Título: China and Financial Reform: An Approach to Resolve the Problem of Overinvestment.

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Síntesis curricular:

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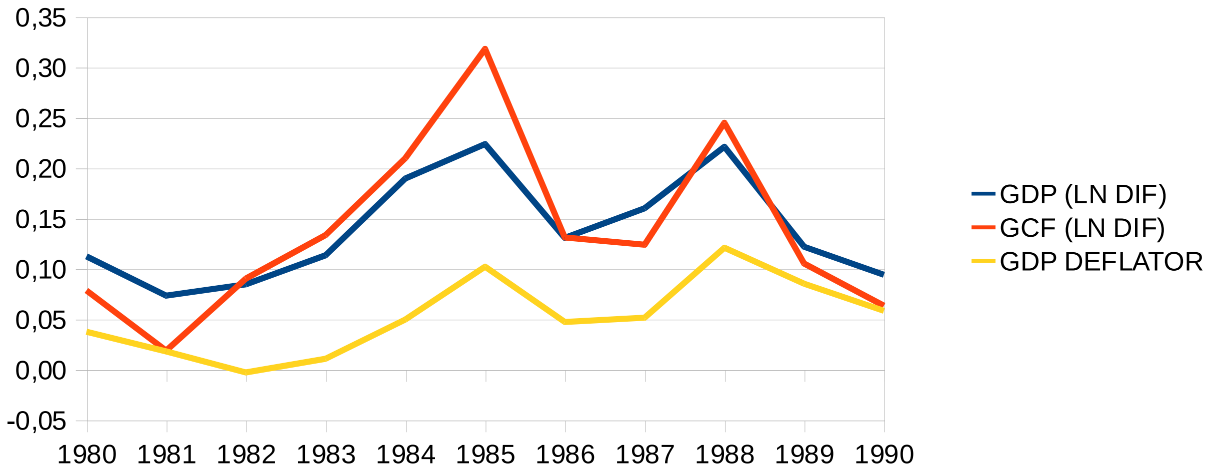
ABSTRACT

After more than 30 years of financial reforms and opening-up policies, China clearly stands at the crossroads. On one hand, its economic performance has been revealed itself quite impressive during the referenced period. It has lifted millions of people from the extreme poverty and achieved an average annual economic growth rate of 9,89% since 1979. But, on the other hand, both financial and social imbalances have raised some concerns on the viability of Chinese economy. How grave are these shortcomings compared with the current strenghts? This will be our first object for analysis. Secondly, and regarding to the latest economic conference held in November by the Communist Party of China, we will try to infer how some of the already unveiled major financial reforms can transform the Chinese economic structure as well.

1- FROM DENG XIAOPING TO DATE: THE OVERINVESTMENT PROBLEM

In 1979, guided by the leadership of Deng Xiaoping, China started a comprehensive and gradual reform which became crucial for Chinese economic development[1]. Firstly, “gradualism” is very important to understand why reforms in China are still lasting for more than thirty years. As Deng Xiaoping stated, “crossing the river by feeling its stones”, no major change has been placed in China before being tested first. For instance, Special Economic Zones (SEZs) such as Shenzhen in 1980, have played a significant role in opening Chinese trade to the world. China has gradually laid the fundamentals of its competitive manufacturing industry and joined the World Trade Organization (WTO) in 2001. Eight years thereafter, China surpassed Germany as the world largest exporter, a very gradual and experimental process which began in 1979. The “Household Responsability System” replaced also the maoist quota mechanism in the very early years of economic reform[2]. The Township & Village Enterprises (TVEs), owned by local governments but effectively decentralized, made also a significant contribution to overall growth and employment[3]. And, finally, some other major reforms such as imposing a Retention Scheme intended to encourage Chinese exports, or abolition of the Dual-Price System, were also introduced before 1990[4].

FIGURE 1: Chinese GDP, Gross Capital Formation and Inflation measured by GDP deflator between 1980-90. Source: NBS



Notes: Variation Rates -R- of both GDP and GCF figures have been estimated by taking Natural Logs (LN)
$R_{(t)} = LN\ (GDP_{(t)}) – LN\ (GDP_{(t-1)})$ and $R_{(t)} = LN\ (GCF_{(t)}) – LN\ (GCF_{(t-1)})$
GDP Deflator Variation Rates follow this pattern:
$\text{GDP Deflator}_{(T-T-1)} = [\text{GDP Deflator}_{(T)} - \text{GDP Deflator}_{(T-1)}] \ / \ \text{GDP Deflator}_{(T-1)}$

However, in spite of all these achievements and reforms, China suffered from what would finally become a very recurrent problem since then: excessive investment which, incidentally, has brought an unprecedent volatility to GDP and CPI. Indeed, extreme and unusual high inflation rates lie behind the protests at Tiannanmen Square and subsequent repression in 1989.

