China. Markets and Economy. An Updated Overview.

- China is moving from Party rule to rule of law: The constitution and anti-corruption
- China is deregulating markets and increasing greater market discipline: Testing enterprise bankruptcy law and allowing defaults. Credit is becoming more an alpha market.
- The credit markets are being stabilized through macro prudential policy: New formation of LGFVs banned. Muni bond market open. Systemic risk is reduced.
- The PBOC is firmly in easing mode. MLF and PSL = LTRO = QE lite. Risk assets to rally for some time to come.
- The PBOC will try to sterilize the side effects of its easing: Curbing excesses in equity markets. Buy the dips.
- China intends to internationalize the RMB via the SDR: QDII2. PBOC is counting on outflows being balanced by foreign accumulation of RMB reserves.
- China wants to deleverage local governments and corporates and leverage up consumers. Municipal bond markets supported by commercial banks, consumer sector supported by consumer credit.
- Just a reminder, this is NOT a democracy.

Over a 12 month period the Shanghai composite index has risen by 2.5X and the Shenzen composite index by 2.7X. Equity valuations which were among the world’s cheapest are now among the world’s most expensive. China’s stock markets are reflecting an interesting period of reorganization in the underlying economy.

Political reorganization:

At November 2014’s Fourth Plenum, the Chinese government signaled the importance of rule of law drawing attention to the constitution and establishing a series of circuit courts independent of local government influence. This, together with the anti-corruption campaign that has been deeper and wider than expected can be taken as a sign of a very significant shift in policy. The drivers of this policy are likely pragmatic rather than ideological, yet even so, the reforms that we are witnessing are likely to be durable and positive in the long run. We are under no illusions that China's party wishes to cede control to democratic rule. However, the government has seen what Western democracies are good at, and bad at, and are currently choosing positive elements of Western democracy for its own use. Conceptually, the central government remains a central planner which has chosen to outsource certain parts of the political and financial system to the market where they believe the market provides a better solution than central planning.

A growing middle class, an increasingly fluid flow of information through social media and the evolutionary demands of this growing middle class present to the government significant new challenges in governing the country. The scale of the problem has led the government to conclude that central government is not feasible and that management needs to be decentralized and localized. The government also recognizes that decentralization requires two elements, the first is that policy needs t o be driven by rule of law, and that corruption needs to be minimized. The pursuit of these two objectives are evident.

Economic Restructuring and Policy:

In a global trade war a valuable asset is a large and engaged consumer base. Also, as the marginal returns to exports are eroded, it pays to focus efforts on areas of the economy that are less mature hence the desire to de-focus exports and fixed asset investment and encourage consumption and accumulation of intellectual capital (R&D). In 2005, China was 45% of global new patent filings, in 2010 it was 72%. China recognizes it lags in innovation and is investing in R&D to compensate.

The past 5 years have also seen a surge in credit in particular in local governments and corporate businesses. Local governments were previously prohibited from issuing bonds and instead financed their investments through local government funding vehicles, in effect SIVs. LGFVs are now prohibited; only refinancing of existing assets are allowed. Eligibility of LGFV liabilities as general collateral has also been shut down. Instead, local government has been directed towards the issue of municipal bonds, made available through new legislation. To accelerate this great refinancing, currently estimated at 1.7 trillion RMB, a fluid number likely to be increased serially over the coming years, the PBOC has established repo facilities analogous to the ECB’s LTRO, designating municipal bonds as HQLA for collateral purposes, and discounting risk weights to minimize bank capital consumption. On the corporate front, the government is removing implicit guarantees and seeking to slow the accumulation of corporate debt while Imposing greater market discipline into the market. China has an enterprise bankruptcy law enacted in 2007 which is largely untested. Expect it to be tested this year. There have been 4 defaults to date. The first was effectively bailed out, the second and third are entering litigation. The fourth happened last week.

Where is China expanding credit, if it seems to be trying to reign in government and corporate borrowing? Consumer credit needs to be unfettered if China is to successfully engage its consumer base. The life cycle of income generation makes consumer credit an important necessary condition as house prices grow and as consumer tastes develop and mature. SME lending is another area where credit can be extended. While the Chinese banking system serves SMEs relatively well compared with other countries on access, cost of financing is another matter. The PBOC clearly seeks to lower cost of debt for SME as the economy slows. Banks also have a disproportionate propensity to lend to SOEs which bear implicit state guarantees rather than risky private loans. Deposit caps artificially suppress interest expense boosting margins on low yielding loans. The PBOC has recently signaled it may remove deposit caps altogether exposing commercial banks to higher costs of debt and force them to move down the credit quality curve thus spurring SME lending.

Policy:

The PBOC’s efforts at expansionary policy to address slowing growth, to reduce borrowing costs, to encourage SME lending and consumer credit, have side effects on inflation and asset markets. The PBOC will seek to mitigate some of the asset inflationary impact of its reflationary policies. The CSRC in January limited the pace of creation of margin accounts and most recently in May, brokerages have been tightening margin requirements evidently at the behest of the regulator.

These periodic interventions to cool possible asset bubbles will create volatility in asset markets but are unlikely to prevent a bubble from inflating. Capital finds a way. The credit restructuring efforts of the PBOC will likely lead to credit expansion and asset price inflation. It will likely lead to inflation in the services sector as well but this is a different story. Current valuations are already stretched but the potential expansion of system wide credit will likely carry to stock market further. Eventually, over valuation leads inexorably to correction but under current conditions this is some time away.

RMB and SDR

China will seek the inclusion of the RMB in the SDR. The RMB is the 7th largest reserve currency and 7th most used trade currency in the world. SDR inclusion notwithstanding, the RMB will become an international currency. China will soon launch QDII2, a scheme which will open up its capital account even further by allowing qualified investors with over 1 million RMB in financial assets to invest internationally. The calculus expects the opening of the capital account to help the RMB into the SDR and that the resulting foreign demand for RMB reserves will compensate from the domestic capital outflows for investments. This capital will seek a home by the way.

Reality Check:

I am pretty sanguine about the prospects for China. China is embarking on QE or QE lite on an ever increasing scale. This will fuel the asset inflation. The asset inflation will be punctuated by efforts to deflate any asset bubble, although it will likely be futile. The end game is a bust, but one that is far away.

The risk is political. The government appears enlightened and is pressing reform in many directions. One thing, however, has not changed and will likely not change. China is not a democracy and if it ever does, will not become one in a continuous or smooth fashion. While markets are being liberalized, personal freedoms are being limited. This may have little bearing for foreign investors who have but a commercial interest in China, however, there is a way in which the failure to reform the political system may be asynchronous with the economic reform. There is that old communist fallback of redirecting internal tensions into external tensions.