BNP PARIBAS
INVESTMENT PARTNERS | The asset manager for a changing world

Chi on China

China's Supply-side Reform is not What You Think

I hope everyone that is reading this is having a really good day. And if you are not, just know that in every new minute that passes you have an opportunity to change that.

Gillian Anderson

SUMMARY

- Do not expect China's supply-side reform to resemble that of the US-UK style in the 1980s with massive layoffs and bankruptcies. Today's reform is even different from its own form in the late 1990s, when Beijng closed tens of thousands of state firms and cut millions of jobs.
- China's macroeconomic objective of supply-side reform has shifted from closing down companies/plants and cutting jobs to improving operating efficiency of state companies, subject to the constraint of minimising the reform's negative impact on employment.
- The economic effect of closing down "zombie" firms is smaller than many observers have expected, so Beijing still means business in its structural changes. Blanket implicit guarantee is gone. But inherent in the reform process is an incentive problem which distorts Beijing's decision-making.

Due to the scale of China's system, it will not be possible for Beijing to pursue a "shock therapy" to cure its structural illness like the Regan-Thatcher reform style of the US-UK in the 1980s which resulted in massive bankruptcies and unemployment. Given today's weak growth momentum and sensitive political environment, China cannot even afford to repeat the same state-sector reform effort that it implemented in the late 1990s.

Rather, supply-side reform today is aimed at improving the state-owned enterprises' (SOEs') operating efficiency through mergers and acquisitions, public-private partnership or mixed ownership, job-retraining, early retirement etc. The trouble is that this approach may address the flow of the new excess-capacity problem but not the stock of the old problem, and there is an incentive incompatibility problem behind the process.

Reform in the good old days

China went through some serious supply-side reform in the late 1990s and early 2000s when former Premier Zhu Rongji sold off and closed more than 60,000 inefficient SOEs and cut more than 30 million jobs. This was impressive because at that time China was a closed economy with little foreign exposure. So there was no threat of foreign capital flight and a currency collapse. China could have gone for using heavy fiscal expansionary measures to avoid a sharp economic downturn while buying time for a "soft" and gradual deleveraging of the corporate sector with no aggressive capacity shake-outs and job losses.

However, Premier Zhu chose a tough route to tackle the inefficiency problems. He did go the Keynesian way by expanding fiscal spending considerably to prevent GDP growth from contracting. But it also followed the Austrian discipline by taking the painful decision to close down inefficient state firms (Chart 1) and lay off millions of state workers. As a result, the share of loss-making SOEs in the industrial sector fell dramatically (Charts 2), and profits of the industrial sector improved throughout the 2000s (Chart 3).

The reality of supply-side reform today

What is missing in today's supply-side reform is the destruction part of the state sector. Beijing's reform focus has shifted from eliminating the bad SOEs to increasing operating efficiency of the SOEs. In December 2015, the State Council announced for the first time a timetable and specific guidelines for cleaning up the "zombie" SOEs.

For centrally-owned SOEs in the six over-capacity sectors, namely iron & steel, cement, coal, aluminium, ship-building and flat glasses, and for the SOEs that have incurred losses for more than three years, they will be closed, merged or restructured by the end of 2017. The government will also push commercial banks to increase their effort to write off bad loans in the over-capacity sectors.

However, given the prevailing weak economic momentum and sensitive political environment, it is unrealistic for Beijing to pursue a "big bang" approach. Economically, private-sector investment growth has been falling, indicating a lack of "animal spirit" to drive growth. This has only been partially offset by credit-fuelled public-sector and real estate investment (Chart 4). So the economy can ill-afford to receive a shock-treatment type of supply-side reform that hurts public confidence further.

