Cross the River by Touching the Stones
Exploring China’s Reform Landscape

EXECUTIVE SUMMARY

In our previous white paper, “China at a Crossroads,” we concluded that China would face potential economic stagnation if it failed to proceed with structural reforms. With China’s new political leadership now in place, we can explore the reform landscape with greater precision. This paper will assess the various structural reforms that are on the new leadership’s agenda and the subsequent investment implications of their implementation.

Pragmatism and gradualism have defined China’s economic reform over the past three decades. Deng Xiaoping, the reformist leader of the Communist Party of China, first communicated this reform philosophy in the late 1970s with his famous quote, “crossing the river by touching the stones.” Although the country is at a developmental crossroads currently following a few years of reform stagnation, we are cautiously optimistic that the new leadership will lead the country toward reform success with a resumption of the deliberate, thoughtful, and pragmatic approach outlined by Deng Xiaoping 30 years ago. Unlike the prior decade, the political tolerance for lack of action will be low, as current growth rates are clearly unsustainable in the near term without the implementation of the structural reforms we discuss in this paper.

According to the government’s 12th Five-Year Plan, China’s new leaders will focus on land reform, state-owned enterprise (SOE) reform, and continue with financial and fiscal reforms. If implemented successfully, these reforms will facilitate structural rebalancing, which should improve productivity and, ultimately, raise consumption.

Understanding the nature and speed of China’s reform process illuminates several important investment implications. Firstly, as China’s economy continues to grow and climb the value chain, its currency should experience pressure to appreciate. Although that pressure is not a new phenomenon, we expect China will gradually become more comfortable with yuan appreciation as a means of controlling inflation and facilitating the transition from export growth to internal demand. As a result, we also expect a much more balanced current account over the next decade. Secondly, financial liberalization will certainly lead to a decline in the importance of state-owned banks and lead to a slow rise in the cost of capital for most of China’s publicly listed companies. Such a rise would squeeze profit margins for capital-intensive corporations and highly leveraged industries.

RETROSPECT ON PAST REFORMS

China’s economic reforms that introduced capitalist market principles began in 1978. From 1978 to 2010, China experienced average growth rates of 9.5%—a rate and duration of growth unprecedented in human history. That economic growth lifted hundreds of millions of people out of poverty and propelled the size of China’s economy to the second largest in the world behind the U.S. The conservative Hu-Wen Administration more heavily regulated the economy after 2005, reversing some reforms.
Criticisms that have been attributed to the incomplete reforms are listed below:

- Despite reducing poverty and increasing China’s wealth, Deng Xiaoping’s reforms also increased inequality and the wealth gap by “allowing some people to get rich first.” The Hu-Wen Administration halted privatizations and increased the state sector’s importance in the economy and promoted state-run monopolies in key sectors, which encouraged corruption and the collusion between the powerful and the rich. China’s State Council recently approved an income distribution plan to tackle the widening wealth gap and redistribute wealth from SOEs to households.

- The effects on public health and the environment of industrialization and the government’s pursuit of gross domestic product (GDP) growth at any cost have been horrific. Public health and environmental issues are likely to become major obstacles to the growth of China’s economy during the coming decades if improvements do not materialize.

- There has been an implicit pact between the Chinese government and its citizens: the government would ensure prosperity so long as its citizens obey its rule and not demand too much freedom. China will unlikely adopt Western-style democracy soon, but we expect the new leaders to implement modest but meaningful political reform in order to ease social tensions. Over the past three decades, Chinese leadership has been very proactive, dynamic, and flexible in responding to the changing political conditions.

THE NEW LEADERSHIP IS MORE LIKELY TO CARRY ON THE INCOMPLETE REFORM

China’s new leaders’ style certainly breathes fresh air into the traditional rigid and dull stereotype. The new leaders have exhorted reform and the rule of law, made symbolic trips to Shenzhen tracing Deng Xiaoping’s footsteps to show their commitment to reform, vowed to crack down on corruption and reduce the wealth gap, and reduced official extravagance and bureaucracy. Current President Xi Jinping clearly understands the power of popular opinions, particularly on the issue of corruption and official extravagance. His famous musings of “four dishes and a soup” has become the media sensation for his more frugal, down-to-earth approach. We believe Xi could be just like his father Xi Zhongxun, who was one of the masterminds behind Deng’s reform agenda. However, we think major structural reforms are quite unlikely before 2014. Xi and Li Keqiang, the new Premier, will most likely take the first couple of years to consolidate their power base and make allies. Only after they achieve these tasks can they become powerful enough to challenge China’s vested interest groups.

