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China

Defining the New Normal

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Introduction

Setting ambitious targets and reaching them fast has been an essential part of China's dizzying economic success story for more than three decades. But now that push for growth-at-any-cost is being replaced with what China's leaders call the "New Normal".

Officially, it is being billed as a balanced and holistic development approach that strives for "quality" – even if that means "lower" – growth while placing overriding importance on ethics, equality, justice, and social harmony. This sweeping sea-change is powering a comprehensive overhaul of the policies of, and the mentality behind, the system that manages the giant economy of the world's most populous nation. Investors and businesses, both inside and outside China, must understand that many old ways are gone or are going.

The transformation has already begun with major reforms chalked up since President Xi Jinping came to power a little over two years ago. They include deregulating key utility prices, experimenting with free trade zones, amending budget laws to allow local governments to issue debt conditionally, reforming the hukou (or household registration) system, developing mixed-ownership for some state-owned enterprises (SOEs), strengthening the foundation of law, and even relaxing the one-child policy.

Such change, so far at least, seems to be cautious in action and measured in magnitude, which makes sense at a time of transition for China's development. Moreover it has been enacted apparently without systematic risk, despite a highly volatile external environment and a decelerating domestic economy. That bodes well for China's macroeconomic management structure, which appears to be maturing in a positive way.

After taking into account the outcomes of this year's National People's Congress (NPC), we will examine four key areas of change:

- Macroeconomic management
- Socio-microeconomic management
- Institutional reform
- Foreign policy

This report will attempt to bring context to the many deep and fundamental policy shifts under the "New Normal" and will highlight how doing business and investing in China's maturing economy are likely to move in new directions.

Macroeconomic Management

Monetary Policy Recalibrated

Premier Li Keqiang announced to China's 12th NPC in March that the nation's GDP growth target had been lowered to around 7%, down from around 7.5% last year (Diagram 1). By doing so he clearly signalled that the government is now willing to accept slower growth as it presses ahead with structural reforms.

Diagram 1: Key macroeconomic targets announced

	2015	2014
Real GDP growth	around 7%	around 7.5%
CPI	around 3%	around 3.5%
M2 growth	around 12%	around 13%
Total exports and imports growth	around 6%	around 7.5%
Fixed assets investment growth	15%	17.5%
Retail sales growth	13%	14.5%
Registered urban unemployment rate	not to exceed 4.5%	not to exceed 4.6%
Budget deficit to GDP	2.3%	2.1%

Source: Report on the Work of the Government / DBS Group Research

The inflation target was also lowered to around 3% from around 3.5% in 2014. Given the fact that heightening disinflation forces are expected to cap inflation at 1.8% this year, conventional wisdom suggests there must be tremendous room for more monetary stimulus. Even so, the government has stressed the importance of "monetary prudence" despite decelerating domestic demand. Nowadays the intention of monetary policy is not to engineer a V-shaped rebound, but to support growth. This is a profound departure from China's past macroeconomic management philosophy.

So too is the new way of dealing with the problems of excessive credit-driven growth and the debt it generates. The Global Financial Crisis left a legacy of massive local government debt, overcapacity problems, and a property bubble in China with total domestic debt as a share of GDP almost reaching 250% in 2014. Faced with this the authorities in Beijing chose not to tread their usual policy path. Instead they brought in new prudent macroeconomic management measures.

