

Keep an eye on reforms in China's Two Sessions

This year's "Two Sessions" will be different from previous years, as President Xi extends his tenure. Reforms will be under the spotlight. We share our thoughts on what reforms to expect and the risks and opportunities for some sectors



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This time would be different

With President Xi's tenure extended, talking points in the Two Sessions will be different from previous sessions.

As Xi has consolidated power in the Party and also the State, he will demonstrate to the country and also to the world that he is capable of achieving results that previous leaders of China could not fulfil. These include raising the profile of China in international platforms, in terms of economic power and in influencing international opinion. In other words, Xi would like China to play a more prominent role in international politics. At first, this may be imperceptible, but over time, Xi would like China to be a country that is impossible to ignore.

Quantitative vs qualitative targets

To become too big to neglect, the first step is to make the economy even stronger. And the government has realised that quantitative growth targets may not be enough to bring the economy to the top of the world.

We expect that in the coming Two Sessions, especially on 5 March when Premier Li gives the government report, GDP growth targets could be vague or even absent. Instead, there would be more emphasis on qualitative growth. Last year's "around 6.5% GDP growth target" could become a wide range this year or disappear altogether.

This would induce local governments to focus more on how to grow in line with qualitative targets. These could include, making people wealthier (ie, lower unemployment and higher wages), healthier with less pollution, or enjoying more convenient lifestyles with the help of advanced technologies. In terms of corporates, local governments have to make sure that corporates in their locations comply with the State's regulations (eg, not over-invest abroad), and also become more technologically advanced, and push ahead with anti-pollution measures.

We expect local governments will have to work a lot harder under qualitative targets because they are more difficult to measure. The old ways of boosting local GDP by building inefficient projects have passed.

Reforms to achieve qualitative targets

As qualitative growth is increasingly important, the central government will implement more reforms. On the one hand, to clean up issues like overcapacity, and on the other hand, to create better economic growth prospects.

Here are some of the reforms we expect to see in the forthcoming government report, and their potential risks to the economy.

1 Supply-side reforms

It is almost certain that supply-side reforms will continue, but focussed on different sectors, now that production cuts in iron and steel have yielded such good results.

We expect to see more raw material sectors becoming targets of supply-side reform. That means more overcapacity cuts in raw material sectors, including cement and glass. These production cuts would push up prices of materials, and could create better profits for surviving companies in these sectors.

The risk comes from debt defaults from factories facing production cuts, which could in turn affect the quality of the banking sector and the bond market.

We think that some of these risks would be absorbed by other SOEs but some of the losses would be borne by banks and bond investors. Debt-for-equity swaps could play a role in these default cases.

2 Financial reforms

Financial deleveraging will be the key reform in 2018 as the government is determined to clean up

shadow banking in the financing sector. It means that the "super financial regulator" will steer reforms to guard against risks coming from online platforms for financial products, including personal loans and wealth management products.

This means tighter liquidity and will result in higher short-term interest rates.

Overly tight liquidity could create tensions for banks and other financial institutions. But we see this risk as quite low as regulators manage liquidity on a daily basis.

There could be some closure of small online financial platforms, possibly creating credit risks among banks and other non-bank financial institutions that have indirectly lent to those platforms through the interbank market, trust companies, etc. To avoid credit risks turning into a domino effect, regulators would act sooner rather than later, and tighten regulations to rein in future risks.

3 Green reforms

Reforms on moving from traditional energy to green energy will also play an important role in the government report. It seems to us that China would like to wash away the stigma of a pollution-generating country, and even reverse that into a clean-energy country.

This would mean big changes in the energy sector in China, and would directly increase infrastructure investments in the utility sector.

Related sectors would also need to adapt to these changes. For example, there would be more production of new energy cars, and that would bring changes to the battery sector.

Green reforms sound a great step forward, but traditional energy companies will find it harder to maintain profit levels and will need to set aside more money to keep pace with ever-tighter environmental regulations.

4 SOE reforms

Reforms on corporate governance and corporate structure of state-owned enterprises (SOEs) will continue.

This reform area is often neglected by the market because of its long term nature. This means that the market will only slowly see the implications for the economy from SOE reforms.

We expect more mergers of SOEs in strategic sectors, eg, energy, raw material sectors. The government's intention is to close down small and loss-making SOEs, and reduce the number of SOEs to a point where they are sufficient merely to serve the strategic needs of the country.

But this does not mean that SOEs will no longer be relevant to economic growth. Quite the opposite. The remaining SOEs will be very important to growth as they will support the economy when needed, and may drive experimental projects for the government.

As some SOEs will close down, there is credit risk to the banks most exposed to the SOEs. Banks will need to be watchful of their capital ratios as write-offs increase.

The preceding ideas are only likely to be part of the reforms announced from the coming

Two Sessions. We would not be surprised if there were other new ideas from President Xi, ideas that would justify his longer tenure.

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