The Economist Events

EXECUTIVE SUMMARY

THE BELLWETHER SERIES 2013: CHINA

ASIAN FINANCE: CREDIT WHERE IT'S DUE

December 6th 2013 • Sofitel Wanda Beijing

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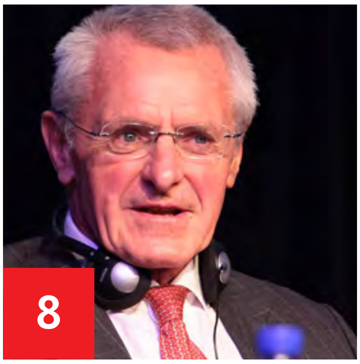


INTRODUCTION

December 6th 2013, Sofitel Wanda Beijing

The recent third plenum of the ruling Chinese Communist Party offered a tantalising vision of the country's financial future. Cadres agreed at the meeting that a "modern financial system" should be established by 2020, and gave firm backing for further steps to liberalise controls over interest rates, the exchange rate and the capital account. Eye-catching proposals to allow more private capital into the banking sector, to overhaul capital markets and to enact fiscal reforms were also included in the "decision" released after the plenum. If these reforms are implemented, China will have made important steps towards a more sophisticated and market-based financial system.

"Moving too quickly on financial sector reform could augur badly for stability if broader changes to the economy do not keep pace."

Simon Cox
Asia Economics Editor
The Economist

The plenum reforms have been greeted warmly by those who have long railed against China's under-valued currency and its system of financial repression. However, they will also be hugely challenging steps to take. Moving too quickly on financial sector reform could augur badly for stability if broader changes to the economy do not keep pace. Moreover, the financial system faces massive structural challenges, particularly around the country's further urbanisation and the rapid growth of China's elderly population. Both developments will require vast financial resources.

The China meeting of the Bellwether Series 2013 brought together business leaders, experts and academics to discuss the issues facing China in the aftermath of the third plenum. Here are some of the highlights.