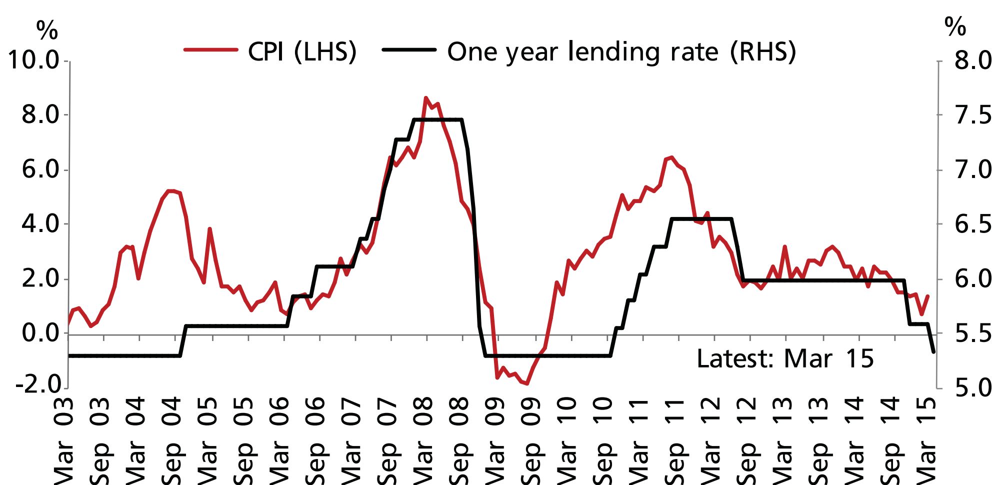
Nowadays the intention of monetary policy is not to engineer a V-shaped rebound, but to support growth

Even though annual GDP growth has dipped below 8.0% since 2012, and decelerated to 7.4% in 2014, monetary loosening has remained largely restrained. The central bank has been mitigating the impact of temporary liquidity crunches by buttressing economic growth with a combination of short-term liquidity operations, standing lending facilities, and medium-term lending facilities. It has also lowered the reserve requirement ratio (RRR) for designated banks to boost lending to rural and small businesses. Moreover, sparing interest rate cuts (one each in June 2012, July 2012, November 2014, and February 2015) have been counter-balanced by the lifting of the deposit rate ceiling, which furthers interest rate liberalisation. China's deposit insurance scheme, which is to be introduced on May 1, will bring the country another step closer to the full liberalisation of bank deposit rates. We anticipate the deposit rate ceiling will be completely removed within this year.

This approach differs markedly from the past. For example, benchmark lending and deposit rates were cut aggressively by 144 basis points (bps) and 180 bps respectively in October 1997 after GDP growth fell from 9.7% in the 1996 December quarter to 8.0% in 1997 September quarter. The People's Bank of China (PBOC) lowered the RRR from 13% to 8% in one hit in March 1998 when GDP growth was 7.2%. Let's compare that with today's RRR. It stands at a high 19.5% after a recent 50 bps cut in February 2015.

In another major shift, the PBOC is likely to pay more attention to movements in property prices than blips on the consumer price index (CPI). Historically, interest rates had been cut in response to sharp falls in the CPI (Diagram 2). There is a strong historical relationship between benchmark lending rates and the CPI. Most notably, in 2008 the PBOC cut rates to 5.31% from 7.47% (216 bps in total) within four months in response to a sharp fall in the CPI to 1.2% in December from 7.1% in January that year.

Diagram 2: Monetary policy in the past decade



Source: CEIC / DBS Group Research

Interest rate decisions will still largely hinge on inflation. That said, there is reason to believe the government will place more emphasis on the direction of property prices in the near future. After all, the real estate sector makes up about 25% of China's GDP. As such the slowdown of the sector could pose serious risks as much of China's debt is tied to real estate. The fact that property prices in major cities recorded month-on-month declines after May 2014 was the likely trigger for rate cuts made in November 2014 and February 2015. Property prices are still moderating across China. Therefore one more rate cut and a further 100 bps reduction in the RRR are on the cards.

PBOC Governor Zhou Xiaochuan told March's NPC that deposit rate liberalisation could be completed this year. If so, competition among the banks would likely drive up deposit rates. The central bank might then want to bring down the cost of capital to aid business. But in this scenario, the banks would face rising risk premiums and higher funding costs. This would prevent the lending rate from coming down. The banks would not issue loans easily either. On the contrary, they would become more risk averse. This would be tough for would-be borrowers initially. However, it would ultimately be beneficial for asset quality. In other words, long-term benefits would trump short-term relief. If we take all this into account, it is not coincidental that China's 2015 growth target has been lowered to around 7%. The idea is to support, not stimulate, the economy.

