

**UBS Investment Research****China Focus**

## When the Dust Settles – the Impact of the Reforms

18 November 2013

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- The announced reforms beat market expectations, likely boosting market confidence and sentiment in the near term. The implementation could be difficult and will take time, and not all measures are positive for near term growth or for listed companies.
- We see the main impact of the reforms to be a reduction of “tail risks” facing the economy rather than faster GDP growth.
- Impact on various sectors will be mixed – banks should benefit from improving local government finance and lower “tail risks” facing the economy, but will likely be hurt by interest rate and capital account liberalization.
- Consumption should benefit from the relaxation of the one-child policy, wider coverage of pension and health care insurance, services deregulation, hukou and land reform, and interest rate liberalization.
- The pace and sequencing of reforms will be important. We worry that fiscal, governance and SOE reforms may lag too far behind progress in investment decentralization and financial deregulation. We consider the pace of capital account opening a key risk to be monitored.

**Tao Wang**

Economist  
wang.tao@ubs.com  
+852-2971 7525

**Donna Kwok**

Economist  
donna.kwok@ubs.com  
+852-3712 3160

**Harrison Hu**

Economist  
S1460511010008  
harrison.hu@ubssecurities.com  
+86-105-832 8847

**Ning Zhang**

Economist  
ning.zhang@ubs.com  
+852-2971 8135

**Doris Weng**

Economist  
S1460513100004  
doris.weng@ubssecurities.com  
+86-213-866 8813

## The overall impact of the reforms

The full document of the 3<sup>rd</sup> Plenum, “**Decisions on Major Issues Concerning Comprehensively Deepening Reforms**” (Decision), contained a detailed blueprint for sweeping reforms on almost all fronts, including economic, social, government administration and judiciary issues. The breadth of the reform plan has certainly exceeded most expectations, and the equity market has already reacted positively. As the public and market gradually digest these new details contained within the Decision in the coming days and weeks, sentiment and confidence will likely stay positive.

However, the reform plans in the Decision are meant for the coming years not months, some of them will be difficult to implement, and many of them are not going to be all positive for growth or for many of the listed companies. When all the excitement about reform plans cools, as the reforms get implemented – when the dust settles, what will likely be the impact of these reforms?

We think the overall impact of the reforms will be positive over the longer term, not necessarily in terms of higher GDP growth rate, but in terms of more sustainable and efficient growth, lower tail risk of a hard landing and meltdown in the medium- to long term, and the improvement of household welfare and corporate performance at the micro level. The impact on various sectors may be mixed at different times. In addition, the sequencing of reforms, which in part depend on the resistance to various reforms, will also be important.

### The impact on economic growth

**Positive for headline growth:** Removal of government approval for corporate investment in principle, decentralization of investment approvals for other projects, simplification of business approval and registration, opening up of service sector for private and foreign entrance and competition, relaxation of hukou in small and medium-sized cities, land reforms to give farmers more rights to facilitate the monetization of rural land, development of free trade zones, relaxation of the one-child policy, expansion of pension and health care insurance coverage, allowance of local government to issue construction bonds, and further development of capital markets and new financial instruments. These measures should either facilitate and encourage investment or help boost consumption, leading to faster GDP growth.

**Negative for headline growth:** Harder budget constraints on local governments, higher dividend payment by SOEs, tougher rules and restrictions on government administrative or officials’ spending, performance evaluation system that takes into account factors such as damage to environment, use of resource, production safety, and debt increase, energy and resource price adjustment which will likely increase the cost of inputs, interest rate liberalization and capital account opening which could lead to higher cost of capital, and property tax. These measures would serve to constrain (public) consumption or investment, leading to lower GDP growth. Of course, these measures are not negative for the economy over the long term, as they tend to help increase the more efficient use of resources and help to make long term growth more sustainable.

**Short-term outlook:** In the next 12 months, we are unlikely to see major progress in most of the areas – given the complexity and difficulties of the reforms, the challenges to overcome ideological resistance and opposition from special interest groups, and the basic fact that many reforms have to follow the usual bureaucratic and legislative process to be enacted. Therefore, in the short term, we believe the most important determinants of growth remain to be (i) external recovery and demand for Chinese exports; (ii) the credit cycle; (iii) property sector development; and (iv) household income growth which is the most important determinants of consumption. As such, we maintain our current 2014 GDP growth forecast of 7.8%, on the basis of better global growth and improving exports, stable property investment growth with largely unchanged policy, and a rebound in corporate investment on better earnings and outlook, all of which offsets the slowdown in government infrastructure investment.