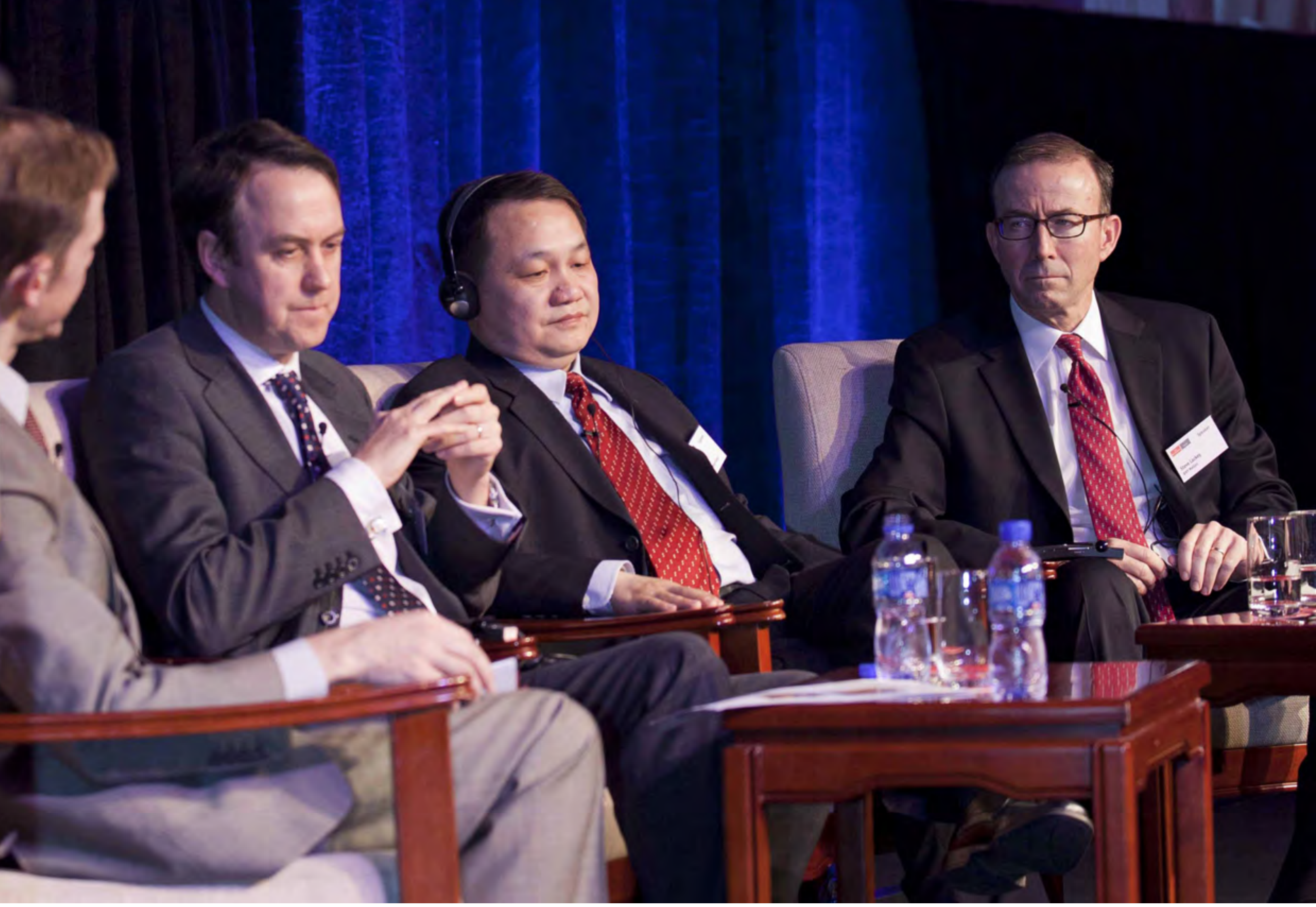
OPENING REMARKS

"Emerging economies... may have to enact difficult structural reforms if they are to withstand potentially volatile capital flows in the coming years."

Simon Cox
Asia Economics Editor
The Economist

Simon Cox, Asia economics editor for *The Economist*, chaired the event, and set the scene for subsequent discussions by offering a positive view of recent developments in the global economy. The US economy appears to be on the road to a sustainable recovery, Mr Cox pointed out, with the jobless rate heading down and the country's stock market in rude health. As a result, the Federal Reserve was soon likely to begin trimming back its quantitative easing (QE) programme and return to a more normal monetary policy setting. Japan's economy was enjoying a revival due to the stimulus policies introduced by the prime minister, Shinzo Abe. Even debt-ridden European economies, which have experienced a more protracted period of stagnation than others around the globe, are showing promising signs of recovery.

With the advanced economies seemingly on the mend, the developing world was being subjected to greater scrutiny, Mr Cox pointed out. The prospect of imminent QE tapering in mid-2013 had highlighted the vulnerability of emerging economies, including some in Asia, to tighter global liquidity conditions. These economies may have to enact difficult structural reforms if they are to withstand potentially volatile capital flows in the coming years.



THE GLOBAL FINANCIAL LANDSCAPE

Simon Cox's opening comments led into the opening panel discussion, which focused on developments in the global economy and their implications for China. Steve Lackey, Asia-Pacific chairman for BNY Mellon, and Keith Wade, chief economist for Schroder Investment Management, both echoed Mr Cox's comments on the positive outlook for the US economy, which was enjoying steady growth after a period of deleveraging. Mr Wade said the recent debacle over US debt ceiling negotiations appeared to have persuaded both main political parties that they should avoid such high-wire antics in the future.

