Discourse

Shedding light on domestic politics and policymaking with concise analysis of the week's most important meetings, speeches and essays, so you know who is saying what, and why it matters.

Xi's political economy symposium

Xi Jinping hosted a symposium this Monday, bringing top officials and prominent economists and sociologists together in Beijing to discuss the upcoming 14th five-year plan. While the meeting was closed-door and their individual comments have not been made public, the meeting has been prominently featured in state media, and Xi gave a speech discussing six key takeaways:

- new opportunities and challenges should be viewed dialectically
    - particularly challenges including rural-urban inequality and social issues, and navigating an increasingly complex international environment
- building a new pattern of development requires smoothing circulation of the national economy
    - i.e. the domestic half of **dual circulation** (see below)
- China must rely on indigenous innovation to achieve high-quality development
    - i.e. taking control of key core technologies, and strengthening domestic R&D capacity
- deepen reform to stimulate new development vitality
    - i.e. continuing existing reform agenda including strengthening IPR, market competition, etc.
- build new advantages in international cooperation & competition through high-level opening up
    - especially in terms of
        - increasing international cooperation, including at the state, local and enterprise levels in the U.S.
        - balancing cooperation and security, and strengthening ability to regulate & control risks
- social development via "joint efforts and shared governance"
    - this point not made particularly clearly, but Xi calling to improve social security & public health, address "social contradictions" and maintain social stability

Government attendees included:

- Han Zheng 韩正 and Wang Huning 王沪宁 Politburo standing committee members
    - both known for high level economic planning, with projects such as the Shanghai FTZ
- Ding Xuexiang 丁薛祥 chairman of the State Council General Office; government's chief-of-staff
- Liu He 刘鹤 deputy premier; Xi's economic mastermind
- Huang Kunming 黄坤明 head of the publicity department; the propaganda specialist
- Xiao Jie 肖捷 State Councilor; an in-house economist of the government and ex-finance minister
- He Lifeng 何立峰 NDRC head; another economics Ph.D.

Academic attendees included:

- Justin Yifu Lin 林毅夫 Peking University National School of Development
- Fan Gang 樊纲 China Society of Economic Reform
- Jiang Xiaojuan 江小涓 School of Public Policy and Management of Tsinghua University
- Cai Fang 蔡昉 Chinese Academy of Social Sciences
- Wang Changlin 王昌林 Academy of Macroeconomic Research
- Zhu Min 朱民 Tsinghua PBCSF
- Lu Ming 陆铭 Shanghai Jiao Tong University Antai College
- Zhang Yuyan 张宇燕 Chinese Academy of Social Sciences Institute of World Economics and Politics

- Zheng Yongnian 郑永年 Chinese University of Hong Kong (Shenzhen)

Dual circulation

"Dual circulation" (as we've discussed before) has become increasingly prominent as the top focus of macroeconomic policy. The high-level strategy is still in the process of being fleshed out, but is emerging as the guiding principle for China's macro policy for years to come, accelerated by increasing pressure to become more self-reliant as the U.S. pushes to cut off access to chips, which domestic observers have grown to call "stranglehold tech," 卡脖子技术.

There has been a lot of buzz about it in the last week especially: economist Yu Yongding 余永定 spoke at a Sunday event on the topic organized by the China Wealth Management 50 Forum, and the state-run Economic Daily newspaper on Wednesday published a front-page article on it under the Zhong Jingwen 钟经文 pseudonym, indicating an authoritative interpretation of the theory.

That article concluded with a specific reference to its importance as the 14th 5-year plan approaches. Analysts widely agree that the dual circulation notion will be a key guiding doctrine in the 14 5-year plan.