TABLE 1: Gross Capital Formation (GFC), GDP and CPI in China. Source: NBS

YEAR	GCF y / y	Real GDP y / y	CPI y / y
1985	37,50%	13,50%	9,30%
1990	6,50%	3,80%	3,10%
1993	55,80%	14,00%	21,00%
1998	4,50%	7,80%	-0,80%

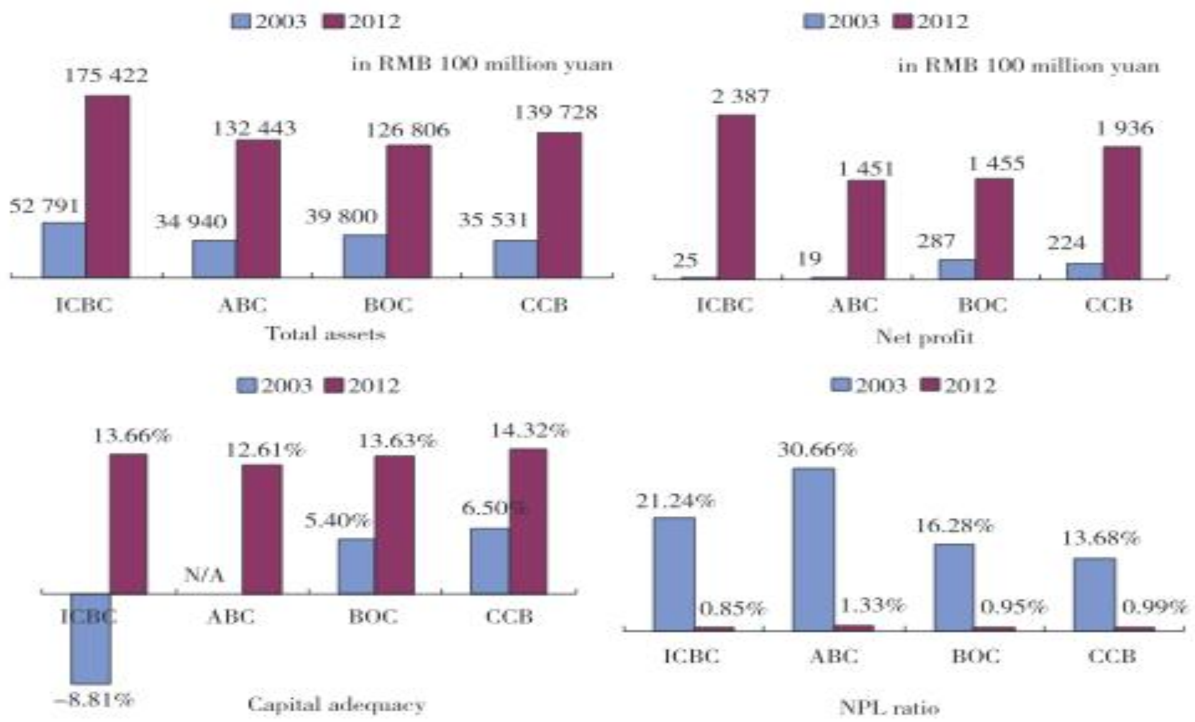
As clearly showed at Table 1, robust growth periods have been traditionally followed by a sharp deleveraging (lower GCF, Inflation and GDP). For instance, in 1993, a record increase of monetary aggregate M2 led to overinvestment (+55,8%) and Chinese output growth rate soared up well above its potential level (+14%).

Five years later, and coinciding with the Asian financial crisis, Non-Performing Loans (NPLs) amounted to more than 25% of Chinese GDP. Consequently, the Ministry of Finance set up four Asset Management Companies (AMCs) to absorb these bad loans from commercial banks. And, due to this deleveraging process; M2, GCF and GDP sharply decelerated again in 1997-98.

May overinvestment bring a long-lasting economic meltdown in China?