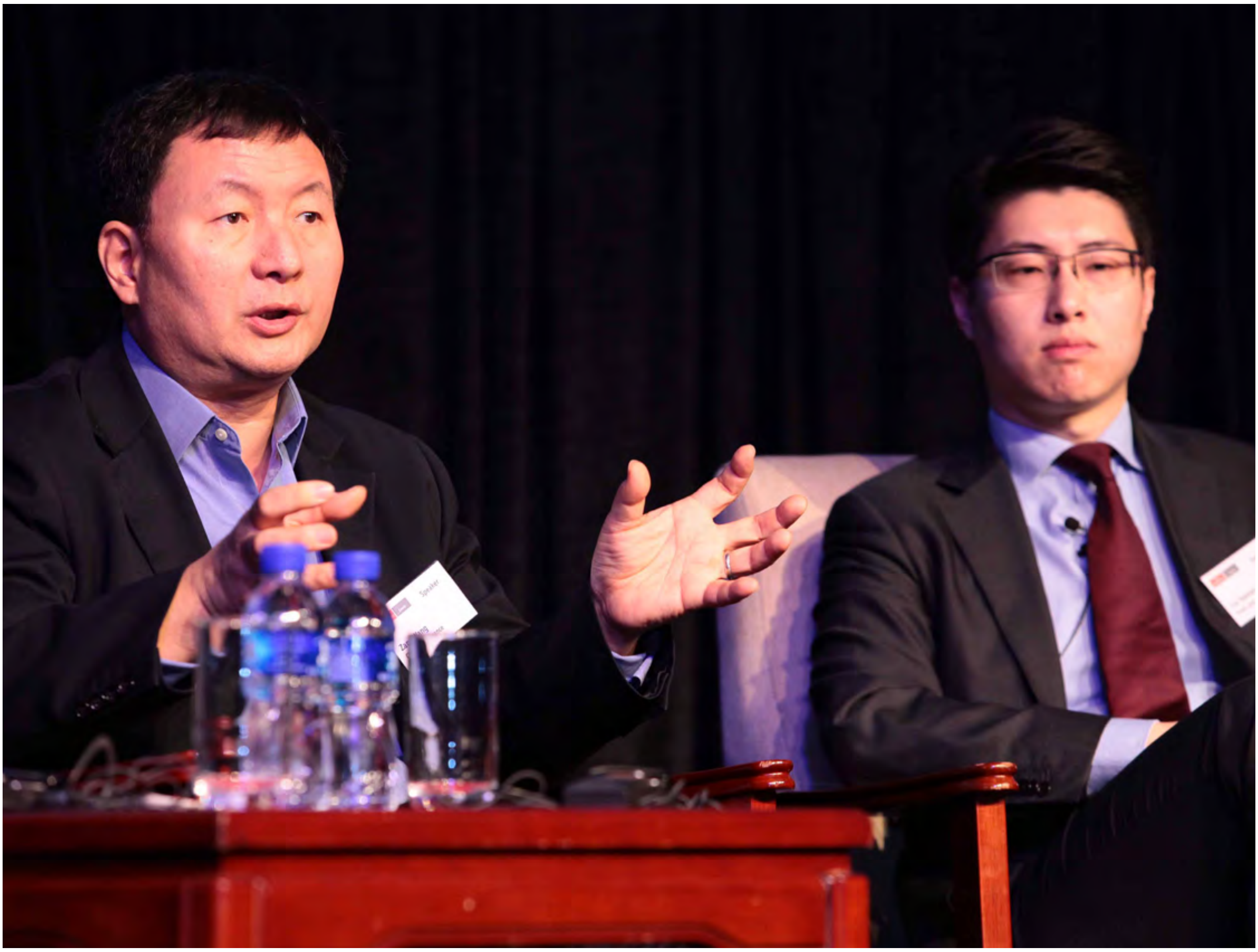
Mr Lackey was reluctant to extend this optimism to other advanced economies. He believed Europe was still some way short of the "take-off point" the US economy had reached, because its banking system had to yet to undergo a similar degree of deleveraging. Banking reforms due to be implemented in 2014 would act to dampen growth on the continent, and he believed that governments would be wise to prepare renewed fiscal support. On Japan, too, Mr Lackey was cautious. The economy's recent revival had been driven by the devaluation of the yen, but there was a limit to how far that policy could be extended without aggravating international trade tensions. The structural reforms that had been promised by "Abenomics", which would be important to driving growth in the longer term, had so far not been forthcoming. Mr Lackey also saw the consumption tax due to be introduced in 2014 as having the potential to take the country back into recession.

Turning to China, Cao Honghui from China Development Bank stressed that it was the quality, rather than the speed, of the economy's growth that should be policymakers' main concern. He said the Chinese economy faced several structural challenges, among which industrial overcapacity stands out—capacity utilisation in sectors such as steel, cement and glass was wastefully low: below 70% at present. Mr Cao saw industrial upgrading and the relocation of excess capacity to neighbouring regions as the solution.

