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IIMA symposium on global finance and economies

The third plenum and its implication for the Chinese economy

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Chart 1: China's growth

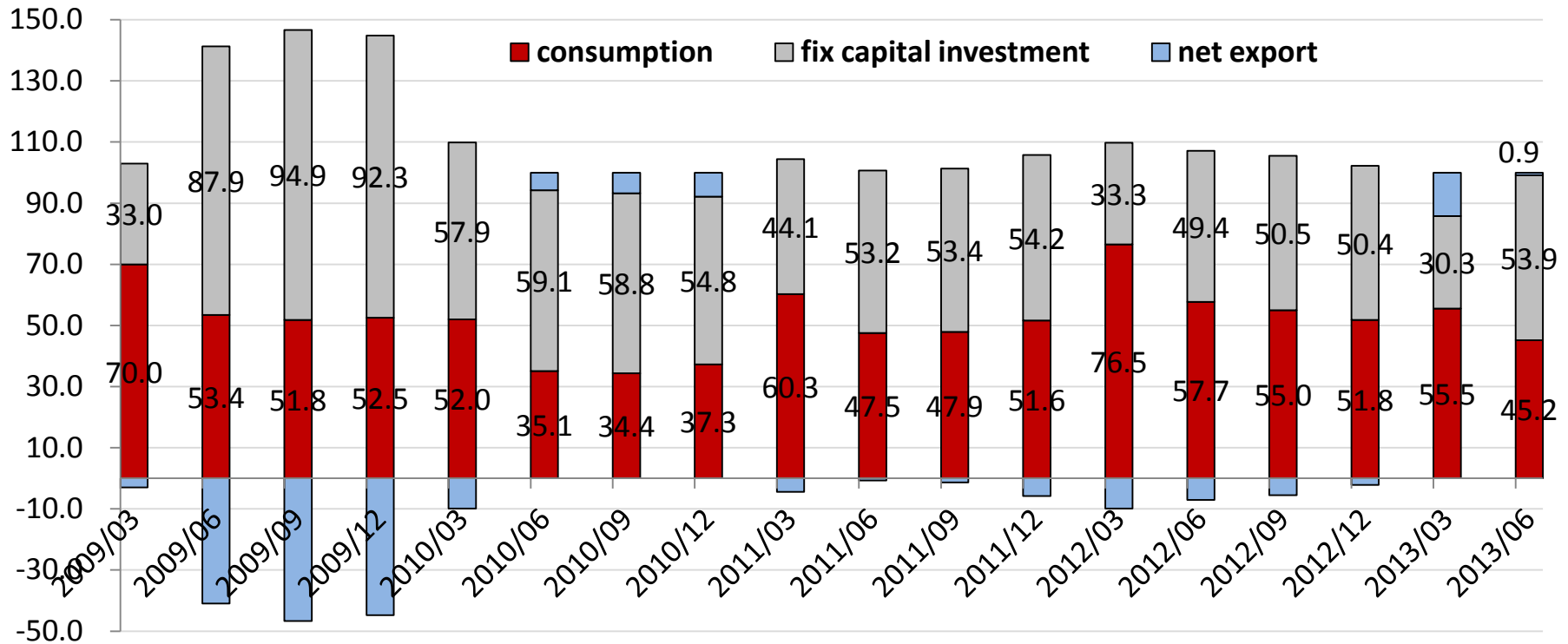


SOURCE: WWW.TRADINGECONOMICS.COM | NATIONAL BUREAU OF STATISTICS OF CHINA

The Chinese economy: slower growth



Chart 2: Three drivers as percent of GDP



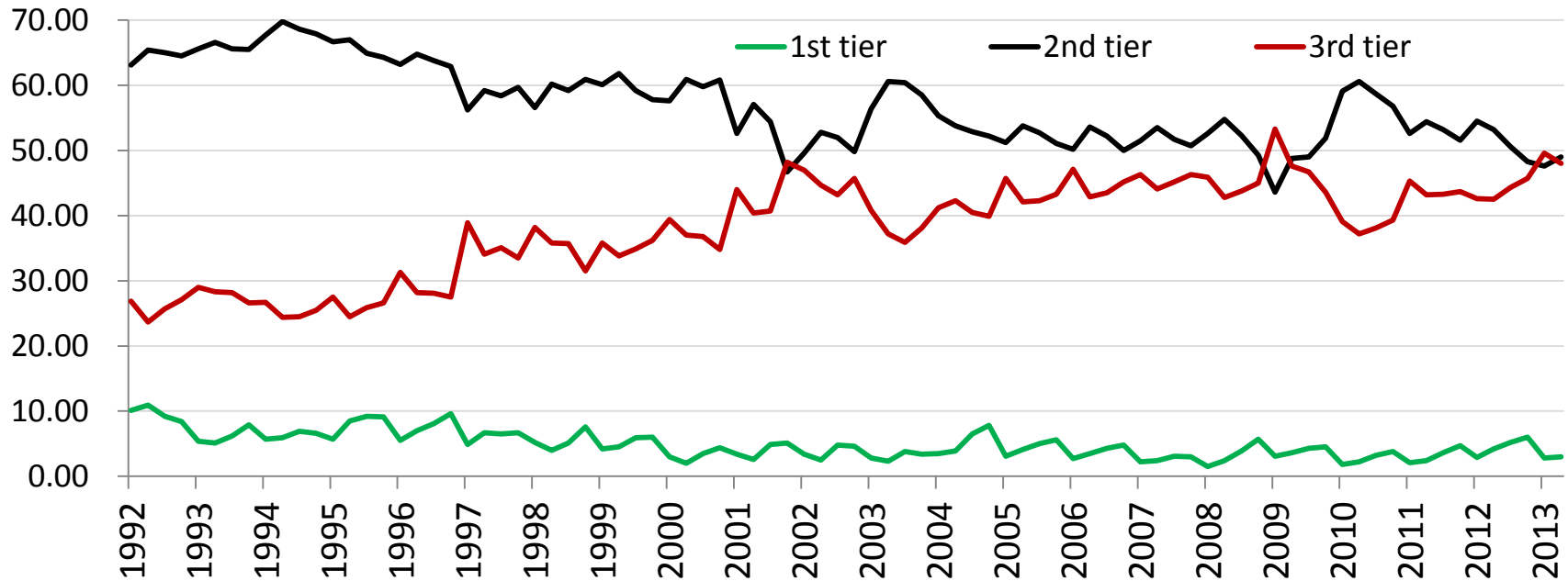
Export contribution turned to be positive but is marginal;

Fix investment, the major drive to the growth, hit the great wall (overcapacity....);

Consumption is still below the expected level.



Chart 3: Structure change Three sectors as % GDP Agricultural , industry and service



Service sector growth steadily.
In 2013 it accounted 46% of GDP,
against industry's 44% .

Structural forces move China steadily onto a
lower growth: potential growth rate in the
next 10 years is between 6% to 8%, and
slower capital and labor input is expected.



2013-2020 :The second round of reform

- The old model, export orientation and fix investment concentration, can't go on. It, especially, is true when China comes across profound social change, deep water reform, and environmental problem.
- What's new? 1978-2013: to make the cake bigger; 2013-2020: to distribute it fairly.
- Means to achieve it: Marketization and Liberalization.
- The plan delivered by the third plenum covers six areas of reforms: Economic and financial, Social, Political, Cultural, Ecological, and National security.



The Third Plenum policies in brief

Reform areas		Policies	Objectives