Some international investors and analysts are warning that China is on the verge of collapse due to current overinvestment levels. Certainly, overall investment or GCF accounts for more than 40% of Gross Domestic Product in China. Chinese GDP growth, as everybody knows, is decelerating significantly (from 10,4% to 7,7% between 2010 and 2013). Although NPLs ratio is well anchored at 1%, according to Peoples Bank of China (PBOC), the so-called “shadow banking” has recently arisen some concerns[6]. Indeed, it has been said that many financial products sold through these informal mechanisms are at risk of default. However, and by recalling previous experiences as those occurred decades ago, a long-lasting financial meltdown is unlikely to happen[7]. Why?

FIGURE 2: Chinese Banking System "soundness" in 2003 and 2012. Source: Peoples Bank of China (PBOC)



The main reason is that Chinese capital account has not been liberalized yet. In any event of a massive default over the informal deposits, which pay higher interests than formal ones, savings are not allowed to flow out from China. Moreover, deposits at formal banking system are equal to 17 trillion USD. So the overall saving rate in China, well above 50% of GDP, should be enough to avoid a systemic crisis. We should not forget either that China ranks as the second world largest net creditor. And neither that Chinese international currency reserve holdings are worth 3.3 trillion USD. Most of the loans recently lent at shadow banking have been intended to fund overheated industries, real estate projects and some other investments planned by local governments through financial vehicles or LGFV (Local Governments Financial Vehicles). And, as showed by the current

M2 / GDP ratio which is equal to 2, it seems that China might be suffering from overinvestment again. The Chinese GCF, especially real estate and some overheated industries such as steel, is already reducing its overall contribution to GDP. So these lower returns from investments are leading to a surge of NPLs at informal system, more deleveraging and lesser credit which altogether is resulting in the current economic slowdown. However, we should note some differences between the situation today and that in 1997-98. As Figure 2 shows, banks are more resilient than they were years ago. And assuming that every off-balance loan would finally result in a massive default, what constitutes an apocalyptic scenario, the final figure can represent just 30% of overall commercial banks assets[8]. This is, in any case, not enough to conclude that China stands on the eve of a national bankrupcy.

- **Inefficiencies should not last forever**

Undoubtedly, massive investments and exports have allowed an unprecedent development in China since 1979. However, overinvestment reflects that this traditional model is nearly exhausted. We have already ruled out any short-term significant impact of overinvestment on Chinese economy through its banking sector, especially given that China still enjoys from huge savings, but there still exist some social and political risks.

High levels of overinvestment in some industries such as real estate have been creating price bubbles during the last two decades. However, says Rafael Galán, the Chinese housing bubble is not that big as some media pretend to[9]. Anyway, this distortion might be preventing millions from finding better jobs at urban areas what may cause some social discontent among people as well.

Corruption affecting to State Owned Enterprises (SOEs), largely controlled by Communist Party members, is also another social problem. While large corporations make money but do not share any dividend, more on the contrary they allocate those profits for re-investment, only few officials have been able to become very rich. Morover, private companies still find many hurdles to get funds through the banking sector. And, besides these facts, an increasing inequality measured by the GINI Index has also happened (it currently equals to 0,473).

Other potential problem comes from the so-called financial repression. As Chinese savers do not have any option but putting their money into banks deposits or underdeveloped financial markets, many of them just turn to the informal system. Shadow banking, as aforementioned, normally offers better rates but investors should also bear a higher risk. Even though this circumstance might not pose any threat for the whole economy it introduces a moral hazard: Chinese savings are still funding unprofitable investments. And, as Spanish economist Luis Torras points out, “although Chinese banks have the capability to roll-over bad loans one time and another they cannot avoid long-term losses”.

Is this an unbearable financial bubble? As showed before, commercial banks are well capitalized, and Chinese financial system has enough liquidity even to solve the sovereign debt crisis in EU. However, the problem is more about social than economics: Why do savings must continue to feed overinvestment in China? Of course, they do not have to. This assumption leads us directly to the second part of our paper.

2- SHIFTING THE MODEL TOWARDS CONSUMPTION. A LOWER GROSS DOMESTIC PRODUCT BUT MORE SUSTAINABLE: THE FINANCIAL REFORM[10]

Ramping non-profitable investments up implies that they can result in increasing bad loans, bank leveraging and a slower growth rate. Therefore, if China wants to avoid this economic hard landing, some other sectors rather than massive investment -such as private consumption or high-tech manufacturing- must weight more on Chinese GDP.

