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China's "New Normal"

Beijing is Quietly Making Policies to Accommodate Slower Growth

Summary. In 2015, Premier Li Keqiang broke new ground when he said China is preparing for a "new normal" as the result of slower economic growth. However, he focused his speech on the shining glory of new industries – rather than a realistic appraisal of the nuts and bolts of deleveraging. This has given rise to a debate about what China's policies will be as GDP growth winds down. Will stimulus continue? Will there be reduced growth in bank loans and the money supply?

We believe that China ***is acknowledging the "new normal" in a series of policies that are designed to adjust the economy to slower growth,*** a kind of unofficial reform. Chinese policymakers have been busy designing and implementing significant changes in China's economy – ***but they have not been announcing these as part of a major change in policy.*** There are two reasons for this. First, there is significant opposition to any retrenchment from pro-growth stimulus among senior leaders, including Premier Li Keqiang himself. And second, senior leaders do not want to hint at a slowdown for fear of losing political support among the Chinese people.

We believe, however, there is a significant change underway. These policies could help pave the way for a manageable decline in growth – although it's too early to tell how effective they will be. They could also offer opportunities for foreign investors to acquire distressed assets.

There are several components to these behind-the-scenes macroeconomic changes. The **catalysts** are:

1) A decline and a geographic divergence in land sales.

2) Falling local government revenue.

3) Rising corporate defaults.

The government's **responses** include:

1) A new tax regime.

2) Negotiations over debt workouts.

3) Expanded court power over "zombie" firms.

4) Expansion of Asset Management Companies (AMCs) for debt disposal.

These policy responses are a move in the right direction and could be an opportunity for investors.

Key Catalysts for the "New Normal"

1) Declining Land Revenue – "Winners" and "Losers"

Land and property account for 30 to 80 percent of local government revenue. In 2015, land revenue fell 21.6 percent to 3.4 trillion yuan. First half 2016 land sale revenue rose 13.1 percent to 235.7 billion yuan, while property taxes rose 8.5 percent to 116.9 billion yuan.

The interesting point about land sales is that there is a growing split between the biggest, Tier 1/2 cities and everyone else. In the first half of this year, the top four cities and 18 second tier cities saw land revenue jump 89.2 percent. Shanghai fiscal revenue grew more than 30 percent. Others didn't fare as well. Land revenue in industrial Liaoning Province and coal mining Shanxi Province were down 18.6 percent and 7.4 percent. This polarization is a leading indicator of property values, with capital aggregating to the wealthiest, politically most powerful cities.

Meanwhile, the supply of land – local government's biggest single source of income -- is declining. In the first half, the supply of state-owned land for construction fell 12.5 percent, with the industrial warehouse space falling 15.2 percent, real estate land down 20.9 percent, and land for infrastructure declining 7.1 percent. Future revenue from land sales will become more difficult over time.

3) Income Not Keeping Pace with Expenditure

National fiscal spending rose even faster than income. But income from land, along with revenue from other sources, failed to keep pace with spending. In June, fiscal expenditure rose 19.9 percent to 2.26 trillion yuan, while 1H 2016 expenditure increased 15.1 percent to 8.92 trillion yuan. Local governments continue to spend to maintain growth but their revenue is declining. This is clearly unsustainable.

And as with the property sector, there is a growing divergence between urban and rural areas. As an example, more than half county-level rural areas experience deposit outflow. Up to 68 percent of rural financial institutions' loan-to-deposit ratios are less than one. That means money loaned to rural areas is less than that deposited in banks by rural households, so money flows out of rural areas.

2) Corporate Defaults Rising

The fiscal pressure on local governments is being compounded by corporate defaults. As corporate profits decline, the ability to pay interest is falling and defaults are rising. As the IMF noted in a recent report, "Lower profitability and cash generation have pushed debt relative to earnings (debt/ earnings before EBITDA to a multiple of just under four for the median Chinese firm, more than doubling since 2010 (IMF, Global Financial Stability Report, April 2016).

