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ECONOMICS: ASIAN PERSPECTIVES

CHINA: POLICY DILEMMA MAY RESURFACE IN 2018

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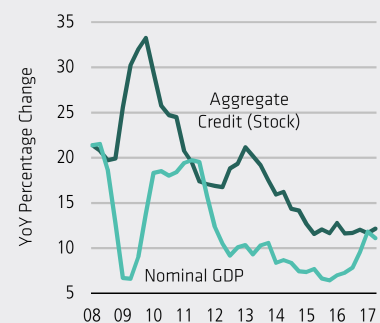
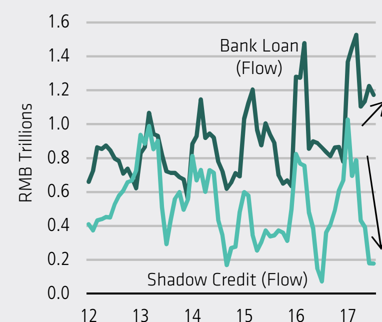
The desire to suppress any disruption ahead of the all-important Communist Party Congress forced China to put utmost priority on economic stability in 2017, at the cost of potentially painful reform. With President Xi Jinping seemingly poised to consolidate power, the question now is whether he will shift his focus back to the reform agenda in 2018.

Display 1
Growth in Credit Stock Stays Robust



As of June 30, 2017
Source: CEIC Data and AB

Display 2
Bank Loan Resumes Despite Curbs on Shadow Credit



As of July 31, 2017
Source: CEIC Data and AB

A Year of Stability

At the start of 2017, many China experts were worried about a bulging list of economic risks facing the country. But somehow, President Xi Jinping's administration—with a barrage of centralized, heavy-handed measures—managed to contain capital outflows, fear of currency devaluation and potentially toxic leverage. It also forestalled a housing bubble, large credit defaults and an outright trade war with the new US administration led by President Donald Trump.

Critics would still argue that Beijing's solutions to the problems were largely just addressing the symptoms rather than their root causes, merely pushing out the timeline for overdue reform.

Like it or not, however, financial markets have generally repriced China's risk as a result of the relative stability. The question now is, what next?

Drastic Measures for Drastic Times

It is widely understood that President Xi, amid the intense political jockeying in the run-up to the 19th Communist Party Congress in late 2017, was simply not going to accept any economic instability that could undermine his effort to consolidate power.

To maintain stability, he rolled back reforms, stepped up central state controls, and de-emphasized market principles and economic liberalization. For example, draconian measures—including a forceful scrutiny of overseas investment and spending at almost all levels, from big businesses to individuals—were deployed to stem capital outflows. Explicit means and moral suasion prompted state entities and even private companies to repatriate offshore funds raised through initial public offerings. Enterprises under official investigations were ordered to liquidate assets and send funds back home.

In the banking sector, shadow financing was cut off drastically by administrative and political means to prevent a credit bubble. At the same time, to avoid a credit crunch or an abrupt economic downturn, the state commercial banks stepped up their lending, at least for state investment, infrastructure projects and housing. As a result, the central bank's balance sheet, and the broad, system-wide liquidity never shrank (*Displays 1 and 2*).

Halting capital outflows helped to stop a depletion in China's foreign exchange reserves. Indeed, China regained US$70 billion in reserves on a year-to-date basis after losing US$320 billion in 2016. That, together with increased foreign exchange intervention and various market maneuvers by the People's Bank of China (PBOC), has helped the onshore-traded renminbi (CNY) appreciate by 5.5% against the broadly weak US dollar so far this year.

With Politics Settled, What Next?

At least until the dust settles with the Communist Party's top leadership changes later in the year, all of these major policies and trends are likely to stay. But the key question is, what awaits in 2018?

Although speculation remains rampant about China's political infighting, our central scenario is that President Xi will consolidate his position as the unquestioned leader and will set off on his second term in office with an even more centralized power base in 2018. Once the politics are out of the way, the main issue will be whether the administration continues to favor a pro-growth policy over tackling underlying structural imbalances, or shifts its focus back to reform for the sake of long-term economic development.

The key guideposts to monitoring the policy trajectory in this regard will be whether Beijing implements a more meaningful state-owned enterprise (SOE) reform, further reducing overcapacity. Likewise, whether it tolerates a temporary buildup in nonperforming loans and allows inefficient companies to truly default will also be a critical signal, as it would mark a departure from the high-leverage culture supported by the state's implicit guarantees. It will also be important to see whether the more politically secure administration will revisit the liberalization of China's capital account and the internationalization of the RMB, both of which have taken a noticeable step backwards over the past year.

At this point, we think the odds are marginally in favor of some reform being resumed next year—a probability of, say, 60%. Sticking to a crude pro-growth policy, driven by state funding, would help to boost infrastructure but risks accumulating more debt and may eventually lead to a bursting of the housing and credit bubbles.

Xi Seeks to Reshape China Inc.

There is also a chance that this traditional "two steps forward, one step backward" stereotype isn't the right way to look at China's economic reform anymore. President Xi may have much greater ambitions.

One clear trend under the Xi regime is the expanded role of the state in economic affairs, or the reduced emphasis on market forces in resource allocation. Strikes for national campaigns in key strategic industries and the blatant meddling with private companies' offshore investment activity—under the pretext of curbing capital outflows—have raised questions about the role of private capital in the next stage of China's development. The direction seems to be away from the orthodox Western free-market principles which foreign investors hope to see, but it may be a reflection of so-called "socialism with Chinese characteristics" showing more of its true colors.

How to Perceive China Risk?

A very important consideration here for global investors is China's growing importance in the world economy. China will soon have the world's largest economy and, with it, the largest domestic bond market, featuring greater liquidity and denominated in a more internationalized renminbi. It's a market that can't be ignored but one where the modus operandi may be very different from conventional Western markets, retaining risks typically associated with emerging markets. As such, the risk and reward of investing in Chinese assets is likely to remain a hotly debated issue in the years ahead.

One thing that is more certain in the near term is that China's highly leveraged economy, without a change in the credit culture and meaningful bad-debt resolution, will continue to dictate the conduct of the PBOC's monetary policy. This means that the policy stance cannot be too tight, given the risk of widespread defaults, or too loose, to avoid adding fuel to the fire.

From this perspective, investors can be reasonably confident that local bond yields will meander within a certain trading range for some time. We believe that a 10-year government bond trading in the 3.5%–4% area would represent a decent opportunity in the coming year or so. ■

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