- **Third plenary session of the 18th Party Congress**

The last stage of Chinese economic reform is going to take place at its financial sector. Alongside an equally necessary fiscal and land reform, the Chinese capital account will gradually be liberalized.

This will have immediate effects on interest rates and the RMB. And it should facilitate the transition from an investment-export model towards a domestic consumption-oriented economy.

a) Effects over the Chinese RMB

The Nobel laureate economist, Robert Mundell, stated that "one country cannot simultaneously manage free capital flows, conduct an independent monetary policy and keep it exchange rate well under control". This theory, known as "Impossible Trinity", implies that China has the ability to control its exchange rate under a fixed exchange regime and it can also carry out an independent monetary policy. However, its capital account must still remain closed and the Chinese RMB cannot be fully convertible. Algebraically, considering the US-China financial interaction, we can express this theory as follows:

$$1\$ \, (1 + R_{USA}) \neq 1\$ \, (E / E^e) \, (1 + R_{CHINA})$$

Where R = Annual Interest Rate, E = Spot Exchange Rate and E^e = 1 yr Expected Exchange Rate

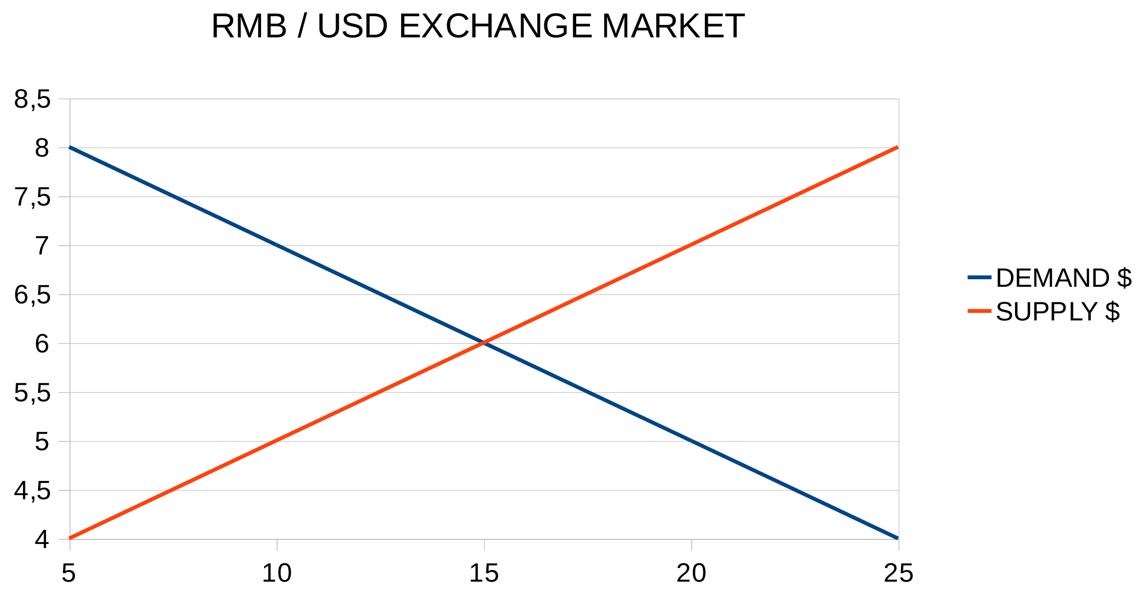
This basically implies that China can determine its own R and E thanks to the imposition of capital controls ($\neq$). However, since the government has already expressed a commitment to liberalize Chinese capital account, RMB exchange rates (E / E^e) must become flexible simply because China is not gonna give up its control over monetary policy (R_{CHINA}).

Therefore, the previous equation would turn into:

$$1\$ \, (1 + R_{USA}) = 1\$ \, (E / E^e) \, (1 + R_{CHINA})$$

Where R = Annual Interest Rate, E = Spot Exchange Rate and E^e = 1 yr Expected Exchange Rate

So liberalizing the Chinese capital account means that RMB should become a free float or flexible currency but: How about its trend?

