NRI

Summary of Discussion at Financial Markets Panel
(Thirty-sixth Meeting)

January 12, 2016

Topic China's recession and policy response

Date October 29, 2015 (9:30am–11:30am)

Participants

Mr. Wei Jianing, Inspector, Department of Macroeconomic Research, Development Research Center of the State Council (guest speaker)
Mr. Kazuto Uchida, Executive Officer and General Manager, Treasury and Investment Division, Bank of Tokyo-Mitsubishi UFJ (absent)
Mr. Yukio Egawa, Chief Strategist, Research Division, Shinsei Securities
Mr. Amane Oshima, Managing Executive Officer (Joint Head of Markets Unit), Mizuho Corporate Bank
Ms. Yuri Okina, Vice President, Japan Research Institute (absent)
Mr. Izuru Kato, President and Chief Economist, Totan Research
Mr. Yukinobu Kitamura, Professor, Institute of Economic Research, Hitotsubashi University
Mr. Takashi Kozu, Chief Research Fellow, Ricoh Economic and Social Institute
Ms. Miyako Suda, Special Advisor, Canon Institute for Global Studies (absent)
Mr. Hajime Takata, Managing Executive Officer and Chief Economist, Mizuho Research Institute
Mr. Katsuyuki Tokushima, Senior Research Fellow, NLI Research Institute
Ms. Naoko Nemoto, Managing Director, Standard and Poor's (absent)
Mr. Shinichi Fukuda, Professor, Graduate School of Economics, The University of Tokyo
Mr. Kaoru Hosono, Professor, Faculty of Economics, Gakushuin University
Mr. Noriyuki Yanagawa, Professor, Graduate School of Economics, The University of Tokyo
Mr. Toshiaki Watanabe, Professor, Institute of Economic Research, Hitotsubashi University (absent)
Mr. Hiroshi Ugai, Research Professor, School of International and Public Policy, Hitotsubashi University
Mr. Yosuke Tsuyuguchi, Senior Advisory Officer, Shinkin Central Bank
Mr. Mitsuhiro Fukao, Professor, Faculty of Business and Commerce, Keio University
Mr. C. H. Kwan, Senior Fellow, Nomura Institute of Capital Markets Research
Tetsuya Inoue, General Manager, Financial Technology and Market Research Department, Nomura Research Institute (organizer)
Takeshi Jingu, General Manager, Financial Technology Research Department, Nomura Research

Key Discussion Points

1. **Presentation by Mr. Wei**
2. **Free discussion**

Summary of Comments

1. Presentation by Mr. Wei

Inoue (organizer):

・We have invited Mr. Wei Jianing who is from the Development Research Center of the State Council and who is a regular participant to the Japan-China Financial Roundtable meeting. Mr. Wei specializes in macroeconomics and made proposals regarding municipal bond reforms and the creation of a deposit insurance system. His presentation on China's economy will be followed by free discussion. We have also invited the experts on China's economy and financial sector: Hiroshi Ugai, Yosuke Tsuyuguchi, Mitsuhiro Fukao, and C.H. Kwan.

Mr. Wei:

○China's economy today

・China's economy grew at an annualized rate of just 6.9% in 3Q, being below 7% and with the downward trend. Some local economists often view the current slowdown as the "new normal", but I do not think it can sufficiently explain the situation. Today I would like to discuss on the reason for Chinese slowdown from long-, medium- and short-term perspectives.

○Economic growth from a medium- and long-term perspective

・From a long-term perspective, China's economic growth rate is declining. A variety of institutions and scholars have published their estimates of China's potential growth rate, The growth rate was about 9-10% in the 6th-11th Five-Year Plan period, and then dropped to 8% in the 12th Five-Year Plan period. It is estimated that the average growth rate in the 13th Five-Year Plan period will be 7.19%, and the figures for the 14th and 15th Five-Year Plan periods will be 6.35% and 5.41%, respectively.

・In my opinion, one reason why the economy's potential growth rate is trending lower is that the pace of economic reform slowed under the previous administration. For example, it has been over a decade since economist Cai Fang warned about the disappearing population bonus and its impact. However, the relevant authorities initially did not undertake any reforms but criticized his arguments. More recently, people from all walks of life, including government officials, have a broad consensus on this issue. However, it will take at least 16 years for children born under deregulation and the new population policy to enter the labor force.

・As has been repeatedly pointed out, in the medium term, China has a "reform cycle". Over the past 36 years, the nation has experienced a number of economic crises, and each time an opening of ideology has led to further reforms and opening of the economy, which in turn generate new growth.

○**Short-term factors**

・Firstly, a look at recent economic trends via the analogy of a three-horse carriage (exports, consumption, and investment) shows that exports have declined as the global economy slows. Secondly, in terms of consumption, the current administration's anti-corruption drive has weakened government consumption. Public eating and public drinking has fallen along with the suppressed expenses on overseas travel, vehicle purchases, and entertainment using public funds. Affected by this, the overall consumption growth also declined from the previous 12% or so to the level of 10%.