"The idea is to support, not stimulate, the economy"

Fiscal Reform Accelerates

China's local governments must have enough money to implement fiscal policies effectively. However, most are debt-burdened with limited autonomy to raise revenue. Under a tax-sharing system established 20 years ago, revenues have been divided between the central government and local governments more or less equally. However, local governments are responsible for nearly 80% of public expenditure (Diagrams 3A & 3B).

To make up the shortfall, local governments have resorted to wasteful transfer payments from the central government and pursued extra-budgetary land revenues. The latter often resulted in unfair land expropriation and produced over-investment in property. Meanwhile, many took on mountains of debt via local government finance vehicles (LGFV). This has raised fears about its potential consequences on China's overall economy.

The central government has acknowledged the urgent need for reform, particularly as the economy slows. It is introducing new and sustainable sources of local government funding. In mid-2014, China's Ministry of Finance set up a pilot programme in which ten local governments – including Beijing, Shanghai, and Guangdong – were empowered to issue

The central government is introducing new and sustainable sources of local government funding

Diagram 3A: Average share of national government revenue over 2010-2014

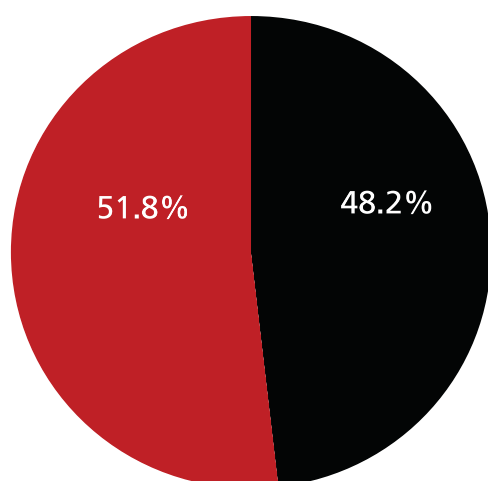
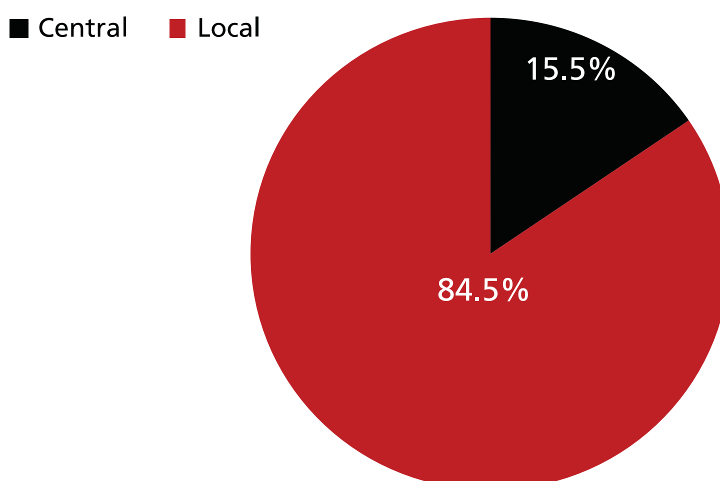


Diagram 3B: Average share of national government expenditure over 2010-2014



Source: CEIC/ DBS Group Research

local government bonds. In the past, local governments were banned from raising money this way. So, many circumvented the regulations by borrowing through LGFVs that took loans or issued bonds on their behalf.

To help make this new bond issuance scheme work, budgetary information is being made more transparent. With the exemption of classified information, all central and local government departments must now release their budgets and financial accounts for public oversight. The hope is that this will encourage officials to make good use of public money. So, budgetary transparency and fiscal autonomy/responsibility will go hand-in-hand.