Both Yu's talk and the Economic Daily article are fairly long and heavy on jargon, so we don't have room to fully unpack them here, although do recommend reading them to get a sense of how key voices are discussing the topic. From a more applied perspective, however, ICBC International economists Wang Yuzhe 王宇哲 and Cheng Shi 程实 recently explained the concept more clearly, arguing it's based on three key trends:

- relying on the scale of China's domestic economy and available policy space and putting existing economic resources to better use
- domestic consumption and industrial upgrading forming a more closed loop, helping create a new growth engine against the background of shifting global trade patterns and value chains
- reform and opening up, particularly in terms of factor markets enhancing resource allocation efficiency and financial sector opening helping actively link internal and external "cycles"

They provide a handful of examples to illustrate those points:

- "consumption backflow" supported by strong domestic demand amid contraction of service trade
- policy focus on industrial upgrading, as discussed in Xi Jinping's July meeting with entrepreneurs and highlighted at the Two Sessions
    - specifically, the new infrastructure initiative, the April guiding opinions on "setting up a better market-oriented production factor allocation mechanism" and the May guiding opinions on "accelerating the improvement of the socialist market economy system in the new era"
    - Cheng and Wang consider the two guiding opinions "programmatic documents" that lay an institutional foundation for supply-side reform, minimizing government intervention in markets and breaking through bottlenecks to domestic "circulation"
- financial opening and reform enhancing links between the sector and real economy, as well as between China and the global economy

Liu He and Yi Huiman on capital market reforms

Vice premier Liu He 刘鹤 and CSRC Chairman Yi Huiman 易会满 both spoke on capital markets this week, reiterating the core concepts underpinning recent and upcoming reforms, and clarifying what they mean in practice.

Yi emphasized the principles of "institution-building, non-intervention and zero tolerance," set as priorities at last year's Central Economic Work Conference, explaining that

- institution-building is an important basis for standardizing market order and optimizing governance efficiency
- non-intervention is an important way to keep the market functioning normally, stabilize market expectations and enhance market vitality
    - and is *not* the same as laissez-faire, nor inconsistent with day-to-day supervision
- zero tolerance is an important guarantee for strengthening regulatory deterrence and purifying the market ecology

Liu likewise highlighted the three principles above, but also made a pointed call for efforts to "stay ahead of the market curve." The expression was previously used at a July CSRC meeting in reference to strengthening risk assessment and monitoring of leveraged funds, and guarding against systematized, large-scale off-site allocation of capital.

Yi and Liu delivered the remarks Aug. 24 at a ceremony celebrating the first batch of companies to list on the ChiNext board in Shenzhen under the new registration-based IPO system.

Data Digest

Illustrated insights into China's macroeconomy and what's happening on the ground in the financial sector.

Chinese banks face multiple challenges after COVID-19

First challenge: profit drops

Chinese commercial banks reported their biggest profit drops in more than a decade after they have helped revive the economy. In H1:

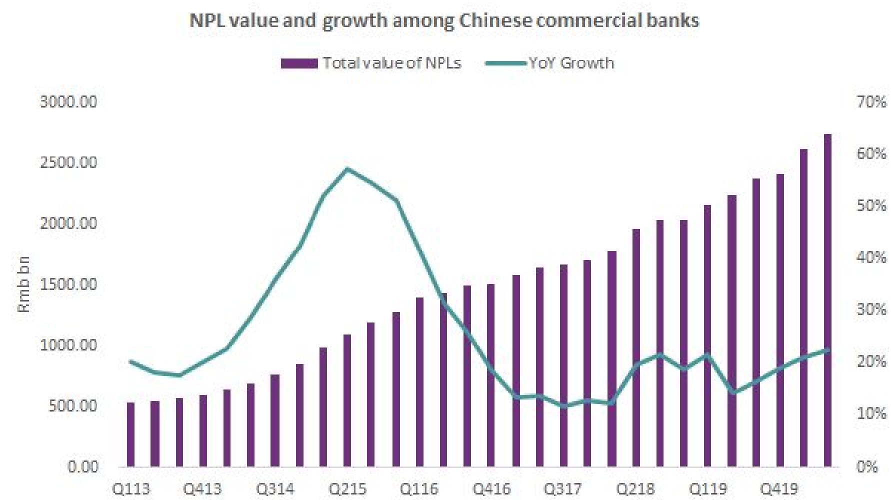
- commercial banks overall posted a 9.4% net profit fall
- the six biggest posted a 12% profit fall

The fall in profitability resulted from both a surge in bad debts and higher loan-loss provision, as well as sacrificed profits to support companies with lower rates. The profit growth might slow further.