REFORM BARRIERS: IDEOLOGY AND VESTED INTERESTS

We think that two major barriers to successful future reform exist. The first is about ideology. Unlike the 1980s when China just opened its doors and started economic reforms, China needs to emulate various market institutions of developed market economies. However, three decades of reforms have picked much of the lowest-hanging fruit. China’s leaders lack a clear sense of direction for the future, especially after the global financial crisis. The crisis showed that capitalist business models bring complex challenges as well. The real areas for deeper reforms are in China’s political and social institutions. It is not clear to Chinese leaders which political system is optimal.

Secondly, as in any political system, vested interest groups present a major challenge to successful reform in China. Today’s vested interest groups have cemented the power gained from three decades of tremendously beneficial, pro-market reform. Those vested interest groups will strongly resist any reform that could endanger their advantageous economic position. To be fair, Deng’s reform also met with strong resistance from vested interests, but China’s leadership implemented reform against all odds. We are hopeful that the new leadership can achieve the same thing.

OUTLOOKS ON POTENTIAL REFORMS

We believe the new leadership will be most committed to the following reforms:

1. THE CONTINUOUS FINANCIAL REFORM

The reform of China’s backward financial system should continue at a rapid pace. Still, China’s economy exhibits many features of financial repression. In the early stage of China’s economic reform, financial repression had contributed to China’s fast growth as low interest rates subsidized SOE borrowers with funds channeled from household savings by the state. However, over the years, the benefit of financial repression
has been outweighed by its cost.

Financial repression has led to increased structural risks, has restricted economic efficiency, and has become a key obstacle to rebalancing economic growth from investment to consumption. Financial reforms need to change three aspects of the current system that are caused by financial repression: 1) key financial prices, such as interest rates and foreign-exchange (FX) rates, should be determined by market forces; 2) the allocation of capital should be a function of market prices, not government decisions; 3) financial institutions should operate as market entities rather than being directed by government policies. To achieve these goals, the Chinese government has an ambitious financial reform agenda affecting the following five areas:

- **Introduction of market-based interest rates**: As the most important element of the cost of capital, state-regulated interest rates lead to an inefficient use of capital with very cheap bank lending to SOEs and unusually high interest rates in black markets. The People’s Bank of China (PBOC) will increasingly conduct monetary policy by using price-based tools, such as interest rates, rather than quantity-based mechanisms, such as loan quotas, to control the economy. The PBOC will establish the Shanghai Interbank Offered Rate (SHIBOR) as the key benchmark rate for China’s monetary policy and will gradually forgo direct control of interest rates. We believe this is in line with the PBOC’s current actions of increasing the use of reverse repurchase transactions and other short-term money market tools to keep markets liquid, instead of adjusting the required reserve ratio (RRR). The PBOC will also widen the floating band on lending and deposit rates. Eventually they will remove restrictions on limits for lending and deposit rates.

- **Capital-market development**: 
  
  - **Debt market development and disintermediation**: The most obvious imbalance in China’s financial system is the prominent role played by banks in financing corporations. Of total funds raised by the corporate sector, bank credit accounts for 80% to 90%. The bank-dependency model of finance was effective in mobilizing savings to satisfy investment needs during China’s earlier stages of development but has placed small- and medium-sized enterprises (SMEs) at a disadvantage. China’s bond market is still underdeveloped. According to Chinabond.com, in 2012 total bond market capitalization represented 46% of GDP, compared with a loan-to-GDP ratio of over 120%. The development of capital-market and direct financing, especially bond market financing, will be a focus for reform in the next couple of years. The government has a goal to increase the share of non-bank direct financing to reduce the corporate sector’s dependence on banks. Increasing the share of direct financing would benefit non-bank financial service providers, such as brokers and mutual funds, potentially at the expense of banks, which are largely state-owned assets.