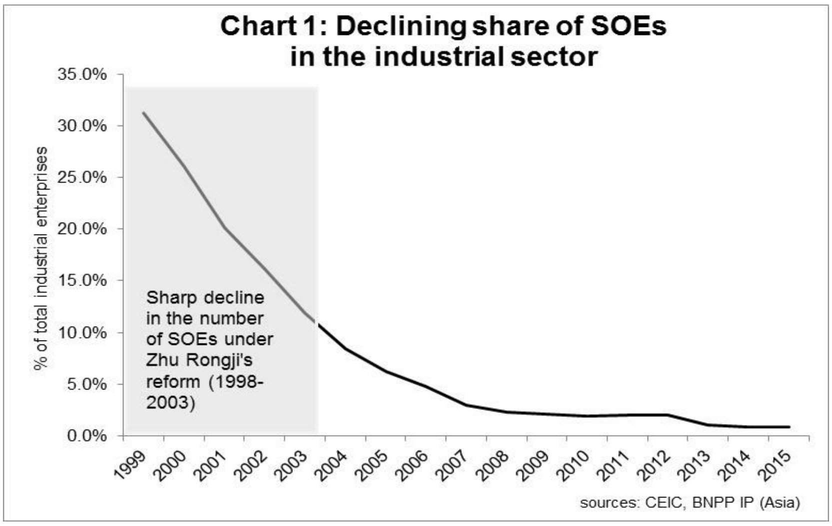


Chart 1: Declining share of SOEs in the industrial sector
% of total industrial enterprises
35.0%
30.0%
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
Sharp decline in the number of SOEs under Zhu Rongji's reform (1998-2003)
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015
sources: CEIC, BNPP IP (Asia)

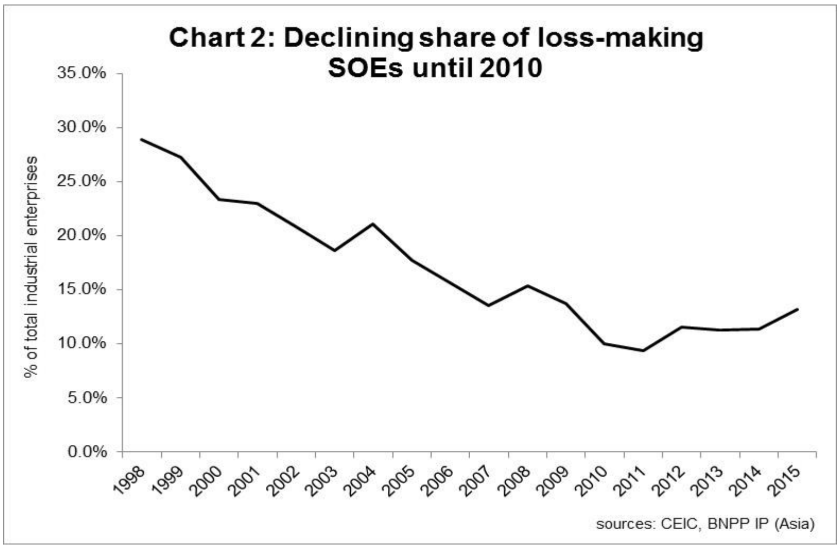


Chart 2: Declining share of loss-making SOEs until 2010
% of total industrial enterprises
35.0%
30.0%
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015
sources: CEIC, BNPP IP (Asia)