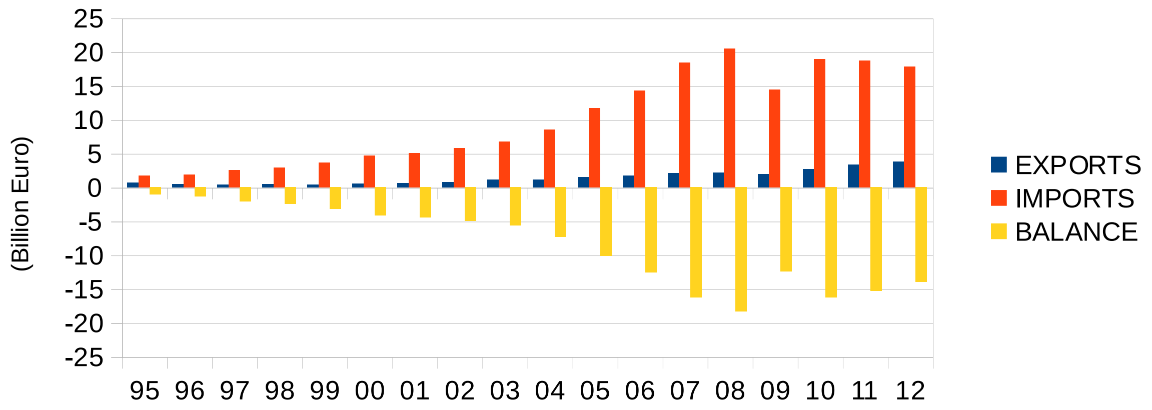


Our above graph depicts an example of one exchange rate established by Chinese government at RMB / USD = 7. However, at that point, the supply of USD exceeds demand at foreign exchange markets (what means that China is just posting an external net superavit with US). In this situation, for instance, the new exchange rate at equilibrium under a perfect free-float system without capital controls should go down to RMB / USD = 6 (a nominal appreciation).

However, during all these years, the Chinese RMB has been able to avoid such a sharp appreciation simply thanks to capital controls. Once they get removed, and given the fact that Chinese RMB has remained undervalued during all these years, it seems reasonable to expect a further appreciation.

This outlines again the idea that Chinese natural trend is reducing its external surplus and, subsequently, start to consume more.

FIGURE 3: Spain trade balance with China between 1995 and 2012. Source: ICEX



The current financial crisis, originated at Western countries due to their high levels of debt, is also varying some main trade and investment patterns in China. Sino-Spanish trade, for instance, is becoming much more balanced since 2009. Indeed, Euro currency has lost 20% of its value in the last five years against RMB. Spanish exports to China are at their record highs now. And Chinese trade surplus with Spain has started to moderate just after the global financial crisis. In real terms, Spanish wages have decreased for some consecutive years while Chinese salaries continue to increase. As Figure 3 depicts, we can also see a turning point in their bilateral trade balance shortly after 2008.

The high leverage levels at some EU countries might lead to subdued growth rates there for a while. Expectations over RMB / EUR exchange rate are in line with a Chinese Renminbi appreciation or Euro depreciation (and, indeed, we should rule out any sudden reversal of this trend started by 2008). Spanish labor costs, in a period of sharp declines and high unemployment, are not expected to recuperate their pre-crisis levels any time soon. However, Chinese wages will keep rising in accordance to the GDP. Then, our forecast is that China will continue to reduce its exports towards traditional EU markets, such as Spain, mainly given the internal devaluation suffered by all those countries. Conversely, Spain should increase its exports towards China considering the huge existing potential at this market.

These fundamentals just underpin the two trends that we were trying to figure out before:

1) The Chinese Renminbi is gaining momentum and it could gain more under a free-float exchange regime.
2) China is its external surpluses while domestic consumption increases.

The external surplus of China has been always used to fund overconsumption at some Western countries as US. However, as former Premier Wen Jiabao stated in 2010, Chinese investments on debt securities are no longer safe in America. The Quantitative Easing program, alongside with the USD depreciation, are resulting in huge losses for China. The world economy needs a rebalance. So China must consider to allocate its huge savings for consumption, or encourage business merger and adquisitions instead, rather than funding an unsustainable debt everywhere else in the West.