  - **Revive and reform the stock market**: The performance of China’s stock market over the past years has not reflected the country’s economic growth well. The stock market is not a good representation of China’s economic prospects due to the predominance of large SOEs within the listed universe, especially within the banking sector. The China Securities Regulatory Committee (CSRC) has tried various means to revive its stock market. Recent measures include an anti-insider trading drive and an expansion of the Qualified Foreign Institutional Investors (QFII) quota, encouraging long-term institutional investors to participate in the stock market. The government also has tried to encourage listed companies to pay cash dividends. The CSRC has recently announced policies to cut futures and A-share market transaction fees, streamline initial public offering (IPO) procedures, strengthen sponsors’ responsibility, discourage IPO speculation, ensure proper and adequate disclosure, and create a mechanism to force unattractive companies to delist. The overall goal is to allow the market to play a bigger role in deciding who can raise funds and at what price while the government focuses on regulation and rule enforcement.

- **Capital-account convertibility and exchange rate flexibility**: Promoting the international status of the renminbi (RMB) perhaps has the least resistance. The goal is to make the RMB fully convertible within five years. Gradually the RMB could be freely used to settle trade and direct investments, and we expect the PBOC will further encourage the use of the RMB for portfolio investment and as a reserve currency by other central banks in 2013. The quota for RMB QFII could be raised and more foreign entities may be permitted to issue dim-sum bonds. The PBOC aims to 1) realize full convertibility for inbound and outbound direct investment as part of the opening up of the capital account, and 2) keep the RMB stable at a reasonable and balanced level.

- **Improvement of corporate governance at financial services institutions**: China’s fiscal tightening after its large 2009 stimulus package accelerated the growth in shadow banking. UBS, a global financial services organization, believes shadow banking liabilities could be as big as RMB 24 trillion, or nearly 50% of GDP. The shadow banking sector poses both financial and regulatory challenges to China’s financial stability. To address these challenges, the Chinese government ordered financial services to closely serve the real economy. To achieve this, the govern-
ment strictly prohibits 1) capital leaving the real economy for speculation activities; 2) the overexpansion of the shadow banking system. We expect that the government will target reform of irregular lending and shadow banking in the upcoming years. Funding in these markets may flow back to the financial system and be regulated to support the real economy. We also expect more policies to support lending to SMEs and tighter regulation of the local government debt market.

- **Development of financial products and risk hedging.** Interest rate derivatives and credit derivatives are developing gradually. Rapid growth in wealth management products increases risks facing the banks. China also needs to develop FX derivatives to allow economic actors to hedge FX risks.

The 12th Five-Year Plan has discussed reforms in all of the above areas, although it did not set out a specific timetable. The key is interest rate liberalization, which is a major source of factor cost distortions in China today. At the heart of these reforms is the willingness by the central government to give up some of its control over the financial market. After a shift toward recentralization during the global financial crisis, deregulation is again becoming the medium-term trend in China, so we remain hopeful that some of these reforms will get done. If these reforms are not achieved, we expect an increase in financial-system instability over the next few years. The government understands these risks well and reform efforts are certainly accelerating. We expect significant deregulation will be implemented over the next three to five years.

**Roadmap and Key Hurdles**

The political leadership has a firm consensus on the roadmap of financial reform: start with liberalizing the lending rate, then the deposit rate, and then increase the flexibility of the managed float FX system by gradually increasing the allowable valuation bands around the reference rate. A key debating point is whether banks are ready for a full deregulation, especially of the deposit rate due to a fear of irrational competition for deposits—currently one of the few investment conduits for household savings. Domestic inflation and overseas quantitative easing (QE) programs also may play an important role in determining the pace of the deregulation. Both risk financial instability in China and would likely undermine political support for reform. Slowing the pace of liberalization in response to domestic inflation or excessive external liquidity may increase the chance of reform success but would raise the risk of economic stagnation and worsen structural imbalances. Besides, deposit insurance and bankruptcy laws governing financial institutions need to be put in place before a full deregulation due to heightened bankruptcy risks in a freer, market-based financial system. Financial reform could lead to significant changes in the financial landscape in China, including:

- A higher cost of capital, especially for state-owned firms;
- Rapid expansion of corporate and municipal bond markets and decreasing importance of bank indirect financing;
- Changes in the business models of banks, as they become oriented to market competition rather than directed by state policy;
- More cyclical and more volatile financial risks following dramatic and widespread adjustments of financial prices.