The central government has also promised to find better long-term ways of carving up revenues with local governments. This might include local governments being allowed to raise their own local taxes. Perhaps local governments might also be entitled to a larger proportion of shared taxes. Both moves would mean shifting fiscal power away from central to local governments. As such, neither will be implemented overnight.

In the meantime the central government is employing quicker fixes to bring the local government debt problem under control. In March, the Ministry of Finance permitted local governments to convert as much as 1 trillion yuan of high-yielding debt (out of 17.9 trillion yuan) into lower-yielding municipal bonds. This is to reduce interest rate burdens on local governments, and so alleviate rising credit risks. Monetary laxity and an absence of fiscal autonomy are the root causes of debt accumulation at the local government level. The former is being addressed by ongoing prudent monetary policy. The latter requires faster fiscal reforms. And, both measures have sped up since President Xi took office.

Flexible Exchange Rate Management

China's growth rate is slowing while disinflation in consumer prices and deflation in producer prices deepen. Faced with these, Beijing is permitting the renminbi (RMB) to weaken against the US dollar. This is a major departure from the past when China steadfastly kept the RMB stable against the US dollar during crisis episodes (Diagram 4).

As an example, let's look at the Chinese response to the 1998 Asian Financial Crisis. Even as export growth dived to just 0.5% in 1998 from 21% in 1997, the RMB was kept stable. The authorities of the day could count on Chinese exports remaining competitive as its labour costs then were very low. So China did not have to resort to exchange rate depreciation to stimulate growth even though exports accounted for about 20% of GDP back then.

Diagram 4: Behaviour of RMB during export growth decline

Asian Financial Crisis	
1997	21.0%
1998	0.5%
Swing	20.5%
Movement in RMB/USD	0.0%
Tech Bubble Burst in the US	
2000	27.9%
2001	6.8%
Swing	21.1%
Movement in RMB/USD	0.0%
Global Financial Crisis	
2008	17.4%
2009	-16.0%
Swing	33.4%
Movement in RMB/USD	0.0%
European Sovereign Debt Crisis	
2011	20.3%
2012	7.9%
Swing	12.4%
Movement in RMB/USD	1.0%
Current Situation	
2013	7.8%
2014	6.0%
Swing	1.8%
Movement in RMB/USD	-2.4%

Source: CEIC / DBS Group Research

The mentality behind exchange rate management has clearly changed under the leadership of President Xi and Premier Li

China also did not devalue its exchange rate to arrest big declines in export growth during subsequent economic turmoil, such as the 2008 Global Financial Crisis and the 2012 European Sovereign Debt Crisis. In both instances, the exchange rate was used to anchor expectations and instill confidence in China's economic performance, not cut to boost growth.

However, a turning point came in the 2014 March quarter when the PBOC engineered RMB depreciation and altered expectations of a one-way bet on the currency. Although the RMB stabilised by the 2014 September quarter, an interest rate cut in November triggered market expectations of further RMB depreciation in 2015. Indeed, the RMB continued to weaken in the 2015 March quarter.

China allowed the RMB to depreciate even in the absence of an external crisis. There are several possible explanations for what was a clear divergence from past exchange rate management:

1. Exchange rate depreciation is being used to help cushion China's economic slowdown. The legacy of debt left by the credit binge in the aftermath of the Global Financial Crisis imposed tremendous restraints on fiscal and monetary policy. Monetary loosening, in particular, has been executed very cautiously since President Xi took office.

2. Many currencies are depreciating against the US dollar, including the Japanese yen and the euro thanks to new rounds of quantitative easing. As a result, the RMB appreciated 6.2% against other currencies in trade-weighted terms in 2014. Moreover, China's cost of labour had risen substantially since its entry into the World Trade Organisation. Such developments do not augur well for domestic industries already surviving on thin margins amid a fragile external environment.