TABLE 2: Chinese exports, annual labor cost per worker and exchange rate of RMB. Does 2008 represent an inflection point? Since then, overall exports stopped growing while both Chinese currency and wages continued to increase their value. Source: National Bureau of Statistics (NBS)

YEAR	CHEXP	CNYEUR	LCCHINA	CNYUSD
2005	1.17E+10	10	18200	8,19
2006	1.44E+10	10	20856	7,97
2007	1.85E+10	10,41	24721	7,60
2008	2.05E+10	10,22	28898	6,95
2009	1.45E+10	9,52	32244	6,83
2010	1.89E+10	9	36539	6,77
2011	1.87E+10	8,99	41799	6,46
2012	1.78E+10	8,1	45000	6,21

b) The interest rates liberalization

A more flexible exchange regime without capital controls, alongside an appreciating RMB, will bring some interesting adjustments for interest rates. Excess of liquidity has traditionally contributed to overinvestment. Capital controls, as everybody knows, prevent a better allocation of national savings abroad for better returns. Consequently, the vast money supply and low interests, all have traditionally promoted a surge in overall investment (which today is equivalent to 40% of

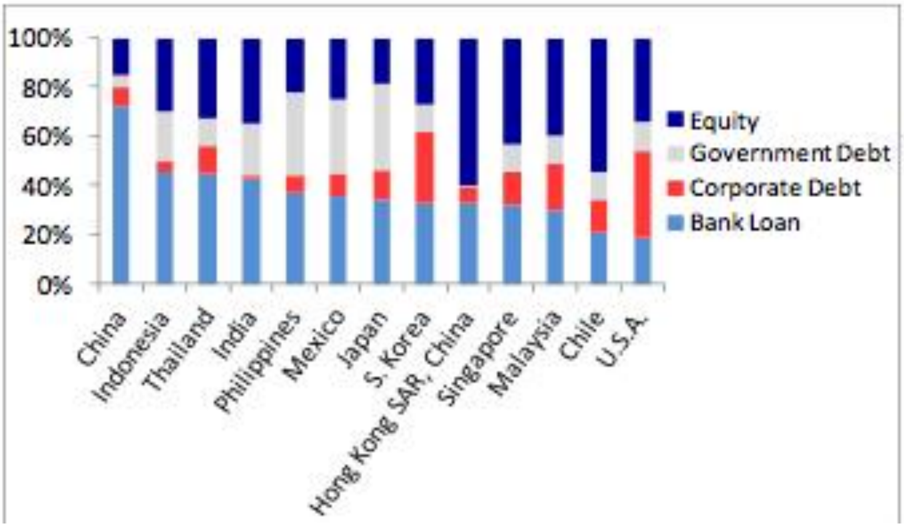
GDP).

However, China is willing to open its capital account. This would encourage competition in the Chinese financial markets. It would allow people to allocate savings in financial assets with higher returns both at home and abroad. Therefore, commercial banks would charge a higher interest rate to their loans and, subsequently, investments should become more productive. Erradicating capital controls would not only flexibilize exchange rates for a natural appreciation of the RMB. It will also help to effectively tackle the overinvestment problem in China. Note also that higher returns of deposits or financial assets, indeed, are supposed to promote domestic consumption (alongside with higher wages derived from profitable investments).

c) Allowing the private sector to gain more protagonism

The OECD has already stated that Chinese private sector contribution to GDP is greater than that of public companies even though it still lags behind their aggregated size[11]. Traditionally, larger SOEs have been fueling overinvestment by reinvesting own profits. They rarely share dividends. And this has created some oversized industries, such as steel, even though those benefits could be better allocated for consumption whether through increasing salaries or social taxes. Moreover, these less productive SOEs have enjoyed a better access to credit than those at the private sector. So this has generated a bunch of structural inefficiencies in China (See Figure 4). We have mentioned before that the opening-up of capital account will introduce more competition in Chinese financial markets. Profitable projects, planned by the private sector, should get a better access to credit then. Moreover, financial innovation would allow these companies to raise more funds by issuing corporate bonds or selling stock. This more rational approach towards credit must create the ideal conditions for a renewed and sustainable economic growth model in China led by private companies. Besides, Chinese government is set to further liberalize some sectors in the economy. Banks and large SOEs will be open to competition. Indeed, foreign investors will be allowed to hold minority stakes at public companies so the latter can improve their management. Finally, experts widely expect lower entrance barriers for private sector in utilities, healthcare and other services[12].

FIGURE 4: Chinese financial sector remains highly leveraged by the big-four state banks (ICBC, ABC, CCB and BOC) which currently account for more than 70% of total funding. Source: KPMG



CONCLUDING REMARKS

The upcomig Chinese economic reform implicitly "approved" in November is much more comprehensive and goes beyond its financial sector. In order to tackle polution, a new tax over coal and some other traditional sources of energy is needed. The land reform will permit people to monetize a particularly vast source of existing savings. And measures like this should contribute to increase the manouvre margin for social spending and private consumption. However, this paper has tried to summarize just only the financial aspects of reform. That is, how this upcoming reform is supposed to tackle the worrying problem of overinvestment in China.