Clearly, financial reform could introduce new risks and volatility due to greater exposure to the global environment. Delaying reform, however, is no longer an option in China. It is critical for leadership to monitor the risks and minimize the probability of financial crisis. Careful design and comprehensive regulations should be implemented together with financial reform to ensure a smooth transition toward a market-based financial system.

2. **FISCAL REFORM IN THE SHORT AND LONG TERMS**

**China’s Fiscal System is Not as Solid as It looks.**

China’s fiscal situation appears solid if examined on the basis of the government’s balanced budget and relatively low public debt ratio. However, the fiscal outlook is more challenging if all contingent liabilities are taken into account, which include debts issued by local governments, the Ministry of Railway (MoR), and SOE policy banks, as well as asset-management companies that hold non-performing loans (NPL) from SOE banks. Furthermore, the Chinese government also is pressured to improve social welfare, including healthcare, education, environmental standards, and the pension system. Those expenses are implicit contingent liabilities. Although we think the probability of fiscal crisis in China is low, the risk is real if contingent liabilities associated with local government debt and pension obligations continue to grow unchecked. In addition, the conditions could worsen if growth slows, capital accounts become more open, and financing costs rise. The key to averting the risk of a debt crisis in China is further financial and fiscal reforms.
China’s Decentralized Fiscal System is the Culprit behind the Local Government Debt Problem

The current decentralized fiscal system faces a significant mismatch between revenues and expenditures at the local level. According to China Tax Bureau data, the central government collects 50% of total revenue but is responsible for only 20% of total expenditure. The responsibility for social spending falls largely on local governments, including social security, basic education, health care, and public safety. Local governments now receive less than 20% of their total revenues from local taxes but need to fund 70% to 80% of total expenditure. The revenue-spending mismatch has had many negative consequences. Local governments often have to resort to fee collections, land sales, risky investment, and direct borrowing to meet their spending needs. The current budgeting system also lacks transparency and accountability.

Local governments borrowed heavily from banks to finance China’s stimulus program during the global financial crisis and are now struggling to repay those debts. Whether local governments go bust will depend on the central government’s readiness to paper over the situation. Based on National Statistical Bureau data, local government debt is likely to hit RMB 12 trillion in 2013, about 24% of GDP. The majority of local government debt was used to finance investment in infrastructure. The big problem that remains with these huge infrastructure projects is the duration mismatch between the lifetime of the asset and term of the loan. Most recently, Chinese banks have rolled over at least three-quarters of all loans to local governments that were due to mature by the end of 2012. We believe China has three feasible measures to control the local government debt risk: 1) issue local government bonds; 2) sell government assets to pay off debt; 3) create a more optimal tax and revenue split between the central and local governments. The present system of fiscal decentralization that encourages a local government-driven GDP growth model should be switched to a more centralized model with local governments focused more on improving local public services. A bigger role for a value-added tax, resource tax, and environmental protection tax also is under discussion. In the meantime, the new government would start gradually replacing home purchase restrictions in lower-tier cities with a property tax as a means of controlling rising house prices.

3. URBANIZATION IS STILL A HUGE ENGINE FOR GROWTH AND THE CORRESPONDING REFORMS

Urbanization has been one of the Chinese leadership’s buzz words since mid-November, when Li, the new Premier, listed urbanization as a “huge engine” for economic growth. In China, a 1% increase in the urbanization represents 14 million people moving from the rural to urban areas. To put urbanization into historical perspective, China’s headline urbanization rose from 36% in 2000 to 51% in 2011, i.e., more than 200 million farmers moved to cities to work during this period. Still, the room for further urbanization is huge. First, excluding migrant workers without urban residence permits and homes, the real urbanization ratio could be closer to 36%. Second, even if we assume 51% is China’s current urbanization rate (this was the level reached by Japan in 1970 and Korea in 1980), should the urbanization rate in China rise to 65%, another 180 million people will move from rural to urban areas (see figure 1).