The other task, according to Mr Cao, was to wean the economy off its dependence on investment. However, he stressed that this transition would proceed gradually, lest growth slip to a level that might put social stability at risk. Mr Cao also believed that productive areas for investment remained, such as in public services, telecommunications and social welfare. China's rebalancing would also require measures to boost private consumption. On the demand side, Mr Cao highlighted the extension of social welfare rights to urban migrants as a potential consumer-spending booster, but believed that it would be hugely difficult to implement. He also said that supply-side measures relating to the "environment of consumption", such as improving food safety, would also have to be taken if China was to become a consumer-led economy.

"Europe is still some way short of the "take-off point" that the US economy has reached, because its banking system has to yet to undergo a similar degree of deleveraging."

Steve Lackey
Chairman
Asia Pacific
BNY Mellon



SHADOW BANKING IN CHINA

"Small and medium-sized enterprises are ill-served by the banking system, as they lack the political connections to secure loans."

Zane Wang
Chief Executive Officer
China Risk Finance

The moderator of this session, Xu Sitao, began by asking delegates to define "shadow banking". Jun Xu from McKinsey & Company said there was no agreed definition. A narrow interpretation of the term would see it consisting of financing activities beyond the purview of regulation. However, in China's case, a number of activities commonly considered part of shadow banking, such as trust loans, are in fact regulated. A broader definition would include all financing activities outside of commercial lending by banks. According to Jun Xu, using this definition, lending through the shadow-banking sector now represented more than 50% of total financing in the economy, compared with less than 10% in the past. The increasing dependence of China's investment-driven economy on credit to sustain growth, as well as demand from wealthy individuals for high-yielding assets, has fuelled the rise of shadow banking in China.

The CEO of China Risk Finance, Zane Wang, said that the informal financing sector had also grown because of distortions in the formal banking sector. Small and medium-sized enterprises were ill served by the banking system, as they lacked the political connections needed to secure loans. As a result, they were often reliant on peer-to-peer networks and microlenders to secure finance. Yannan Liu, the CEO of prominent microlender Yooli, said he founded his company because he believed there were many creditworthy projects that failed to secure funds from the formal sector.

Panellists in this session generally took a benign view of the risks posed by shadow banking, over which regulators have only limited influence. They agreed that the lack of transparency in the sector was cause for concern, particularly because it could make regulators clamp down in an overly zealous manner on fresh innovations. Mr Xu also noted that a sharp macroeconomic slowdown would have an impact on the asset classes into which many of the informal loans are channelled, such as property and local government–backed infrastructure projects. However, in general, the development of shadow banking represented a step towards greater financial sophistication, according to the panellists, and would likely presage broader developments within the formal banking sector.

PAYING FOR CHINA'S CITIES

Further urbanisation has been championed by the authorities as a means of reorienting China's economy around private consumption. However, session moderator Vijay Vaitheeswaran of The Economist suggested there are important questions over the how the process will be funded, as well as concerns about the difficulties and risks that it likely entails.