The likely uneven implementation of the reforms may bring an upside risk to growth in the next 12-18 months. We believe that decentralization of investment approvals, opening up of service sector for private investment,

relaxation of hukou and one-child policy, and development of new financial products will likely proceed more quickly in the near term, whereas the hardening of government budget constraints, SOE reform, and the improvement of bank governance will likely progress more slowly. Such a sequencing of reform implementation may lead to faster investment and growth in the short term, though it may also increase the risks associated with continued rapid growth in investment and leverage.

### **The impact on long-term outlook**

**The successful implementation of the announced reforms should help China to address the structural issues in the economy and society and move towards a more balanced and sustainable development path.**

For example, the energy and resource price reform, SOE reform, local government finance reform, and adoption of a property tax should all help the economy to reduce its reliance on property and heavy industry, reduce the degree of resource- and environmental-intensity of growth. The opening up of the service sector, hukou and labour market reforms, pension and health care reforms should help to facilitate the development of the labour-intensive service sector development, employment and household income growth, and hence, consumption growth. Hukou, land, and social system reforms should also help to reduce the vast income and opportunity gaps in the society, especially between urban and rural population, reducing labour market rigidity as well as the risk of social instability.

To the extent growth will become more balanced and sustainable, and driven more by market forces and more efficient use of resources, there will be less waste of capital and less accumulation of bad assets. In other words, **the “tail” risk of a hard landing or economic/financial meltdown will be greatly reduced**, and long-term growth could be sustained at 6-7% in the coming decade.

### **The impacts on specific areas**

The impact of different reforms on various sectors may be mixed.

#### **State-owned enterprises**

For the SOEs, the participation of private capital could bring needed capital injection for some companies, and the allowance of Employee Stock Ownership Plan (ESOP) could help incentivize better performance. The likely increase of competition and higher costs resulting from energy and resource price reform, on the other hand, may be negative (except SOEs in the energy sector that may benefit from higher prices). Paying dividend up to 30% of profit to the (state) owner, a common practice for SOEs in other countries, will likely lead to higher cost of capital. Although we would argue that dividend payment can help strengthen corporate governance and more competition can lead to efficiency over time, the initial impact of such reforms on SOEs will likely be negative. However, the higher dividend payout ratio is likely to be phased in very slowly to help reduce the negative impact.

As a background, according to the Ministry of Finance, SOEs (excluding financials and mixed-ownership companies) earned a combined profit of 2.2 trillion RMB in 2012 while paid the state a combined contribution of 157 billion, implying a payout ratio of only 7%. Moreover, currently the SOE dividends have been used mainly within the SOE community rather than the public budget, for capital injection or subsidies to other SOEs.

#### **The financials**

**In principle, what is good for the economy should be good for banks.** To the extent that the whole set of reforms will reduce the “tail” risk in the economy and foster a more balanced and sustainable growth in China, that is also positive for the banking sector.

**For the banks, the acceleration in interest rate marketization, which means higher deposits rates and lower interest rate margins, would be a negative.** A quicker capital account convertibility, which is likely to lead to more foreign borrowing by the corporate and increased outward investment by the corporate and household sector, would also be negative for banks. The faster development of capital market would also mean slower growth in bank credit, and hence, slower revenue growth.

**On the positive side, banks' liquidity situation could improve from increased securitization** of their assets. More importantly, **any tangible progress in local government finances**, including additional local tax revenues or dividend collection from SOEs, expansion of local government bond issuance, and harder local government budget constraints, should be positive for banks as they reduce the accumulation of future non-performing loans.

For other financial companies, the IPO reform, the development of the bond market, and the expansion of various types of insurance coverage should also bring related positive factors. However, the “shadow” banking development could diversify away some of the risks currently in the banking system to other financial institutions.

### **The property sector**

The promised property tax, if implemented in a wide area, will likely discourage investment in properties as the carrying cost becomes more apparent and increase the supply of homes for the rental market. As such, this should be negative for the property sector initially, although a property tax could help to keep property sector development more healthy and sustainable.

However, the wording in the Decision on property tax still suggests a relatively slow pace of implementation. The phrase “accelerate the legislation of property tax and proceed at appropriate time”, is more definite than in previous documents, but the **legislation and the implementation will likely take quite some time. We think the earliest possible time for a wide-spread property tax would be in 2015.**

On the other hand, the relaxation of Hukou system in small and medium-sized cities, progress in land reform, together with the new urbanization plan, could be **positive for infrastructure and property construction in the next couple of years.**

However, **land reform could also lead to greater land supply** for urban construction, which could eventually lead to **lower land prices**, potentially a negative factor for the property market that has developed on the basis of ever-rising land prices.

It is also worth noting the Decision said “to study the establishment of policy financial institutions on urban infrastructure and residential housing”, which, in our view, signals that the authorities intend to develop alternative financial channels at some point in the future, similar to housing financing agencies in US (Fannie Mae and Freddie Mac), to help satisfy housing demand for new urban citizens or low-income households.