![Figure 1](China Fears Exaggerated - Tailwind of Modernization Still in Play Urban Population as a Percentage of Total Population; As of 12/31/2012)

Source: Thomson Datastream
We agree that urbanization could indeed become a major driver of China’s growth in the next decade. However, the old urbanization model is not sustainable. The current model is characterized by surging infrastructure investments financed by local government debt and confiscation of migrants’ rural land without giving them urban residential rights. We believe the government needs to remove the key barriers that prevent market forces from maintaining structural balance. Currently, there are three key barriers to true urbanization:

• The current land system restricts the expansion of cities. We will discuss in more detail below.
• The local government financing system causes capital misallocation, with land being heavily used as collateral. Issuing local government debt could greatly enhance transparency and accountability for local governments, which would allow market forces to decide how to allocate resources across cities and projects.
• The household registration system (Hukou) constrains the flow of labor. There are approximately 150 million migrant workers living in urban areas without urban residence permits. Because most of the migrant workers could not sell residential land, they could not afford to purchase a home in the cities. Instead most of those migrant workers live in factory dorms and are excluded from urban public services and social welfare systems. Abolishing the Hukou grids would help release the true potential of urbanization.

4. THE LONG-TERM REFORMS: LAND OWNERSHIP SYSTEM, SOCIAL SECURITY, AND SOE REFORM

China’s current land system has been the major obstacle for its future urbanization. According to China’s Land Administration Office, China’s total area of 9.6 million km² could be divided into three parts: 68% agricultural use, 4% construction, and 28% unused land. All residential buildings have to be built on land for construction, which could be further divided into urban and rural parts. Urban land for construction of residential housing is only 0.011 million km² (3% of total land for construction) and rural land for construction of residential housing is 0.092 million km² (28% of total land for construction). Clearly, an imbalance exists between urban and rural areas with regard to residential land. Residential land for the current urban population at 51% of China’s total population is only 0.011 million km². Meanwhile, residential land for rural residents at 49% of total population is 0.092 million km², over eight times that of its urban counterpart. The key issue in China’s land system is that farmers can not sell their land on the market unless it is procured by the government first. By granting farmers full property rights on their land, the government could effectively increase urban land supply. This way, the government could promote urbanization and curb home prices simultaneously, while also enabling farmers to benefit from the appreciation of land value. This would also encourage farmers to invest in their land, instead of just exploiting its short-term profitability.

In the longer term, centralization of the social security system is another important and necessary reform that the government is likely to tackle. Currently, China’s social security is decentralized to the provincial level. Under the current system, labor mobility is limited due to the different payment schemes and entitlements across the regions. More importantly, reforms related to the Chinese government’s two biggest assets, SOEs and land, are hard to design and execute, as they are the two formidable vested interests in China. Large-scale privatizations of SOE may not be feasible in the near term. But the government will likely move toward leveling the playing field gradually, including removing certain input cost subsidies for SOEs and reducing SOEs’ monopoly power. According to China’s 12th Five-Year Plan, China will gradually allow SMEs to access strategic industries and minimize SOEs’ monopoly on them.