1. Economic and financial reforms	Role of the government	<ul style="list-style-type: none"> – Reduce government intervention in the economy; – Let market determine the prices of water, oil, natural gas, electricity, transportation and telecommunication. – Delink officials' performance from GDP growth-based, link it to an index including resource consumption, overcapacity and incremental local government debt. 	Let the market play a decisive role and establish a modern market system in terms of market rules and pricing.
	Financial sector	<ul style="list-style-type: none"> – Set up privately-funded small and medium sized banks; – Establish a registration-based stock issue system from current approval-based one; – Form a deposit insurance system; – Interest rate liberalization; – Exchange rate formation; – Speed up RMB capital account convertibility toward full convertibility by 2020. 	
	Fiscal reform	<ul style="list-style-type: none"> – Improve the budget system and tax system include the property tax and VAT; – Revenue sharing between local and central government will be gradually adjusted by a local tax system, but the central government will take more responsibilities and have more power accordingly. – Consumption tax instead of business tax 	
	State owned enterprise	<ul style="list-style-type: none"> – Set up state-owned asset management companies; – Increased state capital gains transferred to social security fund from the current level of 0-20% to 30% by 2020; – Allow non-public owned enterprises to take part in state investment projects. 	
	Economic Openness and fairness	<ul style="list-style-type: none"> – liberalize investment access and more free trade zones following Shanghai; – Explore a model of national treatment (being treated the same as domestic investors) combined with a "negative list" – Explore the set up of intellectual-property courts 	



The Third Plenum policies in brief (cont.)