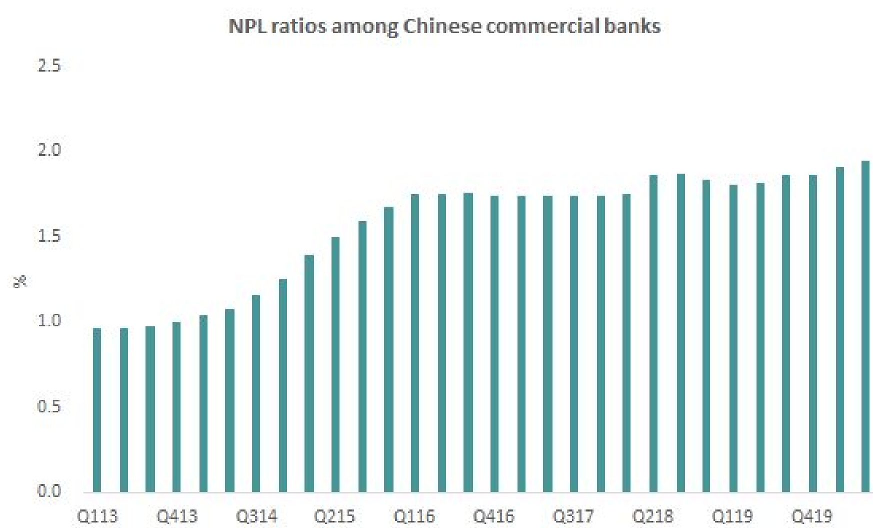
- Higher provisions were the root cause for slimmer profits. China's banking industry disposed Rmb1.1tn of bad loans in H1, after making Rmb1.3tn of provisions for loan impairment losses. The industry is expected to dispose Rmb3.4tn of bad loans in total this year, which suggests banks will make more provisions for loan losses in H2.
- The central bank cut LPR to stimulate the economy, which reduced the net interest margin (NIM) of the banks, which account for over 75% of banks' revenue.

Second challenge: surge in bad debts

Nonperforming loans (NPLs) held by China's commercial banks reached their highest level in over a decade, hitting 2.7 trillion yuan at the end of June, up 22.4% YoY.



The overall NPL ratio also jumped to 1.94%, up from 1.81% the previous year.



NPL value will keep rising into 2021 as more loans go bad, due to:

- increasing exposure to the manufacturing sector, which was hit hard by the outbreak
    - Chinese financial institutions issued more credit to manufacturers in the first seven months this year than they did in all of 2019 in order to prevent widespread layoffs and bankruptcies: 1.6 trillion yuan in new manufacturing loans accounted for 11% of total new bank loans in H1.
    - Manufacturing has a relatively high NPL ratio compared with other sectors, 4.2% as of end 2017, much higher than the overall level.
- increasing exposure to SMEs
    - The banking sector will bear the cost and risks associated with cheap lending to SMEs and roll over of SME loans encouraged by the central government.

- “Inclusive” SME loans stood at 13.7 trillion yuan at the end of June this year, up 28.4% YoY, comprising about 9% of total bank loans; outstanding value of SME NPLs reached 400 billion yuan at the end of June, rising 9.25% from the start of the year.
- The SME NPL ratio had risen to 2.99% at the end of the first half and is now approaching the “tolerance limit.“

Revenue problems remain for local governments

Despite the ongoing rebound in fiscal revenue, local governments have relied heavily on revenue from land sales as they struggle to fill budget gaps left by tax and fee cuts. But this is not a sustainable revenue source, as the land market in major Chinese cities is showing signs of cooling down, and property developers will reportedly soon be subject to new financing restrictions.

Despite falling 10.8% YoY in the first half, China's fiscal revenue rose 4.3% YoY in July, the second consecutive month of growth, as the country's economy continued its recovery from the epidemic and local government debt continued to shore up investment. The growth in fiscal revenue was largely a result of output resumption and land sales.

