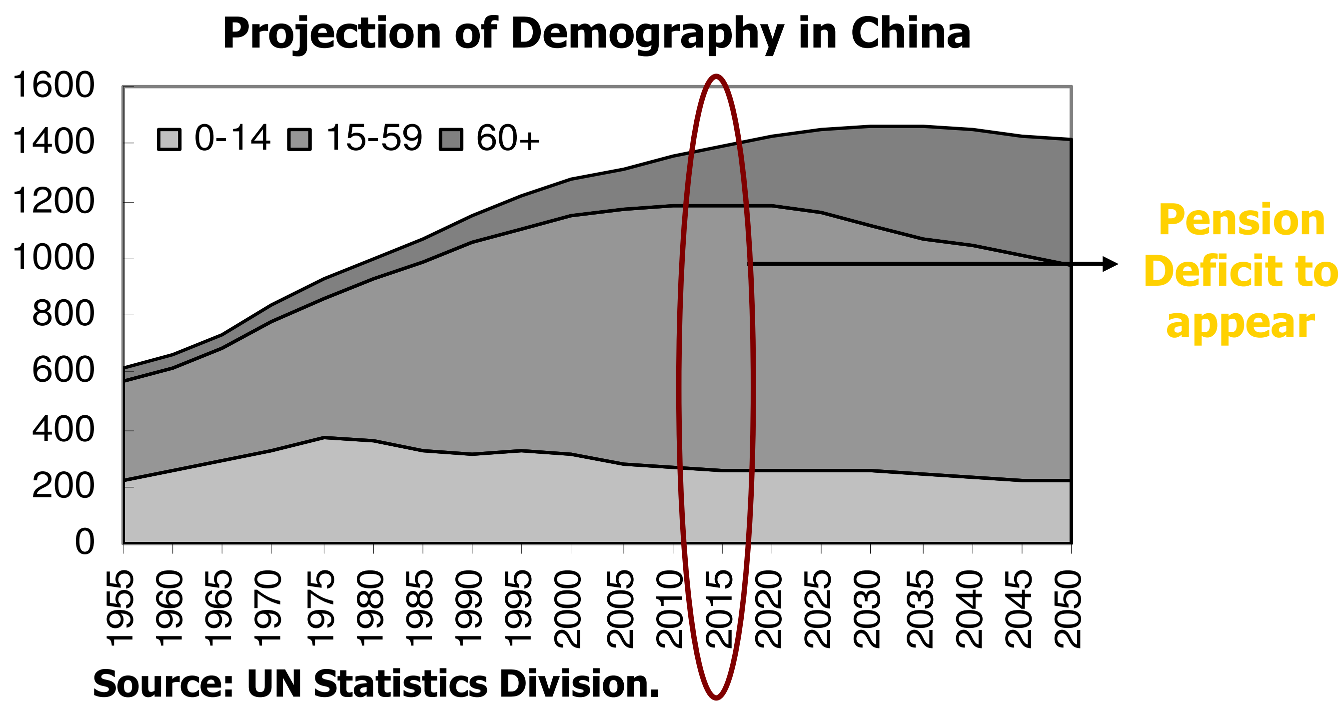
- The balance accumulated in Pillar I & II is still far less than sufficient.
- The net implicit pension debt is very high, originated from pension reform in 1997 and current aging population.
  - MOHRSS estimation in 2005, 6 trillion yuan is needed to finance the gap.
  - Word Bank estimation, the gap would be 9.15 trillion yuan.
  - Renmin University of China estimation, the gap would be 4 trillion yuan.