Reform areas	Policies	Objectives
2. Social reforms	<ul style="list-style-type: none">– More property rights for farmers include limiting the scope of rural land acquisition by local governments and establish a rural property rights trading market– Hukou (residency permit) system reform: fully opening for towns and small cities; gradual loosening limitations to settle in middle-sized cities; reasonable requirements for large cities but strict control of population size in large cities.– Loosen the one-child policy; Improve the education system and help college graduates for employment; Income distribution adjustment, establish a more reliable and sustainable social security system and continue healthcare reforms– Strengthen management of the internet; increase the supervision of food and drugs, and complete the social security risk evaluation system.	Enhance equality and social safety
3. Political reforms	<ul style="list-style-type: none">– Abolish the system of re-education through labor camps; further judicial reform including centralized management of courts.– Complete anti-corruption system and explore an official residence system.– Continue to promote "deliberative democracy"	Enhance social justice
4. Cultural reforms	<ul style="list-style-type: none">– Consolidate media resources to push the merging of traditional and new media; Complete online propaganda system	Enhance the soft power
5. Ecological reforms	<ul style="list-style-type: none">– Protect the environment including making local officials permanently liable for any environmental damage.	Sustainable growth
6. National security	<ul style="list-style-type: none">– Establish a National Security Committee to co-ordinate and centralize national security	



To summarize it

- Government: Less intervention, transparency, rule of law
- Factor prices: Market determination (land, labor, capital...)
- Financial sector: liberalization and decontrolling
- Firms: Innovation and fair competition (SOEs vs non-state ownership)
- Household: Equal rights, social and health safety (e.g. “Hukou” system)

China is on the road towards marketization:
unprecedented, far reaching, and deep and strong reform.



Financial repression and dual bank rates

Chart 4:
Financial repression
Real interest rate->
Discourage consumption
and subsidize state-owned enterprises