This shortage of capital is also is creating a chain effect throughout the economy. Corporates work with local governments on projects that artificially inflate GDP growth. Defaults will cause these projects – and their fiscal stimulus – to end.

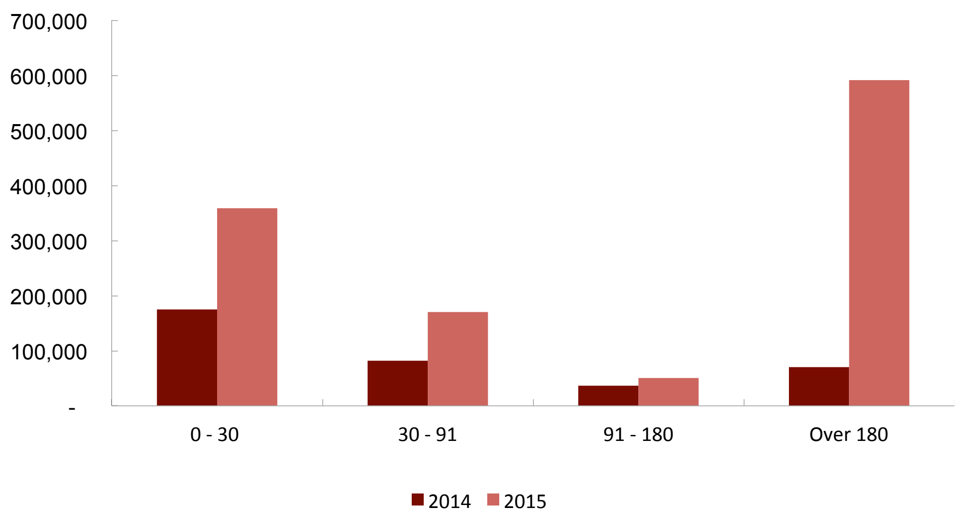
Corporate bonds defaults have tripled in the first half of 2016 compared with all of 2016. The climate has led 70 companies to cancel or postpone new issuances of bonds, sensing that investors are growing more skeptical. This has also led to a widening of the spread between higher and lower rated corporate bonds over the past year and a half.

Even state firms, usually well protected, are defaulting on loans. According to an interview I held last week with the Beijing Rural Commercial Bank, China National Salt Corp. – even though it is a monopoly supplier -- has defaulted on its loans to five different banks as the result of non-payment of a LOC by a salt producer in Guangdong Province. As a result, bank managements have told loan officers to closely scrutinize loans to state firms and have instituted a quota on

SOE loans – an unusual move in China's state-centric economy.

Even China's shadow lenders are becoming stretched. I assembled a chart from one public company, Differ Group, that has diversified from loan guarantees into loans and leases. Increasingly these financial instruments are of longer duration, as borrowers have a harder time paying their debt.

Differ Group's Loans and Leases by Average Duration (Days)



Source: DFH Financial Statements

Policy Changes Under the "New Normal"

The debt/GDP catalysts are widely known. What is not as well recognized are the institutional responses to them that show that China is quietly responding to the deleveraging process. We know China is facing a debt crisis; what is more interesting for global investors is how that crisis will work its way through the political system and what it means for global growth.

1) Rising Independence of Capital

Dongbei Special Steel, a leading producer of special alloys such as those used in making automobiles, earlier this year defaulted on the repayment of 3.1 billion yuan of corporate bonds. Liaoning Provincial Government's state arm, SASAC, which holds 46 percent of the company's shares and is the largest shareholder, proposed a twofold plan: the banks would swap 70 percent of their debt into equity, and the bondholders would lend money to Dongbei to help pay the remainder of its bonds. This was clearly a land grab by a cash-strapped local government trying to save its biggest state-owned employer.