Is China on the edge of collapse due to overinvestment? Our answer to this question, considering the huge amount of domestic savings, is negative. Are overinvestment or excess of liquidity introducing several distortions into Chinese economy such as inequality, oversized industries, inefficiencies and asset bubbles? Of course, they are doing so in a not sustainable way. What could the solution be to erradicate overinvestment? Shifting to a more domestic consumption-oriented economy and rationalize the credit. And how could China have success in pursuing this ambitious goal? Through the financial reform which will modify capital controls, interest rates, currency and corporate lending. Right now there are political and social challenges but not an economic problem. As Prime Minister, Li Keqiang, stated in March 2013: “the reform will be painful but necessary”. Painful because Chinese communist government must give up some privileges derived from the economic boom. More competition, especially in getting access to credit, will be introduced. And this should raise reluctance among some powerful monopolistic groups of power.

However, doing nothing is not an option. Chinese economic imbalances have created too much discontent among people. Financial repression, corruption, rising inequalities or unbearable levels of polution constitute problems that cannot be ignored simply because they could even worsen. The traditional growth model based on cheap exports and massive investments is clearly exhausting. China must shift to a more balanced and sustainable pace of growth. The problem right now is not about growing up double-digits or to grow only just a 6%. It has more to do with the quality of growth. Any growth rate above 8% would indicate a delay of the neccessary reforms to reduce overinvestment in China. Conversely, any gradual soft-landing would be more than welcome to ensure a sustainable and balanced growth in the future for China.

The upcoming financial reform must get rid of both social and political problems which actually represent a threat to stability. But, in our opinion, a financial crash does not constitute the biggest risk in this moment.

REFERENCES:

1- Chinese economic reform has been conducted gradually compared to other countries such as Russia. At KOTZ David, "*Lessons for Economic Transitions in Russia and China*" (Political Economy and Contemporary Capitalism, May 1999), the author states that sudden privatization and overnight liberalization pushed Russian GDP by nearly one-half down between 1992-95. Certainly, that is not the case for China mainly due to "gradualism" in every major economic reform introduced since 1979.

2- Under "Household Responsability System", farmers in China were allowed to produce above their assigned quota and sell the surplus at market prices. It substantially increased grain production and boosted rural percapita income by 50% in 1985 - HE Qing, *Lectures of Monetary Policy at Renmin University of China* (RUC).

3- Town & Village Enterprises (TVE) value added accounted for 6% of overall GDP in 1978. Almost two decades later, in 1996, TVEs contribution to GDP was 25%. In terms of employment, it rose five-fold for the period (from 28 to 136 million) – TAO Ran, *Lectures of Microeconomics and History of Chinese Economy* (RUC).

4- For more details, please see NAUGHTON, Barry (*The Chinese Economy, Transtitions and Growth*. MIT Press, 2006).

5- These four AMC, created to mop-up the Non-Performing Loans at struggling commercial banks, were: Cinda, Huarong, Oriental and Great Wall.

6- The consensus view is that current assets at "shadow banking" account for around 50% of Chinese GDP or 4.8 trillion USD (http://www.frbsf.org/banking-supervision/publications/asia-focus/2013/april/shadow-banking-china-scale-structure/asia-focus-shadow-banking-in-china.pdf).

7- See WANG Tao, "Could a Trust Default be the first domino in China" (UBS, 20140127).

8- Note that as Javier Santacruz posted in this report, http://www.oroyfinanzas.com/2014/02/mediciones-sistema-bancario-sombra-china/?utm_source=rss&utm_medium=rss&utm_campaign=mediciones-sistema-bancario-sombra-china&utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+OroYFinanzas+%28Oro+y+Finanzas+-+Diario+digital+del+mercado+del+oro%29, the shadow banking figures are far from being clear. However, the general view put loans at somewhere around 6 trillion USD.

9- http://www.perpe.es/2013/07/22/wc3013/

10- TORRAS Luis, at *The Awakening of China* (Instituto de Estudios Económicos, 2013), explains this widely expected phenomenon too.

11- OECD (*Economic Surveys: China, 2010, page 106*).

12- See this interview with the Economic Counsellor at Spanish Embassy, Javier Serra, via Dirigentes Digital (www.youtube.com/watch?v=4cyfm463bwY).