Orient Capital Research

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Xi Jinping's Economic Reforms

What are the Chances of Success?

Premier Xi Jinping has surprised everyone by how aggressively he has taken charge. A year ago, analysts looking at China post-leadership transition were interested in only one thing: would the new leaders continue the economic stimulus. Now, Xi is racing past stale assumptions of the glacial pace of change and quickly launching new reform policies. To be clear, he is steering clear of two no-go areas: political reform, and modernization of the industrial sector. Politics calls into question the existence of the Party (witness the threatened expulsion of Xia Yeliang of Peking University Professor for his liberal views) and industrial reform would gore too many Princelings whose revenue is derived from the state system. But he is throwing his weight behind financial, economic and local government reform – far more aggressively than anyone expected before the transition in March. As an example, his first trip out of Beijing was to the Shenzhen Economic Zone where he said China should "dare to tackle tough issues."

We have thus far witnessed these policy "trial balloons:"

- **Interest rate liberalization**. The meeting late in June with the state banks to convince them to allow free floating lending and deposit rates.
- **Calls for Structural Reform.** The pressure for structural reform in China is increasing amid slowing growth but reforms are expected to be rolled out in the coming months, will restore

investors' confidence, according to Li Daokui, director of the Center for China in the World Economy (CCWE) at Tsinghua University and a former central bank advisor, in the People's Daily.

- **Securitization.** This is happening in the shadow banks but is now being pushed officially. China may gradually expand asset-backed securitization to enhance the efficient use of capital, said Liu Jianhong, an inspector at the financial market division of the People's Bank of China.
- **Local Land and Tax Reform.** Documents now being prepared at the People's Bank of China are being drawn to support Xi's proposal to centralize local land sales, create a local bond market, and widen the scope of real estate taxes.
- **Private Banks.** China pledged to allow the establishment of privately funded banks run independently from the government. Private capital will be permitted to establish commercial lenders independent of government control and bailout, the State Council said in a guideline outlining the restructuring of role of the financial sector.

In addition, the State Council – backed by the China Banking Regulatory Commission – issued a statement on financial plans. They include:

1) To continue to pursue a prudent monetary policy to keep the money and credit supply at a reasonable level, and to gradually let the market decide interest rates.
2) To speed up reform in key industries and areas by imposing a strict curb on credit and direct financing for unapproved projects in industries suffering from overcapacity.
3) To support small businesses by mobilizing financial resources in different sectors of society, and accelerating securitization of credit assets.
4) To strengthen credit support to farming and rural development by allowing different reserve requirement ratios in village and township banks.
5) To promote consumer financial services to boost domestic consumption.
6) To encourage overseas development of Chinese enterprises, as well as expand the pilot program for individual investors injecting money into the foreign capital market, or QDII2. There will be innovative ways to invest foreign exchange reserves through commercial bank loans to bring about corporate overseas expansion.
7) To accelerate building a multi-level capital market and innovation for more special funds for mergers and acquisition projects.
8) To enhance the effectiveness of insurance in transforming the economic growth pattern.
9) To open more areas for private investment in the financial sector, especially private capital that will be allowed to set up banks and other financial institutions.
10) To strictly control the financial risk.

(My personal feeling is 2 and 3 are unlikely but the others are possible…)

These trial balloons are all significant policy changes in the economic arena. Xi is pushing them early in his tenure and is reportedly going to present an integrated economic proposal during the 18th Plenum in October.

Xi Jinping has Strong Supporters in the leadership…

Xi is very carefully avoiding backing changes to the industrial economy, namely the state enterprises (SOEs), apart from a discussion to increase the dividend paid by SOEs to 5 percentage

points. Currently, there are three payment bands: 15 percent for highly profitable SOEs, 10 percent for less profitable ones, and 5 percent for military firms. Zhu Rongji wielded a heavy baton by controlling the listing of the big state firms. They are now listed and there is too much graft and employment issues. Instead, he is focusing on economic and financial reform.

He has four charismatic and powerful economic players on his side in the Politburo and elsewhere in the heirarchy: **Zhou Xiaochuan**, Chairman of the PBOC; and **Wang Yang**, former party secretary of Guangdong and now in charge of rural economic affairs. Zhou is a widely respected economist with a PhD from Tsinghua University with reformist views. He tried to clean up the domestic stock market under Zhu Rongji, albeit with little success, and was in charge or recapping the banks in 2003. Wang Yang is the man who allowed the democratic revolt in the town of Wukan to flourish against some opposition in Beijing.

Also a reformer is **Lou Jiwei**, Finance Minister, who was Zhu Rongji's right hand economic man and most recently languished as head of China Investment Corp. Last is **Liu He,** formerly of the National Development and Reform Commission (NDRC). With a Master's from Harvard's Kennedy School, Liu wrote many of the economic platforms for several five-year plans. He is also the head of the Finance and Economics Leadership Small Group of the central Communist Party.

The downfall of Bo Xilai hurt Xi Jinping's candidacy, as they were allies, but former premier Jiang Zemin reportedly (according to a book on Bo Xilai by Pin Ho and Wenguang Huang) persuaded him to stay.

…But Some Will Oppose Change

Several people are less enthralled with economic liberalization. These include **Ma Kai**, an understated technocrat, in charge of the industrial and transportation sectors. The recent appointment of **Jiang Jiemin**, chairman of China National Petroleum Corp, as head of the State Assets Supervision and Administration Commission, was a reshuffling of vested interests. His predecessor, **Wang Yong,** was named State Councilor but is a force for keeping the state sector intact.

The two biggest economic forces within the economy are the state banks and Local Government Financing Vehicles, the biggest borrowers. The **four state banks** are Bank of China, Construction Bank, ICBC, and Agricultural Bank. They reportedly shot down a Xi Jinping proposal in June for liberalized interest rates. Their margins have benefited enormously from low deposit rates. Also profiting from fixed lending rates are the industrial and non-industrial state owned firms whose capital costs are heavily subsidized by the state.

Local governments are most likely against any rule to remove their control over state land; unless they are recompensed by a) corporate bond issuance; b) real estate taxes; and c) countervailing social welfare transfers from the central government. That's what Zhu Rongji did when he centralized tax collection but increased transfer payments.

As Barry Naughton, a leading political scientist at UC San Diego notes of Xi's economic plans, "These areas should be watched closely through 2013: they have the potential to surprise us."