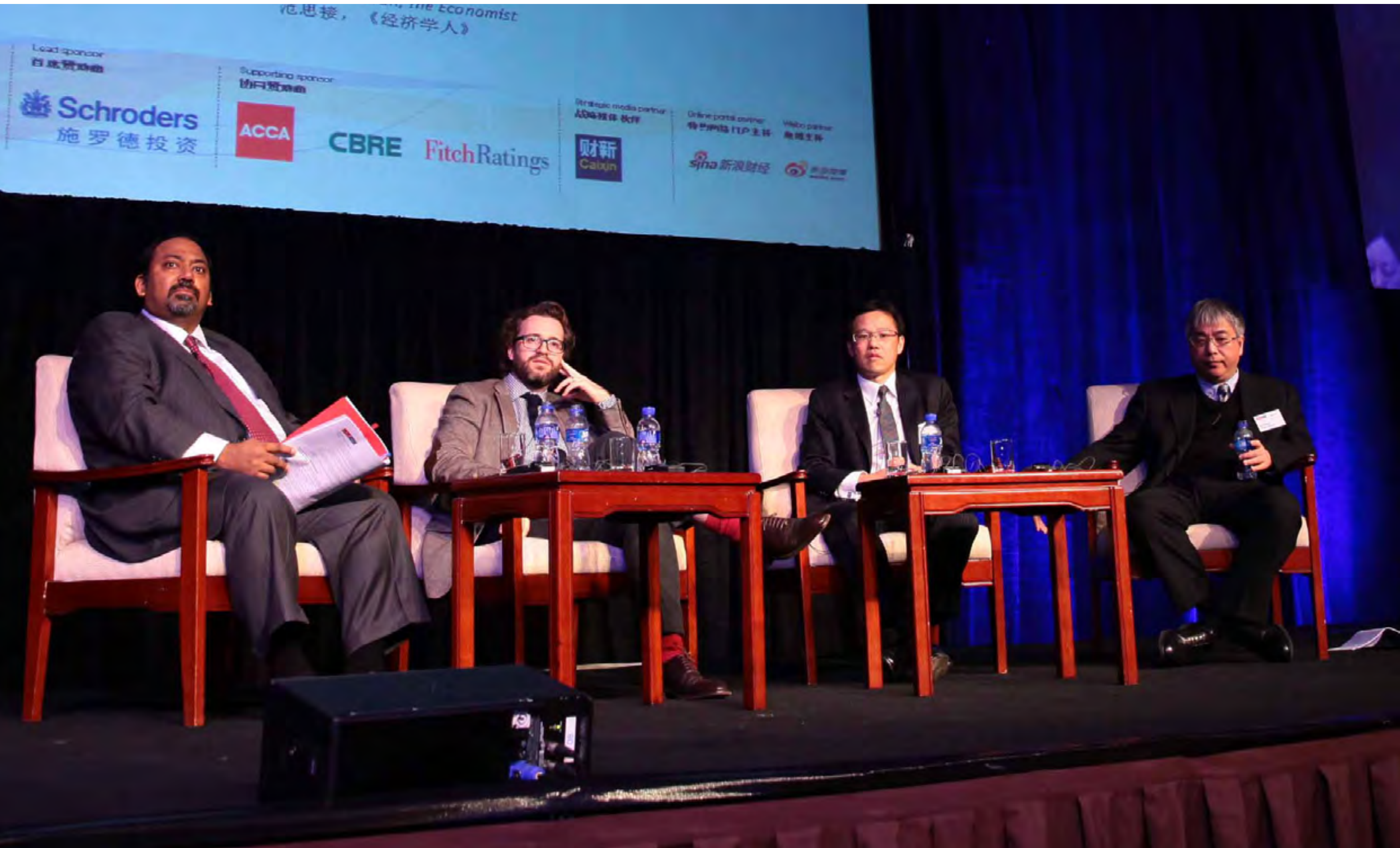
Tom Miller of GaveKal Dragonomics noted that the recent expansion of urban areas had been driven by local governments, who had long depended on revenues generated by appropriating official rural land and then selling it at a markup as urban construction land. The urban boundaries of cities had expanded rapidly as a result. However, this model was nearing its limits: China was at risk of reducing its rural land area to less than the 120m hectares it had decreed as the minimum necessary to preserve food self-sufficiency. In the future, urbanisation had to be underpinned by more productive use of existing land, rather than allowing urban sprawl to expand relentlessly.

Reform of China's household registration, or hukou, system is widely viewed as an important facet in facilitating further urbanisation. The system ties an individual's social welfare rights to their place of birth, which means migrants often do not access public services on an equal footing with local residents in the cities to which they move. Cui Zhiyuan of Tsinghua University spoke about pilot reforms, underway since 2007 in the western municipality of Chongqing, through which rural residents have been able to obtain urban hukou status if they meet certain residency and tax requirements. In return, they must temporarily relinquish their entitlement to farm a plot of land, for which they receive compensation. Mr Cui said that 3.8m migrants had obtained urban residency rights since the pilot began: a sign, for him, of its success.

Funding urbanisation was the other source of debate for the panel. Systemic reform of the hukou system, for example, would result in a massive increase in spending responsibilities for already strained local governments. Frank Chen, head of research at CBRE China, said that the property tax being trialled in Shanghai and Chongqing could serve as a useful additional revenue stream for local administrations if it was implemented properly. However, he was more sceptical about the expansion of local government bond issuance programmes being considered by the authorities. The other key element, Mr Miller argued, would be to boost the income of workers moving to the cities by giving them greater opportunities to profit from their rural land rights. Given the paucity of affordable housing in major cities, migrants otherwise risked being locked out of the urban property market. He took some encouragement from the third plenum, where it was agreed to gradually remove restrictions that prevent farmers from selling rural land directly to the market.