Still low coverage in pension system

- **Pillar I: China has a urban population of 622 million and a urban employment population of 311million. 236 million participate in the basic pension system (Pillar I) as of 2009. The coverage ratio is 38%.**
- **Pillar II: 33500 enterprises set up the EA scheme as of 2008, involving 11.79 million people, compared to 5.6 million in 2000. The coverage is quite low, only 3.8% of urban employment population (311million).**

Pension pressure is looming

Pension deficit will appear in 2015, with more pressure further on



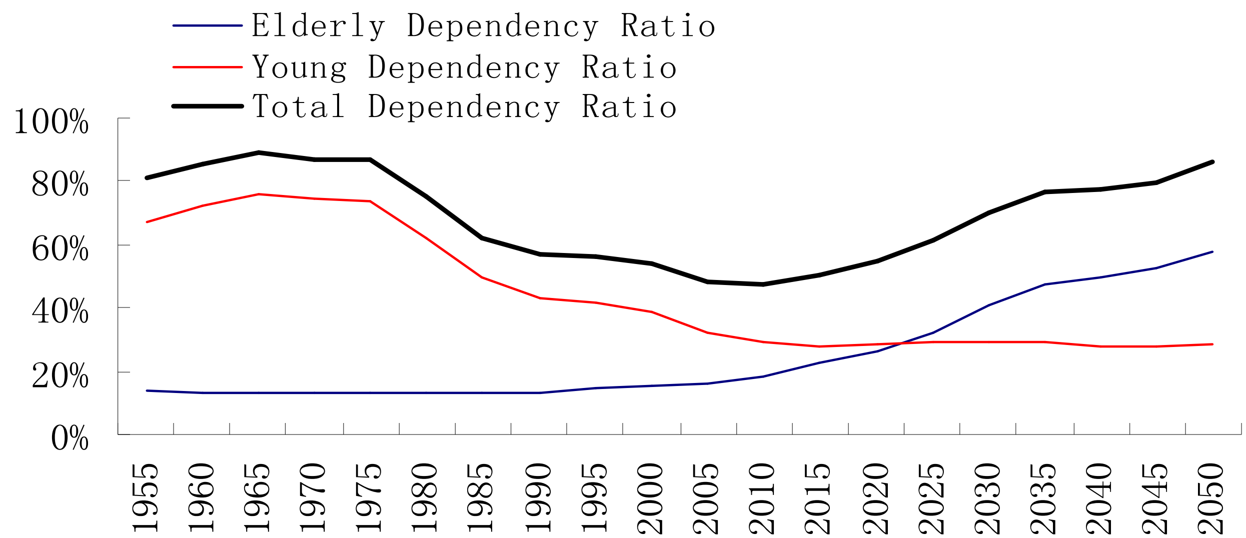
Source: UN Statistics Division.

- **China's population structure has been undergoing a rapid change. As the baby boomers born in the 1950s and the early 1960s will enter retirement age, the elderly ratio is expected to accelerate rapidly after 2010. China still runs a pension surplus so far, but will have a deficit from 2015 onwards based on recent trend.**

- **In 2010, the elderly (60+) accounts for 12.5% of total population, but in 2050, the proportion increased to 31.1% and to over 58% in 2050.**

Aging population will add pension pressure

Dependency Raito



Source: UN Statistics Division.2006 Projection

Note: Elderly dependency ratio = population aged 60 and over /population aged 15-59

Young dependency ratio = population aged 0-14 /population aged 15-59

Summary

- The Chinese pension system is facing looming pension pressure due to fast aging problem.
- China has built the 3-pillar pension system in order to cope with the pension pressure in the future, but it is not yet fully funded. The situation will get worse over the years
- The introduction of Enterprise Annuity (Pillar II) is set to make up insufficient Pillar I. But authorities are still supporting Pillar I so this shift has stalled for the time being.
- This reform is extremely important to ensure the sustainability of China's fiscal situation in the next ten to twenty years

QUESTIONS/COMMENTS

MOST WELCOME

THANK YOU!

Contribution and benefits in China's pension system

Contribution and Benefits

Chinese Terminology	Contributions		Benefits
State Pillar Ia	Employee Nil	Employer ~20%	Pension payment based on average local wage, indexed individual wage and years of employment
State Pillar Ib	Employee 8%	Employer Nil	Pension payment based on accumulated contributions and age specific actuarial factors
Private Sector Pillars II & III	Variable		Variable

The ideal replacement ratio for three pillars:

Pillar 1 : Social security, replacement ratio 50%-60%

Pillar 2 : Enterprise annuities, replacement ratio 20%-30%

Pillar 3 : Supplemental plans, replacement ratio 10%