- Tax revenue rose 5.7% YoY in July thanks to the rebound in industrial output, fixed-asset investment and industrial profits since June, but it’s lower than 8.97% YoY in June.

- Revenue from land sales reached 3.51 trillion yuan in the first seven months of 2020, up 8.1% YoY after rising 5.2% in the first half. But new real estate financing restrictions are set to put the brakes on growth of land sales for the remainder of the year.

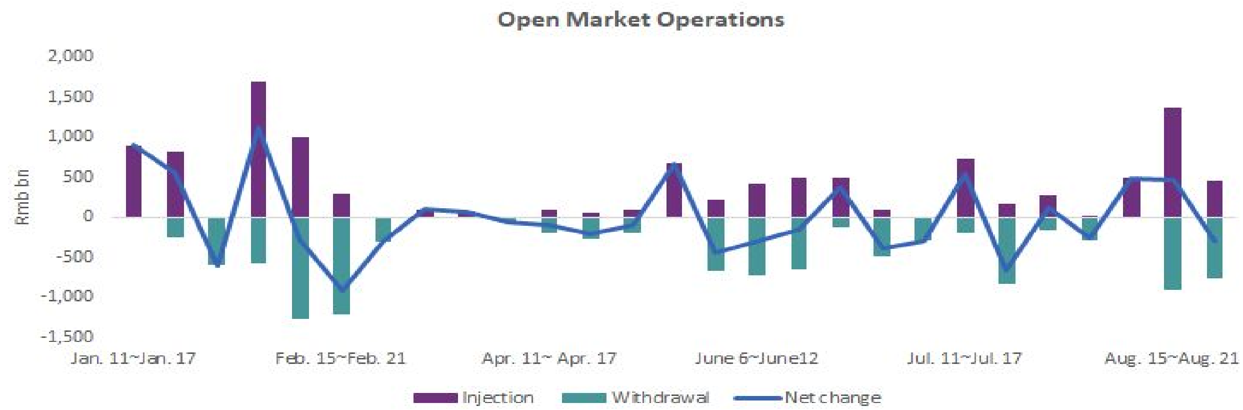
Local governments will need to find another source of revenue to maintain their spending, which was up 18.5% in July, driving rising concern over the rapid growth of local government debt: by Aug. 16, local governments had issued 2.56 trillion yuan ($370 billion) of special bonds, up 51% YoY and accounting for 72% of the available quota.

Liquidity

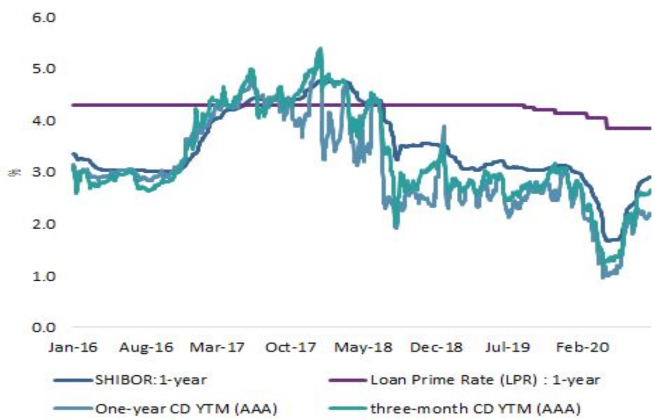
China’s central bank injected further liquidity into the financial system, seeking to support banks amid intensifying liquidity stress and keep a fragile economic recovery on track.