・Thirdly, what is about government investment? In recent years, the central government has been monitoring local government debt more closely. Two years ago, the National Audit Office carried out an audit of local governments, and in last year, the Ministry of Finance did so. In part because these efforts have kept local government investment in check to some extent, overall growth in fixed asset investment has fallen to around 11% (being unable to obtain local government investment data).

・It should be emphasized that we neither deny the negative economic impact of these measures (the anti-corruption campaign, the audit of local government bond issuance) because of their political justifications, nor we deny their political justifications just because of the negative economic impact of these measures. They must continue and be made part of the institutional framework.

・Therefore, the only road ahead for China's economy is to accelerate reforms and gradually substitute private consumption for government consumption and substitute private investment for government investment. These days, the expression "change of gears" is often heard in China. While this is typically used to refer to the shift from rapid growth to more moderate growth, I think it is even more important to shift from government consumption and investment to private consumption and investment.

○**Future developments and risk factors**

・There are possibly three basic scenarios on future developments. First, reforms proceed quickly and economic growth recovers. Second, reforms are delayed, leading to a combination of low growth and high inflation. Third, the loss of expectation on and trust in the reform will make the stock market crashing, the real estate bubble bursting and the massive capital flight happening. In any event, IMF shares my view that progress in reforms holds the key to the eventual outcome.

・The recent economic slowdown poses a number of risks. The first risk is the possibility of growing unemployment, although here the situation varies greatly by region. Unemployment continues to worsen in traditional heavy industrial districts in northeast and northwest China, while southeastern provinces like Guangdong and Zhejiang are suffering from growing labor shortages.

・The second risk is that the real estate bubble will collapse. In 1997, I presented a report about the collapse of Japan's bubble to the central government, and in 2005, I raised the question of the real estate bubble at Tsinghua University, but unfortunately the bubble did not subside. Large cities such as Beijing, Shanghai, and Guangzhou can always be expected to see firm demand for real estate, so a sharp decline in prices is unlikely. But a major bubble has developed in third- and fourth-tier cities. The city of Ordos in Inner Mongolia, for example, is increasingly a ghost town with large numbers of apartments and condominiums but no lights on at night. A collapse of the real estate bubble would also further exacerbate the nation's excess capacity problem.

・The third risk is that a decline in real estate prices will bring local government debt problems to the fore. Falling real estate prices would directly lower local governments' income on the sale of real estate, raising the possibility of defaults on local government debt.

・The fourth risk is the destabilization of the financial system. In 2014, banks' bad loan portfolios and bad loan ratios started to rise. And in 2015, lending for fixed asset investment began to fall even as overall bank lending grew. The authorities are increasingly concerned that many bank loans are being used to speculate in the stock market. If that is the case, a stock market decline could create substantial bad debt.

・The fifth risk involves a further slowdown in the economy. Opinion is divided on whether current conditions point to a recession or a hard landing.

・The sixth risk is the possibility of deflation, which is the subject of much debate in China. Opinions are even split on how to define the deflation. The picture varies depending on what index we use to measure prices: the CPI remains in positive territory, for example, while the PPI has fallen for forty straight months. Nor is there agreement on whether price fluctuations are the result of a decline in the volume of money in circulation or some factors other than money, such as the recession.

○The government's response

・There are three basic views regarding the preferred government response to the economic slowdown. The first view holds that the government needs to use fiscal stimulus and monetary accommodation in a "transfusion" for the economy. The second view has mistaken the "new normal" for an anesthetic or painkiller and says things will improve if we wait patiently. The third view holds that we should carry out economic surgery immediately and accelerate the reform process. I am of the view that China's economy will be in big trouble if we only give it a transfusion or anesthetize it without performing surgery. At a time when blood is spurting from the aorta, no amount of blood transfusions will reach the real economy's capillaries - small and medium enterprises. As such, fiscal reforms and reforms at state-owned enterprises need to be accelerated immediately to stanch the bleeding. If the patient receives a transfusion and an anesthetic but no surgery, the problems could spread to the "heart" - the central bank.

・The central government is actively promoting public-private partnerships (PPPs), but relatively little progress has been made because of a lack of interest among local governments and private enterprises. Enthusiasm for this initiative also varies within the central government itself. The State Development and Reform Commission and the Ministry of Finance, for example, are strong supporters, but departments in charge of individual industries tend not to be interested. The same is true of most commercial banks, with the exception of the China Development Bank. Interest also tends to be greater in the southeast than in the northwest. All in all, views range widely.

2. Discussion

Mr. Fukao:

・Chinese growth rate is on the decline, even though gross fixed capital formation still accounts for a very high 45% of GDP. Japan achieved 10% growth rates during its high economic growth period with a much-lower 30% investment-GDP ratio. As a result, in China, I have a strong concern that a large part of the investment is very wasteful and investors will not be able to recover the cost of investment from its revenues. In order to avoid an accumulation of toxic assets, China should lower the share of investment to around 30% of GDP and increase consumption by the government and private sectors. In order for it to happen, the government would need to tap the retained earnings of state-owned enterprises via dividends, taxes, and wages.