"...urbanisation has to be underpinned by making more productive use of existing land, rather than allowing urban sprawl to expand relentlessly."

Tom Miller
Managing Editor, China Economic Quarterly
GaveKal Dragonomics



PAYING FOR CHINA'S ELDERLY

"Increasing the size of the workforce by raising the retirement age is urgently required to place the finances of public pensions on a sounder footing."

Stuart Leckie
Chairman
Stirling Finance

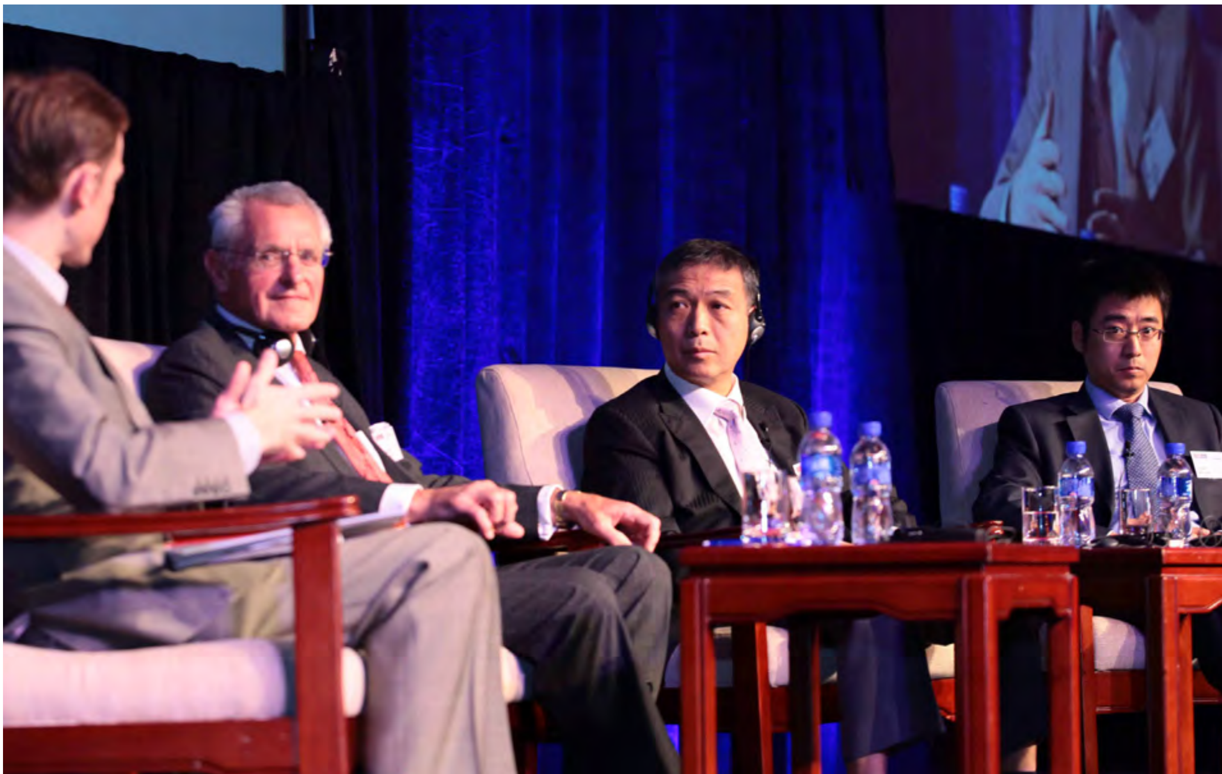
Welfare liabilities associated with China's rapidly ageing population are another daunting challenge facing the country's financial system. At the request of moderator Simon Cox, Sterling Finance chairman Stuart Leckie kicked off the session by describing the "patchwork" of schemes that made up China's pension system. The urban pension system, comprised of a pay-as-you-go (PAYG) scheme and funded individual accounts, differs from that offered in rural areas, which is based on voluntary contributions to individual accounts subsidised by the government. A different (and more generous) system exists for public servants.