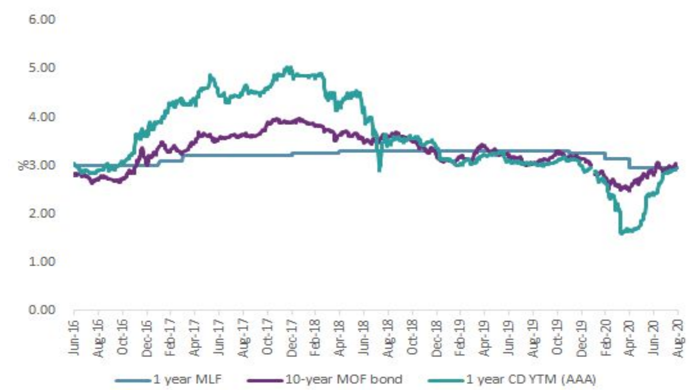
- China’s central bank added 700 billion yuan of one-year funding via the medium-term lending facility (MLF), more than offsetting a total of 550 billion yuan maturing this month, and kept the interest rate unchanged at 2.95%.

- The PBoC resumed open market operations (OMOs) on Aug. 7 after halting them for more than two weeks, injecting a total of 850 billion into the financial system from Aug. 11 to Aug. 28.

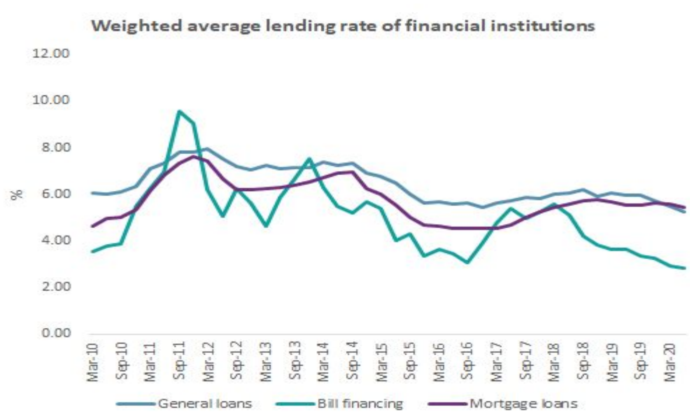


- Commercial banks left the LPR on hold on Aug.20. Given signs that the focus of monetary policy has shifted to containing financial risks on the back of the relatively rapid economic recovery. The one-year rate was unchanged at 3.85%, and the five-year rate was steady at 4.65%.





- The PBOC has also allowed market interbank rates to rise in recent weeks and re-converge with the rate at which it offers funds via its daily repo operations. This increase in short-term funding costs will have made banks more reluctant to lower their lending rates.



Policy

Digest of need-to-know policy developments with none of the noise.

Mixed messages on U.S.-China trade talks

- The Chinese foreign ministry said Thursday that China and the U.S. would hold talks to evaluate the phase one deal, whereas on Aug. 18, the White House Chief of Staff Mark Meadows said no high-level meeting between China and the U.S. has been scheduled.

PBOC does not plan to expand Covid-19 SME credit support

- Gao Fei 高飞, a deputy director general of the PBOC's Financial Market Department of the PBOC, said at a press conference that the central bank currently has no plan to enlarge the scale of the SPV it set up with the Ministry of Finance in June to channel as much as 440 billion yuan ($63.6 billion) of funds to regional banks so that they could provide new loans and roll over maturing loans to small businesses.
- As economic operations have gradually returned to normal, the finances of many small businesses' have improved such that they no longer need loan extensions, Gao said.

Private loan interest rate cap slashed

- The Supreme People's Court (SPC) on Thursday amended the upper limit on interest rates offered by individuals and companies without a lending license.
- The cap is now set at four times the one-year national loan prime rate (LPR), cutting the effective ceiling from a legal max of 36% to 15.4%.
- Why this matters: small businesses in China still rely heavily on such private loans, traditionally shunned by banks who prefer to lend to less risky state-owned enterprises.

Real estate financing 'redlines'

- Real estate developers will soon be subject to new financing restrictions, including three "redlines":
    - asset to liability ratio (excluding pre-sales) of no more than 70%
    - net debt ratio no more than 100%
    - must hold cash at least equal to short-term debt liability
- The rules come following an Aug. 20 seminar held by the central bank and Ministry of Housing and Urban-Rural Development to discuss new "long-term real estate industry regulatory mechanisms" with top real estate executives and representatives from the China Banking and Insurance Regulatory Commission, the China Securities Regulatory Commission, the Foreign Exchange Bureau, and Association of Dealers.