What happened next was surprising. First, the bondholders banded together to boycott Liaoning bonds. The proposal called on "all financial institutions to stop purchasing bonds issued by the provincial government and enterprises." According to Caixin, an independent minded magazine in Beijing, "Banks were shut out of all meetings the government held to discuss how to resolve the problem, even though they are the largest creditors," an executive with one of the company's creditor banks, said. A source close to the state-owned China Development Bank said that the banks "will not implement the plan, because there is no arrangement at all to improve the company's creditworthiness."

Second, even top Beijing officials chimed in against the plan. Wu Yaping, an official at the powerful NDRC planning board, said Liaoning should focus on SOE reform including "mixed-ownership," rather than provide more capital out its biggest state firm.

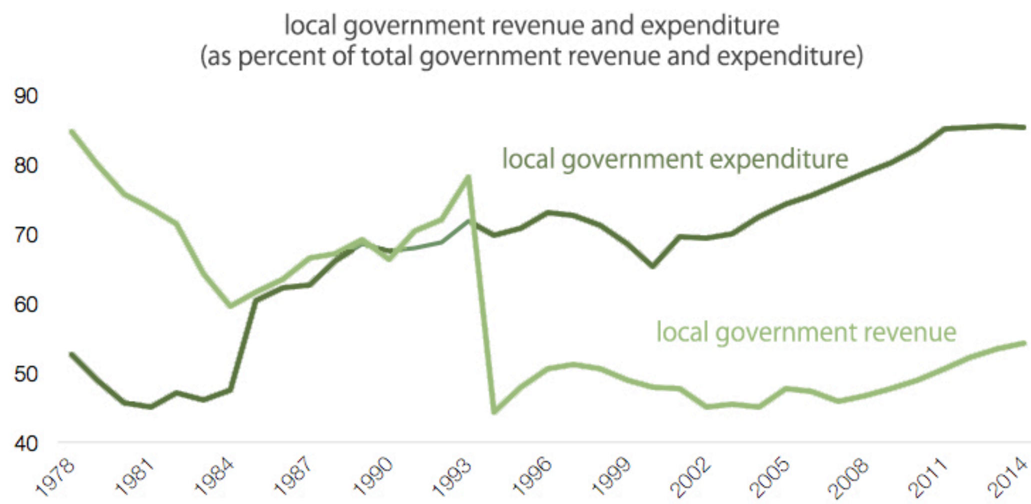
Both responses show significant opposition to financial bailouts to local firms using national funds. The responses also show the increasing ***independence of private capital and of the banks*** to government policies, albeit local ones. The fact that the spat went public is highly unusual in China's usually closed-door backroom political style of deal making.

2) New Tax Reform

Another key response to China's growing debt burden and near fiscal insolvency of local governments is reform of China's tax system by Lou Jiwei at the Ministry of Finance. This has been widely overlooked and could be an important policy – although we will know better when implementation commences. But already the timetable has been on track.

To backtrack, Premier Zhu Rongji centralized tax revenue in 1994 because Beijing was losing control of taxation due to rising business outside of the state system. This caused a longstanding decline in local revenue that led to much of the debt crisis China faces today. That gap between revenue and expenditure was filled by the sale of land and Shadow Banking. Land sales are dropping and Shadow loans are likely to collapse at the first sign of financial panic (Dongbei Steel is a good example).

Local Government Revenue and Expenditure



Source: Ministry of Finance

Under the new plan promoted by the powerful Finance Minister Lou Jiwei, by the end of 2016, China will clarify expenditure between Beijing and the provinces and hand back some tax power to local governments. This policy has flown under the radar but is likely to be a serious rejiggering of national accounts. The leading western expert on China's tax policy, Christine Wong of the University of Melbourne, expect big changes to be announced by the end of the year, although she cautions that some proposals may get bogged down in Beijing's bureaucratic mire. She called this "a big deal." It was promised as phase 3 of the comprehensive fiscal reform announced by Lou Jiwei in early 2014. If announced by end of 2016, it will be exactly on the schedule he laid out.