3. The Chinese government is now committed to greater exchange rate flexibility. A more market-determined exchange rate mechanism has been included in China's package of financial reforms. In March 2014, the RMB trading band was widened from 1% to 2%. Under the current episode, China is merely allowing the currency to respond to market forces, upholding the credibility of commitment.

The mentality behind exchange rate management has clearly changed under the leadership of President Xi and Premier Li. As long as the constraints on fiscal and monetary policy remain, a weaker exchange rate will be allowed to cushion downside growth risks. However, such a strategy is not meant to orchestrate a V-shaped rebound. Instead it is more about demonstrating China's commitment to gradual structural reforms towards an exchange rate that will be increasingly market-driven. It is no longer realistic to assume the exchange rate will be kept stable in the face of unforeseen external economic shocks – or even amid a self-engineered economic slowdown.

Socio-Microeconomic Management

Inclusive Urbanisation Policies

Thirty years ago, fewer than 200 million people lived in China's cities and towns. Today, urban dwellers number around 700 million. This is one of the largest waves of human migration in history, and supplied the massive urban labour force for China's export-driven economic boom.

Urbanisation has long been a central policy of the government. It wants to reach a 60% urbanisation rate by 2020. That will be a tall order as it will require a 1.1% increase in the annual urbanisation rate on average, compared with 1.0% over 1978-2013.

Rapid urbanisation in the past was largely driven by pull factors, such as employment opportunities in cities and large urban-rural wage gaps. But these gaps have narrowed in recent years. From now on, push factors need to play a bigger role. That will entail a complex array of socio-economic factors. For instance, the benefits of rural residency – primarily the allocation of a plot of farmland – sometimes outweigh the benefits of migration to a city. An August 2014 survey by Sichuan province's Bureau of Statistics found that 90% of migrant workers wanted to keep their rural status and did not want an urban hukou. That's understandable, as under existing laws, farmers are unable to transfer or sell their rural land use rights even if they have moved to urban areas. It gives them little monetary incentive or financial resources to migrate.

Also in the past, many cities were simply overcrowded and unprepared for the influx of newcomers. The three biggest cities held 14% of the population, but took up less than 3% of China's land area. Public resources were stretched and social problems deepened as slums and urban sprawl grew. Discontent was generated from the unequal treatment of migrant workers, who made up about one third of the total urban population. Under the household registration system, migrant workers with a rural hukou were not entitled to the same social welfare that was available to residents registered as "urban". Without that safety net, rural newcomers saved their money as a precaution. That in turn crimped their purchasing power as consumers. The tough conditions also deterred some rural dwellers from moving to urban areas altogether.

These sorts of problems do not facilitate economic growth. So, urbanisation under the New Normal must give more emphasis to efficiency and equality, particularly through hukou and land reforms.