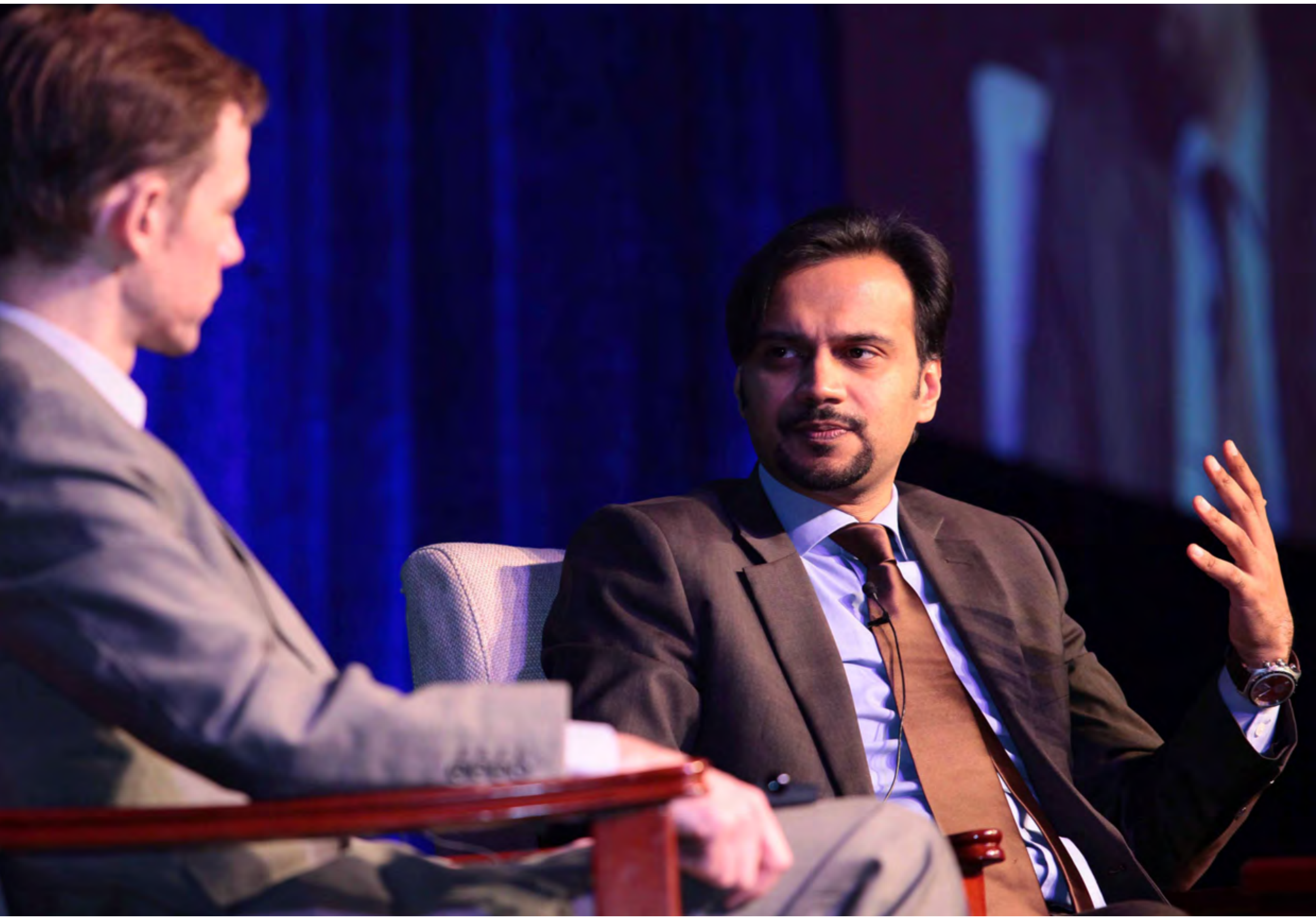
All the panellists agreed that China's various pension schemes suffered from numerous design problems. Mr Leckie identified the early retirement age, which is 60 or 55 for men and 55 or 50 for women, as a major structural issue that will weigh on the pension system. Increasing the size of the workforce by raising the retirement age was, according to Mr Leckie, urgently required to place the finances of public pensions on a sounder footing. However, recommendations to this effect by policymakers had been greeted negatively by the public, he pointed out, suggesting that any concrete moves in this direction would prove politically testing.