If successful, the reforms could go a long way toward moving local governments away from their addiction to land sales and an inflating property market (along with the highly shaky Shadow loans propping the whole edifice up). They would have more power to impose ordinary, and more transparent, taxes.

3) New Bankruptcy Courts will Help Kill "Zombie" Companies. The third key policy that reflects the "New Normal" is a reform of the legal system to promote orderly defaults. This also has passed almost unnoticed in the usual accounts of China's policymaking. The Supreme People's Court (SPC) is circulating a plan to set up bankruptcy courts. Beijing, Shanghai, Tianjin and Chongqing would be the first to establish the bankruptcy and liquidation tribunals, and other major cities would follow. Overall bankruptcies in China have surged 52.5 percent in the first quarter of 2016 compared to a year earlier with 1028 cases being reported by the Supreme People's Court. This is good news for bankruptcies for corporate bankruptcies and, eventually, SOE reform. It also will facilitate the sale of distressed assets through formal channels.

4) New Asset Management Companies Will Speed Up Debt Sales. Current rules state that only banks can sell non-performing loans and only the licensed Asset Management Companies (AMCs) can buy them. This has handed a mafia-like oligopoly to the four central AMCs in Beijing. In 2013, the China Banking Regulatory Commission authorized provincial governments to permit one local AMC. It has since approved 24 provincial and four prefecture-level AMCs (in Wenzhou, Qingdao, Xiamen and Suzhou). More prefecture-level cities such as Shenzhen and Guangzhou are applying for AMC licenses.

In addition, Beijing will relax restrictions on local AMCs to sell assets. Local AMCs are required to dispose of distressed assets through debt restructuring rather than transfers. However, they often get around this by transferring the rights to distressed assets to other financial intermediaries.

Impact on the Economy and Global Markets

The trends discussed above – independence of capital, a new tax code, legal reform, and additional AMCs are powerful ***institutional changes***. What does this mean for global investors and the Chinese economy?

For the Chinese economy, we expect….

1) **Possibility for an Orderly Downturn.** The biggest threat from China for global growth would rapidly declining Chinese GDP or, even worse, a political crisis. We view these institutional changes as preparing to ease the transition from hyper-fast growth to slower growth.

2) **Functioning and Responsive Bureaucracy.** These policies outlined above show that the bureaucracy is responding to an economic crisis – despite the clear evidence of conflict between Xi Jinping and Li Keqiang over the direction of policy. The wheels of policy, among institutions like the Ministry of Finance, and the PBOC, grind forward in efficient ways.

3) **Prevention of a Local Fiscal Crisis.** Local governments have official debt of 24 trillion renminbi and much likely closer to 30 trillion. They are confronting declining SOE profits, lower land sales, and rising social service costs. Revising the tax code to allow them to regularize and retain more revenue is a positive step toward fiscal responsibility.

<u>For Investors, we can see….</u>

1) **More Firms Involved in Asset Sales.** Allowing private firms into the debt restructuring business, as both buyers and sellers, would vastly increase China's institutional capacity to handle debt. It would also help end the cozy relationship between the Central AMCs and the banks that has allowed them to control the best deals. Investors who now confront a monopoly of debt sales by the Beijing-based AMCs are likely to find new channels for debt purchases and restructuring.

2) **Expanded Securitization.** There are currently six pilot projects through the big banks to securitize non-performing loans. There is ample room to allow other banks to securitize NPLs, creating a more transparent market for debt.

3) **Expanded Role of Private Capital.** All of the reforms discussed above provide more running room for private firms to function in China's economy. Shadow Banking already has made private capital an integral part of the financial system by providing a large, new channel of capital flows, equal to approximately half of all lending. Admittedly, shadow banking also has occurred to the detriment of transparency and unfortunately strengthening the hand of corrupt local governments, particularly in the case of the infamous Local Government Financing Companies (LGFVs). But the proposed new tax and legal systems give institutional weight to private capital – out of sheer desperation as much as anything else. But this is a good thing.

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