5. REFORMING THE ONE-CHILD POLICY COULD BE PRIORITY

New leaders might still start some reforms in areas with the least resistance and strongest support. We believe that fine-tuning the one-child policy could be the major reform that is introduced by the new government from 2014 to 2015. In the past three decades, China has enjoyed huge benefits brought by its favorable demographic trends, but in coming decades, diminishing demographic dividends could impose one of the biggest risks to China’s long-term growth prospects. The United Nations estimates that the Chinese population will peak at 1.358 billion in 2017 and decline afterward. Moreover, China’s workforce population already began declining in 2012, according to data from China’s National Bureau of Statistics. An exit from the one-child policy will likely be gradual to overcome resistance and to minimize the short-term impact. In the short term, we expect the reform to likely have quite a small impact on China’s population growth. In the medium to long term, it’s unlikely that China will resume its fast rates of historical population growth.
CONCLUSIONS

We believe there will be no big-bang reforms in the remainder of 2013 as China's new leaders may need a couple of years to consolidate their power base and design the blueprint of a set of reforms for the next decade. We think the roadmap for the next phase of reform would revolve around careful high-level design and implementation of financial and fiscal reform, as well as land, SOE, and social security reform over the next three to five years. We are cautiously optimistic that the new leaders can make some progress in reform in the coming years. However, the tolerance for lack of action will be low as growth would not be sustainable without liberating the constraints on true urbanization and addressing structural imbalances.

If the government is successful in furthering these economic reforms, it may be possible for China to avoid a debt crisis or growth stagnation as a result of a heavy debt burden. Those reforms would have significant implications for the economy and financial markets:

- Liberalization of interest rates and the capital account will further facilitate the redistribution of income from corporations to households, boosting consumption but squeezing corporate profits.
- Financial reforms and disintermediation will hurt state-owned banks and benefit non-banking financial services institutions in the short term.
- Fiscal reform measures, like increasing spending on social welfare and decreasing spending on fixed-asset investment, could boost consumption but lower growth speeds. But policies liberalizing the financial system might increase growth potential by improving the efficiency of capital allocation. Overall, the net impact of all these policy actions is likely to be slightly negative for growth potential, at least in the medium term. However, it should make growth far more sustainable over the longer term.
- Financial liberalization would raise the cost of capital in China. Higher costs for capital may further squeeze corporate profits, increase financial market volatility, and result in the consolidation of some highly leveraged industries. This should encourage corporations to accelerate technological upgrading in order to stay competitive.

INVESTMENT IMPLICATIONS

We believe China can continue to produce growth rates above 6% to 7% for the next five years if the country can successfully implement the reforms discussed above. However, we think the big commodity cycle that was driven by China's insatiable demand is gone for now as the new leadership is committed to improving the country's quality of growth rather than its quantity of growth. Nonetheless, China's continuous urbanization, combined with corresponding reforms, will continue to support the commodity complex. Therefore, our stance on commodity countries and currencies is neutral. Along with China's structural rebalancing and income redistribution from the corporate to the household sector, we are bullish on household/consumer-related sectors. In Global Equity portfolios, we believe sectors benefiting from stronger internal demand growth, such as sectors related to consumption, healthcare, services, and education, provide attractive longer-term opportunities. In contrast, we believe reform and structural rebalancing weaken the investment thesis in state-owned sectors, commodity, and energy-intensive sectors. In Global Fixed Income portfolios, we are closely monitoring the growth of China's corporate and municipal bond markets for potential new opportunities.

We believe that the yuan will experience a modest appreciation of 3% to 4% against the U.S. dollar in 2013. However, the depreciation of the Japanese yen may exert downside pressure on most Asian currencies, including the yuan. Although recent challenges associated with U.S. fiscal policy and China's robust economy have slowed the march toward flexibility, it is important to understand that China's policymakers are still pursuing greater yuan flexibility over the medium term. This follows from last April's yuan trading band widening to +/- 1% and also is in the same vein as China's gradual liberalization of domestic interest rates. Our view on only limited appreciation this year is based on two points:

1. China's central bank thinks that CNY/USD is approaching fair value, while the trade surplus is expected to show a further narrowing to 1% of GDP this year with FX reserves peaking. This suggests that the fundamental case for significant and extended appreciation is lessening.
2. There will be less emphasis on adjusting currency valuation to manage inflation.

If yen depreciation leads to weaker Asian currencies, then the yuan could weaken as well. Beyond the immediate term, appreciation pressure may rise again, as growth stabilizes and capital inflows increase as a result of worldwide QE policies. If the Federal Reserve, Bank of Japan, and European Central Bank withdraw this liquidity, China would not like to see its currency depreciate and may limit yuan volatility.