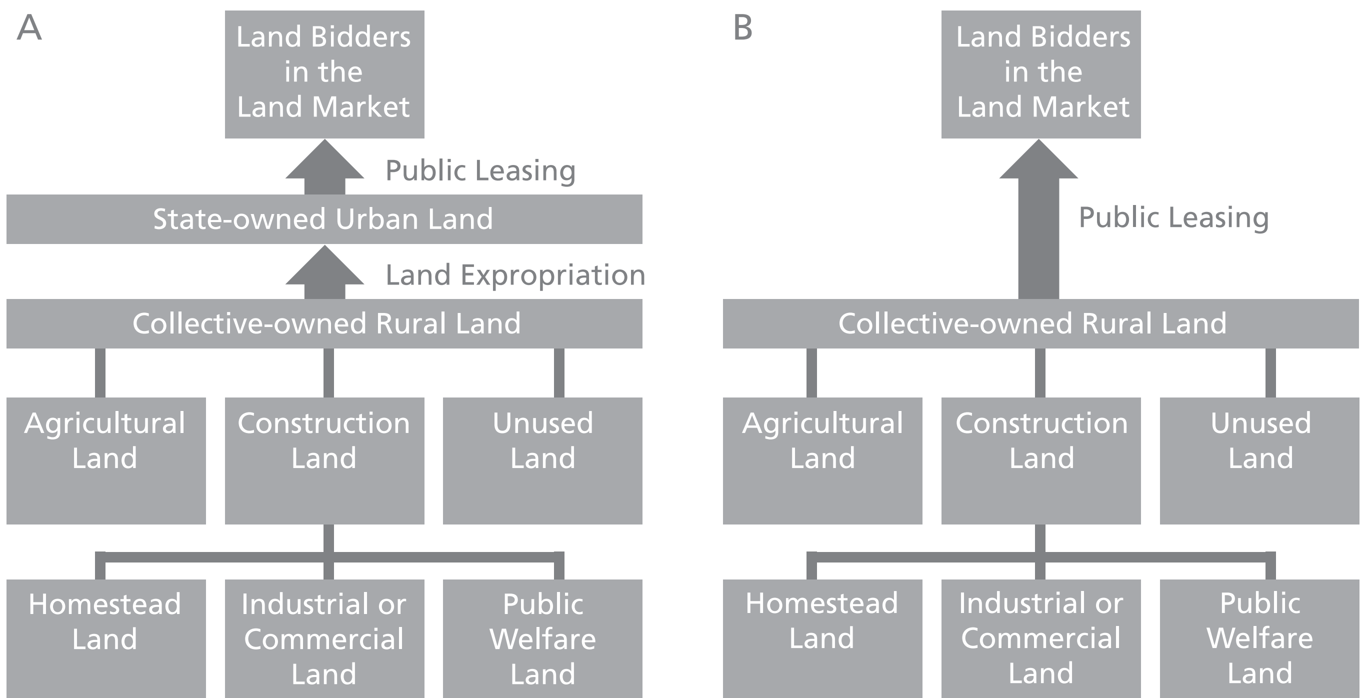
In the area of hukou reforms, the government has set criteria that migrants coming to cities must meet before they can apply for local resident status – the larger the city, the more stringent the criteria. This serves to minimise overcrowding in larger cities and

encourage the development of smaller cities. In the coming years, more local governments are expected to go further and scrap rural-urban distinctions. Unified registration would lead to fairer access to social welfare and improve labour rural-urban mobility. In July 2014, the State Council called for the scrapping of rural-urban distinctions under the household registration system, which have been in place since 1958. In November 2014, Henan, Heilongjiang and Hebei provinces along with Xinjiang Ugyur autonomous region abolished rural-urban hukou distinctions.

> *Urbanisation under the New Normal must give more emphasis to efficiency and equality*

A pilot plan is underway to reduce land expropriation and gradually increase the marketisation of collectively-owned rural construction land in counties and county-level cities. This follows unofficial experiments of property rights transfers by some cities. Shenzhen has already conducted a collective-owned rural land transaction in the open market which sets an example of what land reforms will look like in the coming decade (Diagram 5).

Diagram 5: Comparison of rural land transaction procedure under the dual-track land transaction system (A) and the Shenzhen breakthrough land transaction system (B)



Source: Zou, Yonghua, Wanxia Zhao, and Robert Mason. 'Marketization Of Collective-Owned Rural Land: A Breakthrough In Shenzhen, China'. Sustainability 6.12 (2014): 9114-9123. Web.