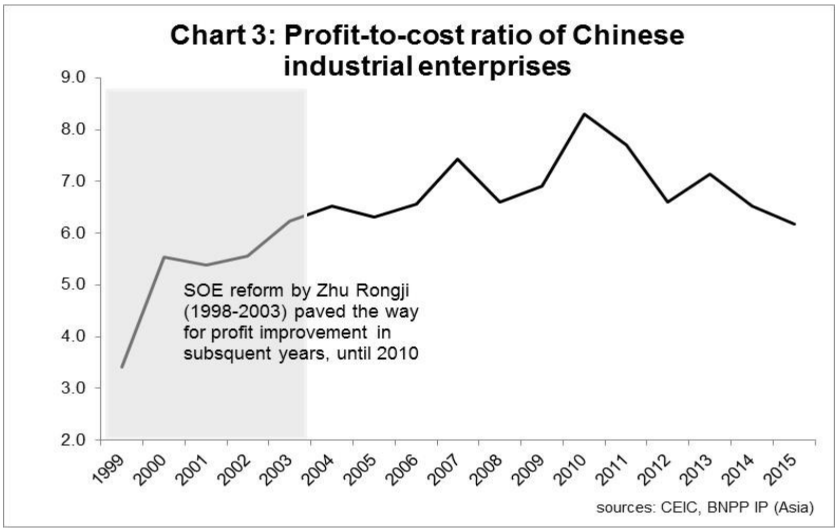
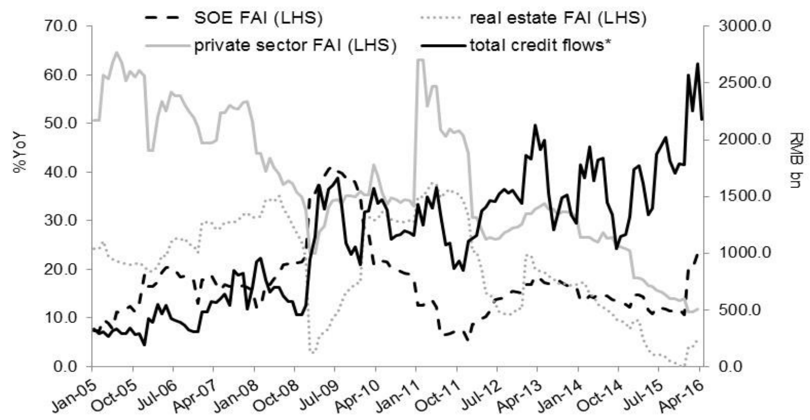


Chart 3: Profit-to-cost ratio of Chinese industrial enterprises
9.0
8.0
7.0
6.0
5.0
4.0
3.0
2.0
SOE reform by Zhu Rongji (1998-2003) paved the way for profit improvement in subsquent years, until 2010
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015
sources: CEIC, BNPP IP (Asia)

Chart 4: Credit-fuelled SOE & real estate investment offsets declining private investment



* TSF + government bond issuance

sources: CEIC, BNPP IP (Asia)

Politically, the first term of President Xi Jinping's administration is coming to an end in 2017. Five senior leaders in the seven-person Standing Committee of the Politburo will have to retire, and President Xi will have to sort out the succession plan for his second term which will start in 2018. Stability is of paramount importance during this period of political transition.

Beijing still means business

Hence, the government is pursuing a cautious supply-side reform approach within its economic and political constraints to balance growth stability with structural retrenchment. Since closing the excess capacity sectors will have a smaller-than-expected impact on China's labour market, this should give Beijing the leeway to force through some reform pains.

According to official data and our estimates, the six over-capacity industries (see above) highlighted by the government accounted for about 12% of industrial employment, or 2% of total non-farm employment in 2015. A 25% job cut in these industries, for example, would lead to 2.8 million job losses, or 0.5% of total non-farm employment (Table 1). This job impact looks small. Further, the job cuts will be carried out over time to minimise its impact on public confidence, with the job losses likely concentrating in regions with excess-capacity industries.

Crucially, Beijing is retreating gradually from its implicit guarantee policy to reduce moral hazard in the system. There will not be blanket support for the state sector going forward. So default risk is expected to rise. This suggests that differentiation between SOEs' risk profiles should become increasingly important for investors going forward.

We can expect industries that have high strategic importance to Beijing or have significant social and systemic effects, including oil & gas, aerospace & defence, national security, public utilities, telecommunications, energy and infrastructure will continue to enjoy implicit guarantee. However, economic-based industries, such as property, construction, retail, tourism and services will likely see gradual retreat of government support.

Table 1: Estimated impact of a 25% job-cut in the excess-capacity industries

Total non-farm emplpyment*	555.3	million
Industry employment*	93.98	million
Over-capacity sectors' employment	11.3	million
(% of industry employment)	12.0%	
(% of total non-farm employment)	2.0%	
Impact of a 25% cut in jobs in the over-capacity industries	2.8	million job losses
(% of total non-farm employment)	0.5%	

* 2015 data sources: CEIC, BNPP IP (Asia)

An incentive problem

Massive overhauls of SOEs outside the designated excess capacity will remain political implausible in the medium-term. The burgeoning service sector may serve as the absorber for labour shed from industrial retrenchment. The likely result of the Chinese-style supply-side reform is not a sharp rise in unemployment, but a further deterioration in household income growth. This is because most of the service-sector jobs being created are low-pay private sector jobs (including self-employing small businesses). This will, in turn, constrain private consumption growth.