### **The commodity and material sectors**

The planned reforms in natural gas, oil, electricity, water and transport prices are expected to benefit some of the upstream companies sectors (relevant mining and power/utility providers), but will likely lead to higher material and input costs for downstream users. The price reform, together with other reforms including SOE reforms and the development of the service sector, should lead to lower commodity- and energy-intensity of future growth in China. As such, we think the net impact of the reforms is likely to be negative for the material sectors.

In the near term, however, as hukou reform and urbanization plan may lead to more infrastructure and property investment, we could see some upside to China's overall investment and therefore demand for commodities in the next 12-18 months.

## **Local government debt**

The Decision detailed a number of measures that could help to rein in local government debt issues: (1) compiling local government balance sheet and consolidating various budgets should help improve transparency of local finance, (2) linking local official performance with debt accumulation could help to curtail debt increase, (3) moving some administrative authority to the central government should help to reduce local spending needs, (4) reducing local governments' involvement in production, including by divesting some state-share to private sector (mixed ownership); (5) increasing local revenue through higher SOE dividend and marginal increase in tax revenue; and (6) allowing local government to issue bonds for infrastructure construction.

Among these, we think (2) is of particular importance as it may change local government behaviour. As for (6), it could help turn local governments' "implicit" debt into "explicit" and longer term debt, helping to solve some cash flow issues. Together with (1), this should also help to improve transparency and public scrutiny. As a background, gross bond issuance by local government financing vehicles totalled 895 billion in 2012 and 535 billion in the first half of 2013, generally under "enterprise bond" category.

## **Consumption**

Most of the reform measures would be positive for consumption:

**Relaxation of the one-child policy:** Families with one parent as a single child can have two children. The Family Planning Bureau expect this policy to lead to an additional 1.5-2 million new birth a year in the coming years, raising the current annual new birth to about 18 million (the level seen around the year 2000). However, it is possible that the additional new birth may be higher because of a sudden release of pent-up demand from women who are close to the end of their child-bearing age. On the other hand, the government said it will try to use phased-in approvals to try to smooth this process.

**Enhancement of social benefits and social protection:** Pension and health care insurance coverage will be widened, and the basic pension will be pooled at the national level, health care services will be further reformed to encourage private entrance and increased supply.

**Hukou and land reform:** The relaxation of Hukou in small and medium cities, access to more job opportunities and better social benefits, and easier monetization of land lease rights, will help boost income and consumption of rural and migrant population.

**Development of the service sector and SMEs:** This should help boost employment and wage income over time, and hence, consumption.

**Financial sector reform:** Deposit rate liberalization, leading to higher deposits rates, should help boost returns to household savings and hence consumption.

*On the negative side*, continued anti-corruption measures, stricter controls on government and institutional consumption and spending by officials, may cut growth in public consumption.

## **Risks of reform implementation**

The reform plan is very ambitious, but **the pace of implementation and a proper sequencing are important**. Liberalizing factor prices too quickly could lead to dislocation in various industries, and hardening the budget constraints for local governments and SOEs could lead to lower growth in the near term. Also, as written in our earlier report (see "Great Expectations – China's Upcoming Reforms", September 25, 2013), if the initial set of reforms and deregulation in investment approval and financial sector are not followed by more fundamental ones in fiscal, SOE and governance areas, they could increase the risk of higher leverage, more

reliance on property and investment, and potentially more serious consequences for the economy and the financial sector. For example, accelerating urbanization and financial deregulation before big changes in public finances, property tax, and social benefit reform could result in another rush for “physical” and “land urbanization” rather than “people urbanization”. Overheating in the property sector and further rise in land prices could increase local government’s reliance on property, push up the cost of production in China further and erode its competitiveness. It would also intensify the existing imbalances, widening the gap between land-losing farmers and migrants and the urban population.

**The pace of financial sector reforms, especially that of capital account opening needs to be in matched and unrolled in tandem with other major reforms.** While financial deregulation would lead to more diversified financing and development of capital markets, it could also lead to a credit bubble, especially if reforms on SOE corporate governance and local government budget constraints lag behind too much and financial supervision becomes increasingly difficult in a deregulated world. Against this background, the continued rapid development of shadow banking could bring systemic risk to the financial sector rather than being a means of risk diversification. In addition, if capital account opening is accelerated ahead of major progress in fiscal, SOE and domestic financial reform, it could amplify domestic imbalances and the impact of external shocks. In our view, the pace of capital account opening is a key risk to monitor for China over the next 3-5 years.

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Source: UBS; as of 17 Nov 2013.

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