Mr. Wei:

・I am currently engaged in a comparative study of the government's response to the Asian financial crisis in 1998 and the global financial crisis in 2008. Two arguments are made as to why the country was able to emerge relatively unscathed from the 1998 crisis: 1) that it issued bonds and used the proceeds to fund public works investment; and 2) that it pursued reforms at state-owned enterprises and encouraged exports by private enterprises. Government investment itself is now substantially less efficient on the whole than it was in 1998.

・In China, of course, it is not that difficult to solve the problems of existing local government debt and nonperforming bank loans. The difficult part is how to prevent new toxic assets from appearing. That is why the government is pursuing financial system reforms such as interest rate liberalization and the creation of a deposit insurance system. Once these reforms are largely complete, the focus of reform will probably shift to the privatization of commercial banks. I think a consensus is gradually forming on this issue.

Mr.Ugai:

・Mr. Wei said that the problem lies in the government debts, but I am more concerned about the private sector's debt overhang. According to BIS statistics, China's nonfinancial corporations hold debts equal to 157% of GDP, which is greater than the corresponding figure for Japan at the peak of its asset-price bubble. In addition, the outstanding debt amount of non-financial private sectors including households was 178% of GDP a while ago, which already exceeded the figure for the US prior to Lehman's collapse and Europe's periphery countries during their debt crisis. Applying the "financial cycle" theory proposed by Claudio Borio *et al.* of the BIS to China with some reservations, it suggests a severe problem for the function of China's financial system in future. The question of how to reduce the accumulated private sector debts while taking also into account the macroeconomic conditions is an extremely important challenge.

Mr. Wei:

・Some argue that these risks should be allowed to manifest themselves, while others say that they should be kept to a minimum by having the government assume some of the excess debt. Academics tend to be of the former view, while government officials - who naturally emphasize social and economic stability - tend to have the latter view. I am closer to the former, but I think a safety net will have to be put in place first.

・There are a variety of views both inside and outside the country regarding the risks that Chinese economy is facing, but they can be largely divided into three groups: the risks of not reforming the economy, the risks that will emerge as a result of reforms, and the risks that will emerge if reforms are not appropriate. Examples of the second type might include heavy fund flows between banks following the introduction of a deposit insurance system or an inability to stop the issuance of municipal bonds after local governments are authorized to issue their own bonds. An example of the third type might be a case in which a bank is allowed to fail before the deposit insurance system is ready, triggering other serious problems.

Mr. Oshima:

・I would like to ask two questions. First, you noted that the legal infrastructure has yet to catch up with the growth in IT-related startups and that this issue needs to be addressed in order to raise the potential growth rate. What specific sorts of reforms should we expect? Second, Japan was exposed to deflation in the process of allowing the prices of its production factors to fall in line with those of other countries. China is moving gradually ahead with the liberalization of its currency amid rising labor costs, but I worry that too-rapid liberalization would result in a major shock to the economy. How do we find the right balance?

Mr. Wei:

・As for your first question, reforms might aim at increasing private investment and investment efficiency or at promoting the establishment of start-ups and new businesses. Regarding the former, the State Council is seeking to utilize private-sector capital via public-private partnerships (PPPs). However, PPPs suffer from the problem that state-owned enterprises tend to monopolize sectors with large profit margins, leaving only the lower-margin sectors to private enterprises. As for startups and new businesses, startups are being encouraged in a wide range of sectors and not just IT, and Premier Li focuses particularly on this area. However, opinions are divided regarding the impact that startups themselves have on the broader economy. I think we should not expect too much from them, at least in the short run. The promotion of new businesses and startups in China is provoking debate on institutional reforms from a different perspective. A typical case is the tax system, especially the local tax system. Some are now arguing that local taxes should be left up to local authorities. In China, a general consensus has formed on the direction that financial reforms need to take, but the same can rarely be even discussed of fiscal and tax reforms. I think institutional reforms regarding new businesses and startups have played an important role simply by encouraging discussion of the tax system.

・As for your second question, I think financial institution reforms are more important than exchange rate liberalization. As long as most financial institutions are state-owned and lend liberally to the government, no amount of interest rate or exchange rate liberalization can be expected to produce meaningful results.

Mr. Tokushima:

・As China shifts from a population bonus to a population onus, how will it deal with the problems of aging society? And after the country abandons its traditional policy of constraining population growth, could we see problems with the food supply or a decline in overall economic productivity?

Mr. Wei:

・It is true that in the past, Chinese government underestimated the problems of aging society. A research looking at the nation's balance sheet shows that old-age pensions are already underfunded. One difference from Japan is that the decline in China's birthrate has been far more severe. In addition, Japan's population began to age only after its economy had matured, while China is aging before it gets rich. There are various views on what should be done, but a typical recommendation is for the central government, which still has plenty of fiscal leeway, to begin centrally managing all pensions. Another view, which happens to be shared by my teacher, Wu Jinglian, is that the shares of certain state-owned enterprises should be transferred to pension funds as quickly as possible. I think these shares should be sold or transferred now, while the economy is relatively strong and state-owned enterprises maintain their asset value. State-owned assets would be more worthless if they were sold after a crisis happened.

Inoue (organizer) :

・I would like to thank Mr. Wei for taking time to discuss a wide range of issues with us today.

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