While Beijing is making efforts to close some of the most inefficient sectors, notably iron & steel and coal, its policy is biased to favour reforms that do not increase unemployment. The problem with this gradualist approach is that it only addresses the flow of the new excess-capacity problem, but not the stock of the old problem.

Beijing's policy directions and guidelines released so far also seem to show a lack of consensus on execution. This may reflect a conflict with guiding principle of the Communist Party, which insists on the Party remaining firmly in control of the system. So while the spirit of reform is trying to segregate SOE management from state ownership, the political incentive is still insisting on strengthening the role of the Party. This creates an incentive incompatibility problem where the reformers are also the party secretaries. How do they separate business from politics?

The leadership's ability to implement structural reforms is constrained by considerable political headwinds. But they do show a will to change. China's reform process deserves the benefit of the doubt, in my view.

Chi Lo
Senior Economist, BNPP IP

DISCLAIMER

This material has been prepared by BNP Paribas Investment Partners Asia Limited* and is issued by BNP Paribas Investment Partners Singapore Limited ("BNPP IPS")** and BNP Paribas Investment Partners Asia Limited, members of BNP Paribas Investment Partners (BNPP IP)***. The content has not been reviewed by the Monetary Authority of Singapore ("MAS") or the Hong Kong Securities and Futures Commission.

This material is produced for information purposes only and does not constitute:

1. an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever; or
2. any investment advice.

Opinions included in this material constitute the judgment of BNP Paribas Investment Partners Asia Limited or its relevant affiliate(s) at the time specified and may be subject to change without notice. BNP Paribas Investment Partners Singapore Limited and BNP Paribas Investment Partners Asia Limited are not obliged to update or alter the information or opinions contained within this material. Such opinions are not to be relied upon as authoritative or taken in substitution for the exercise of judgment by any recipient and are not intended to provide the sole basis of evaluation of any strategy or instrument discussed herein. The contents of this material are based upon sources of information believed to be reliable, but no warranty or declaration, either explicit or implicit, is given as to their accuracy or completeness. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the Financial Instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for a client or prospective client's investment portfolio.

Investments involve risks. Investments in emerging markets involve above-average risk. Given the economic and market risks, there can be no assurance that the Financial Instrument(s) will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the Financial Instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to the Financial Instrument(s) may have a significant effect on the results portrayed in this material. Past performance is not a guide to future performance and the value of the investments in Financial Instrument(s) may go down as well as up. Investors may not get back the amount they originally invested.

Any reference to past performance of any market or instrument should not be taken as an indication of future performance. Neither BNP Paribas Investment Partners Singapore Limited, BNP Paribas Investment Partners Asia Limited nor any BNP Paribas Group company accepts any liability whatsoever for any loss arising, whether direct or indirect, from the use of any part of such information. A BNP Paribas Group company may, to the extent permitted by law, have acted upon or used the information contained herein, or where relevant the research or analysis on which it was based, before its publication. This material is for the use of the intended recipients only and may not be delivered or transmitted to any other person without the prior written consent of BNP Paribas Investment Partners Singapore Limited and BNP Paribas Investment Partners Asia Limited. Furthermore, any translation, adaptation or total or partial reproduction of this document, by any process whatsoever, in any country whatsoever, is prohibited unless BNP Paribas Investment Partners Singapore Limited and BNP Paribas Investment Partners Asia Limited has given its prior written consent.

* BNP Paribas Investment Partners Asia Limited, 30/F Three Exchange Square, 8 Connaught Place, Central, Hong Kong.
** BNP Paribas Investment Partners Singapore Limited, 10 Collyer Quay, #15-01 Ocean Financial Centre, Singapore 049315.
*** "BNP Paribas Investment Partners" is the global brand name of the BNP Paribas group's asset management services. The individual asset management entities within BNP Paribas Investment Partners if specified herein, are specified for information only and do not necessarily carry on business in your jurisdiction. For further information, please contact your locally licensed Investment Partner.