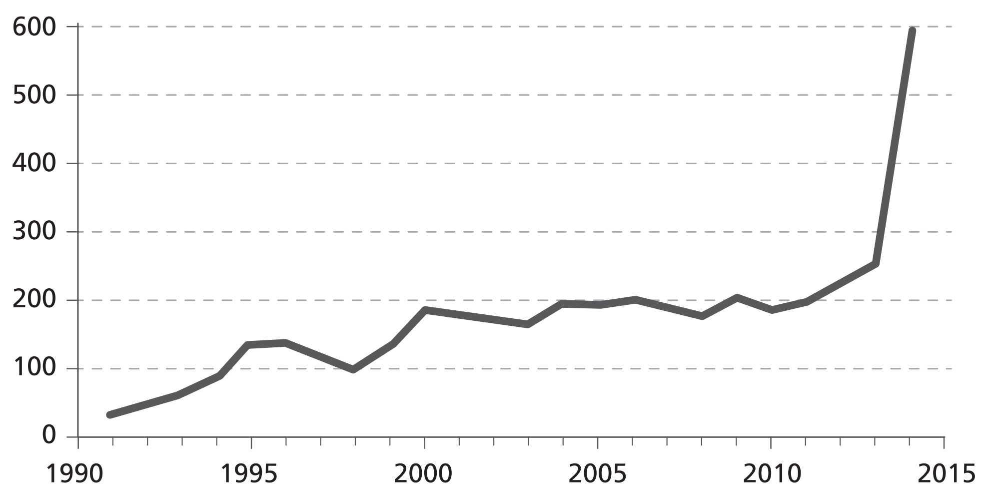
Institutional Reform

Reinstating Credibility

Much of China's future success will depend on institutional reforms that are broad in scope and complicated in nature. The ultimate aim is to engender the credibility of governance and deepen the trust.

On centre stage now, is President Xi's anti-corruption campaign. Unlike temporary crackdowns of the past that simply aimed to purge political opponents and assert authority, this campaign is to be perpetual in nature. During the past two years it has ensnared both "tigers" (top party leaders) and "flies" (low-ranking officials). According to reports, close to 200,000 corrupt officials have been arrested, demoted or dismissed. President Xi said in January that the campaign would have no upper limit so as to help solidify the legitimacy of the Chinese Communist Party (CCP). The campaign has intensified lately. According to The Economist newspaper, a total of 69 senior officials were arrested in the past 28 months or so. That was more than two times the number of anti-graft detentions made under the preceding leadership. In the past seven months or so, at least 24 ministerial-level officials have been detained for corruption. [1]

Diagram 6: Number of senior officials being investigated by procuratorates for corruption*



* Including dereliction of duty
Source: The Economist

The other big wave of reform is simplifying the bureaucratic structure. It has been tried before with little success. China has undergone seven rounds of bureaucratic re-organisation (so-called Super Ministry reform) since the 1980s. Yet, the number of ministerial-ranked agencies has stayed about the same: 73 in 1982 and 74 in 2013.

So far under President Xi, China has abolished the Ministry of Railways, which was folded into the Ministry of Transport. It has also dismantled the State Population and Family

Planning Commission. But there is more to the reform process than just abolishing or merging ministries and departments.

Deep institutional reform will require the state to cede active control in the economy. It will also need a major shift in long-held attitudes. For example, at the Third Plenum of the 18th CCP Central Committee in November 2013, the leadership declared that state ownership was still a pillar and foundation of socialism with Chinese characteristics. While the privatisation of SOEs is not uncommon, the state still retains effective control of many of them. According to a paper [2] by the Paulson Institute, state control is far more extensive in China than state ownership.

Major tangible benefits are likely to come if the state lets go of some of this control. We can see examples of this from the past. During a period of disinflation and deflation between 1996 and 2003, China allowed many inefficient SOEs to shut down. When the state ended direct subsidies and made them accountable for their profits and losses, the number of SOEs fell from 262,000 in 1996 to 146,000 in 2003. The corporate performance of the remaining SOEs in terms of return on equity improved markedly from 0.4% in 1998 to 6.7% in 2003, according to the Ministry of Finance. The government, however, did not allow SOEs to be sold or shut down easily after 2003. As a result, many inefficient SOEs survived simply because the banks continued to lend to them regardless of risk on the assumption that the government would not let them fail. Not surprisingly, the financial performance of SOEs deteriorated after 2008 until now.

Foreign Policy

Gaining Trust and Influence

As the Xi leadership reshapes China's economic policies, it is also ramping up its foreign policy. For years China had been regarded largely as a spectator in international affairs, seemingly uninterested in helping to solve global problems or overtly extending its diplomatic influence far beyond its borders.