Another major funding issue discussed by the panel was whether China needed to move to a notional defined-contribution (NDC) scheme along the lines of that developed in Sweden. As China's population ages, the PAYG system is likely to come under growing strain. The NDC model has been offered as a way of taming public pension costs by defining what people pay in, rather than what they get out. However, panellists were sceptical about whether such a scheme could be implemented in China. Hu Yuwei of the BBVA Group noted that the NDC still had many characteristics of a PAYG model, a comment echoed by Mr Leckie, who argued that rural savers in particular would only trust funded individual accounts. Meanwhile, Wang Jian, chairman of the China Life Pension Company, said that China's local government administrative structures were too complex for the NDC scheme.

Debate was also held over the fragmentation of China's pension schemes, and whether centralisation would prove desirable. Mr Hu pointed out that many individual accounts under the urban pension scheme stood empty, as local governments had taken capital from these accounts to fund the PAYG pillar of the scheme. To backfill these accounts, it is widely assumed that the Ministry of Finance will eventually have to take responsibility. However, there were concerns about the implications of such a move. Mr Wang worried that the asset base would be too large to manage centrally, while Mr Leckie said it would provide opportunities for corruption and that pooling at the regional level might be a better solution.

Finally, panellists turned to consider how pension schemes could deliver better returns for their holders. It was noted that a trial underway in southern Guangdong province, through which pension funds had been handed over to the National Social Security Fund for investment, had delivered much improved returns. In the long run, Mr Wang noted, China may need to liberalise capital flows so that pension assets can be invested in other markets. However, in the short to medium term, there remained plenty of domestic asset classes that could absorb pension funds, assuming the stock market stabilised and more sectors of the local economy were opened up.





KEYNOTE INTERVIEW: IN CONVERSATION WITH THE IMF

Simon Cox's interview with Murtaza Syed, the IMF's resident representative in China, began by probing the sustainability of China's investment-led growth model. Mr Syed argued that the "margins of safety" were decreasing. Investment had become increasingly financed by credit, which had resulted in a sharp rise in corporate and local government debt. Meanwhile, diminished returns on capital investment posed questions about loan repayment capacity. Mr Syed believed that there remained productive areas in which China could still invest, particularly within agriculture and services, but that the process of allocating resources needed to be improved. He saw a gradual reduction in the investment to GDP ratio to around 40% by 2020 as a more realistic goal than a sudden collapse. Even that, however, would require tolerating annual real GDP growth falling to 6–7%.

Weaning China off its dependence on investment would require boosting household income, which had not kept pace with the rate of economic growth, Mr Syed argued. The key element in that process would be ending the system of financial repression that had acted as an effective tax on savers. He saw developments in shadow banking as in many ways a positive indicator of much-needed liberalisation within the banking sector. Yet there was also a need to subject such activities to greater regulatory oversight, as a lot of financing activities in shadow banking appeared to be related to vulnerable areas such as real-estate projects and local-government financing vehicles.

On the recent third plenum, Mr Syed sounded an upbeat note. He thought language used by the authorities in discussing state-owned enterprises (SOEs) was stronger than might have been expected. Reforms to pricing of capital and resources would bring indirect changes to the sector, he believed. However, Mr Syed cautioned against supposing that SOEs might disappear from the scene altogether. Major SOEs would likely remain creditworthy borrowers even if financial reforms were enacted; there were plenty of examples in other countries of state-backed firms that remained competitive even when operating under full market conditions.

"...there remain productive areas in which China could still invest, particularly within agriculture and services, but the process of allocating resources needs to improved."

Murtaza Syed
Resident Representative, China, **International Monetary Fund**

CHAIRMAN'S CLOSING REMARKS

In his closing comments, Simon Cox summarised areas of agreement and disagreement over the course of the day's debate. There was consensus, he believed, that the global economy was improving, led by recoveries in the US and the EU. It also seemed there was agreement that China's investment rate was too high, although there were differing opinions on how quickly it needed to be addressed. The reforms announced at the recent plenum were widely received as setting the correct direction for China's economy, but disagreement was expressed over how effectively the CPC would implement its agenda. Mr Cox ended the conference by thanking delegates for their attendance and contributions, and inviting them to attend again in the future.