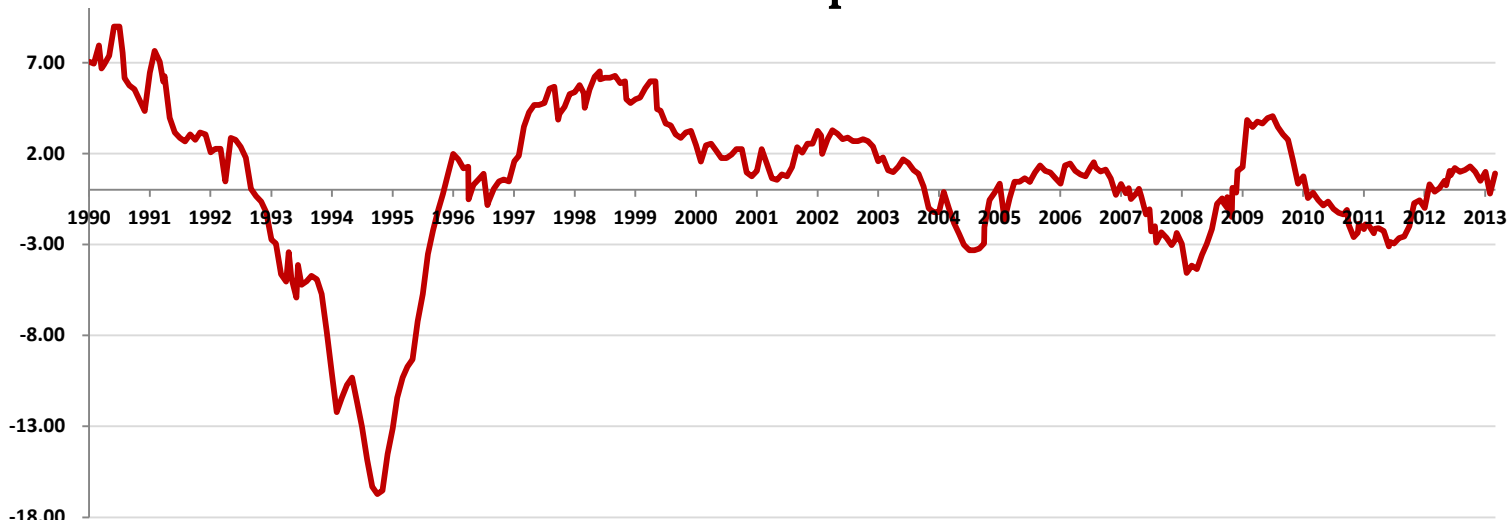
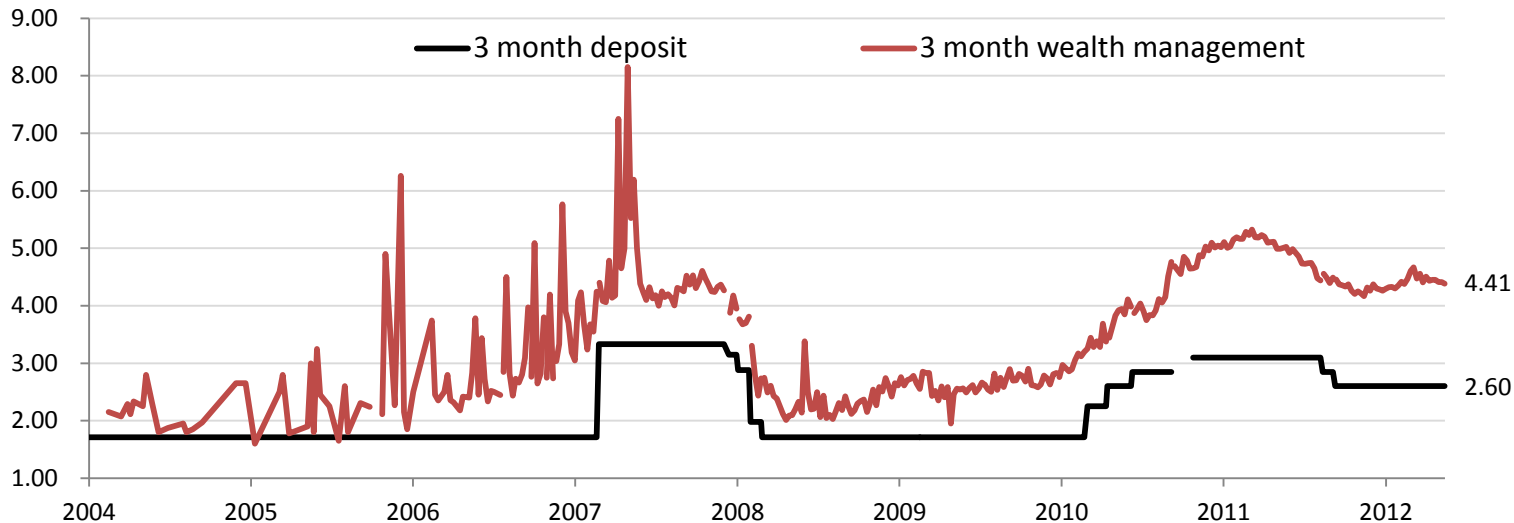


Chart 5:
Chinese shadow banking:
Higher and more flexible rate





Shadow banking

The size?

- Different statistic method gives different figures: from narrowly defined as wealth management products to a broader coverage of trust, securities, and other financial entities.
- FSB: by the end of 2012, trust and WMPs amounted to ¥ 46 billion, 10% of bank assets, 30% of traditional bank deposit .
- Compared with the same kind in other countries: US 170%; Korea, Euro area over 50%; Japan about 20%.
- Incentive for regulation arbitrage: it's like genie in a bottle...



Shadow banking

What concerned most?

- Hidden, off balance sheet, and carries potential NPLs for banks.
- Leveraged, increases the cost of real sector financing;
- Liquidity and credit risks, due to severe maturity mismatch and potential reckless borrowing; (The first cash crunch in interbank market happened in June 2013.)
- An illusion of implicit guarantee. Although the banks (especially the big four banks) never issue the explicit guarantee for their WMPs, it is presumably that the banks (and their products) are guaranteed by the government. (The wake-up call in the end of January 2014: possible default of ICBC's product.)



When shadow bank meets local debt...

- Shadow banking has helped local governments to borrow (using land as collateral) from banks or firms, through local financial platform, to finance its developing projects, a main driver for local GDP and linked to officials' merits; It is also a direct means of supplement of the local government tax collection.
- China National Audit Office: local government debts had reached \$3bn by June 2013, rising 70% from the previous audit conducted in 2010.
- Why is it so dangerous?
Overcapacity (steel; cement; real estate sectors); Environmental problem; Financial risk. In 2014, about \$660 billion of trust loans, the largest form of shadow banking, are due for repayment or refinancing. It is expect to be rolling over. But repeated rolling over just prolongs potential default and is not an ultimate solution.

The worst isn't over.