However, it now wants to be an influential power, not just an economic force. This will require building trust across the international community by using a combination of economic and soft power. China has the potential to do a lot more with other nations to tackle environmental challenges along with cyber-security and terrorism threats.

Beijing is starting to apply its economic strength to achieve foreign policy goals. This approach is embodied in a grand international infrastructure and development concept dubbed "One Belt, One Road". Its aim is to build highways, ports, railways and so on throughout a "Silk Road Economic Belt" across the Eurasian land mass. Similar ambitions are planned for the 21st Century "Maritime Silk Road", which is to take in the South China Sea as well as the South Pacific and Indian Oceans.

The "One Belt, One Road" strategy aims to create a "community of common economic interest" across the region. China would be the biggest financier of the "One Road, One Belt" project. As such, participating countries would likely view it as a benefactor. To do this, it is setting up, and largely funding, the Asian Infrastructure Investment Bank (AIIB) as a multilateral lender for development projects.

In the process, Beijing has shown that by growing into an economic giant it now possesses significant diplomatic clout. Dozens of countries in Asia and Europe – many of them long-time allies of the US – as well as Russia and India, signed up as founding members in the AIIB. This was despite initially strong misgivings from Washington, which for decades has dominated the international developmental lending space. But even American resistance seems to be softening. On March 31, US Treasury Secretary Jacob Lew said it was "ready to welcome" the AIIB as long as it "complements" existing institutions, like the World Bank and International Monetary Fund.

There is an additional diplomatic objective to the AIIB initiative, that is, to hasten RMB internationalisation. First, to finance infrastructure spending, Beijing is encouraging Chinese banks to extend credit to project participants – most likely in the Chinese currency. Second, the "One Belt, One Road" will boost China's overseas direct investment (ODI). An increasing portion of this ODI is expected to be denominated in yuan, which recipient countries may use to purchase machines, capital goods, construction materials and services from the mainland. The circular nature of these flows will further raise yuan settlement for China's exports. Finally, closer trade and business ties with China would

increase demand for the yuan. If this plan is successful, China's influence in the region will be amplified dramatically.

The importance of establishing soft power also matters. China has a rich history and culture that has influenced Asia for centuries and continues to do so. Soft power can also be based on the promotion of values now being pursued by modern China. Take for example President Xi's ongoing anti-corruption programme. It is about improving equality, integrity and justice. If the world sees that China can uphold such values consistently, its influence through soft power will grow over time.

Conclusion

As China embraces long-term change, the world's view on it must also change. Old assumptions need to make way for the "New Normal". Financial markets need to factor in new management philosophies that frame monetary policy. Those who worry about massive local government debt should pay closer attention to evolving measures that promise fiscal sustainability in the long run. The old "one-way bet" on the currency no longer prevails. And, it would be unwise to assume absolute rigidity of the exchange rate should another financial crisis hit.

For businesses, a more holistic perspective is required to gauge economic health. High frequency data can reveal only so much about short-term growth momentum. The figures cannot show the progress of the structural reforms needed for long-term economic wellbeing. In urbanisation, for example, land and hukou reforms are integral to new population policies that are central to the expansion of cities and towns, and ultimately China's sustained economic growth.

Measured progress has already been made in institutional reform, although much more needs to be done. The anti-corruption campaign will be ongoing. It is no longer valid to assume SOEs will be protected by the state or that their executives will be immune from scrutiny and possible prosecution. This will have ramifications for business planning and investor confidence.

China wants to be global power of influence, not just an economic behemoth. Beijing has already outlined the "One Belt, One Road" concept, which aims to generate enormous economic opportunities, including the internationalisation of the RMB. The setting up of the AIIB with solid international support, despite initial US resistance, shows that China can use its economic power to realise its foreign policy goals.

Welcome to the "New Normal". It will have massive ramifications on how business is done in China from now on.

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