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Direction and Challenges of Mainland's Economic Reform

With China's new leadership now officially installed in their positions, reform under China's 12th Five-Year Plan enters a new phase. But as a number of challenges emerged in the horizon, the new government faces some tough decisions to steer the economy out of troubled water.

Growth has slowed in recent months, falling to 7.7% in the first quarter of this year. Both the Purchasing Manager's Index and the Producer Price Index dipped in April, raising concerns about the outlook for the export sector. In addition, growth in fixed asset investment and retail sales has been below trend in the first four months of this year.

Some of the headwinds slowing the economy should be temporary. The H7N9 flu outbreak, which has discouraged poultry consumption, should wane with the end of the flu season. The Government campaign to encourage officials to lead a more frugal lifestyle has hit the high-end catering industry and luxury sector, but the effects on the overall economy should be limited. Meanwhile, slower investment growth is a direct result of efforts to rebalance the economy, and the effects will last.

Looking ahead, the gradual pick up in the US economy should have a positive impact on the export sector in the coming months. We anticipate that China's economy will grow by 8% this year.

Service Industry is the Next Frontier

Urban household income grew by 9.3% in the first quarter, the slowest pace since 2009. According to China's 12th Five-Year Plan, private consumption is expected to become the engine of future growth, as the contribution from investment and exports moderates. Since income growth is the key factor affecting private consumption, China's overall economic reform will be hindered if income growth does not rebound.

As a matter of fact, we believe that growth in disposable household income is a better indicator of the future direction of China's economy than GDP.

To maintain the speed of income growth, we should look to the further development of the service sector. The service industry is labour intensive, consumes few natural resources and emits little pollution. And with a sizable domestic market, there is a lot of room for service industry to climb up the value chain. In short, the sector is an answer to the main ills affecting the Chinese economy today. In the 12th Five-Year Plan, the service sector is envisaged as the leading sector for employment creation. The service industry contributed 44.6% of China's GDP in 2012, significantly less than other BRIC countries (India: 65% (2011); Russia: 60.1% (2012); and Brazil: 67.2% (2012)). There is much room for the sector to grow.

In order to stimulate expansion of the service sector, urban migration is to be encouraged. China's urbanization rate has been on a rising trend, reaching 52.6% at the end of 2012. However, among the 711.8 million urban dwellers, close to 250 million are migrant workers from rural areas. Since they do not have full residency rights, their contribution to urban consumption is limited. Allowing them to have full residential status in second-tier cities will help to stimulate demand for consumer services in the long run.

What Keeps Consumers from Spending More?

Chinese households have one of the highest saving rates in the world – 25.9% at the end of 2012. The lack of a social safety net is often cited as a key reason for the high rate. Since China embarked on the reform of the state-owned enterprises, households can no longer rely on their companies for education, medical services and housing. The only surety is their own personal saving.

In the past decade, income growth outpaced consumption growth by an average annual rate of 1.4%. To encourage spending, the Central Government has made an effort to expand the social safety net[1], boosting spending by 188.5% since 2008, to a projected Rmb 1,551.6 billion for fiscal year 2013. During this same period, spending on these four areas has increased from 15.2% of the Central Government's budget to 22.5%. However, it will take much longer to change people's perception, and these ongoing efforts will only bring a noticeable increase in consumer spending after years of effort.

Another obstacle in the way of consumer spending is the low rate of investment return. China's real interest rate[2] ranged between negative 3.8% and positive 2.8% over the past ten years. Seeking higher returns, households have entertained different options over the years, and more often than not have come up short.

[1] Items of social safety net include education, medical care, housing as well as social security and employment.
[2] Real Interest Rate = 1-year deposit rate – inflation rate

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They suffered following the stock market bust in 2006-2007, and equities are still shunned. They turned to the property market, until the Government moved to halt an unsustainable rise in prices. Now, small investors are turning to relatively high risk trust products, causing concerns to regulators. In the absence of stable and mature investment markets, Chinese households do not enjoy positive wealth effects that could fuel consumer spending. Inflation only makes matters worse, as inflation encourages households to save even more. An acceleration of efforts to reform the financial system is required to turn the situation around.

Business Services Need to be More Efficient

During the era of economic expansion, the policy priority was to build up production capacity to meet the needs of the economy. Operational efficiency was a secondary concern. However, as the size of the economy has grown, bottlenecks and structural problems have compounded, and so the cost to the economy. Taking the logistics industry as an example, logistics cost as a percentage of GDP is around 18.1% in China, close to twice the cost in the U.S. Around 30% of China's entire annual perishable food harvest is lost due to poor efficiency, compared to 5% in most developed countries. There is increasing urgency to address this problem.

The key to successful reform is increased competition, in particular from experienced overseas firms. This will put pressure on all companies to improve efficiency and quality. This will not only lead to direct expansion of individual businesses, but also contribute to lower cost and higher efficiency in the overall economy.

Reform of the financial industry would have the most far-reaching impact on the economy. In the past, the main role of the financial sector was to provide low-cost funding to state-owned enterprises, to promote the growth of the economy. However, with the strategy almost too successful, leading to gross inefficiencies and limits on further growth, it has become increasingly difficult for the banking industry to meet the funding needs of the economy. Together with government's curb on bank lending in recent years, the dominant role of bank lending has diminished. Meanwhile, as mentioned earlier, the development of the equity market has been stunted. As a result, the share of bank lending in the annual increase of the total social financing has trended downward from 73% in 2008 to 52% in the first four months this year, while the respective share of the equity market stayed low at 1%.

Net increase in China's Total Financing

	% share of total			2008-12
during the period	2008	2012	2013 (1-4)	% change
Total Loans*	73%	58%	52%	79%
Entrusted Loans	6%	8%	9%	201%
Trust loans	5%	8%	13%	310%
Banks' Acceptences Bill	2%	7%	11%	887%
Corporate Bonds	8%	14%	12%	307%
Stocks	5%	2%	1%	-25%
Total Social Financing	100%	100%	100%	126%

* = RMB+Foreign Currency Bank Loans

Source: PBOC

Filling in the funding vacuum, many companies opt to raise funds through issuing trust products. This contributes to the growing share of trust loans to the total social financing in recent years. As of March 2013, wealth management products (WMP) totaled Rmb8.2 trillion, or 8.4% of bank deposits. Since retail investors snap up a chunk of these products and it is very difficult for them to evaluate the credit worthiness of the underlying borrowers, the price discovery process is far from optimal. This less efficient financial intermediation process hinders funds from reaching the market demand at the lowest possible cost. The bottleneck not only hinders economic expansion, but also increases the level of risk within the overall financial system.

To address the problem, a series of reforms are being implemented. The PBOC has increased the deposit ceiling by 10 percentage points to 1.1 times the base deposit rate, while it lowered the lending rate floor by 20 percentage points to 0.7 times the base lending rate. In the long run, it is hoped that the squeeze on the interest rate spread will motivate banks to reduce lending to low risk clients and boost lending to high-yield SME clients to improve their interest income. Meanwhile, the regulator has tightened rules on WMPs by requiring banks to limit investments of client funds in credit assets that are not publicly traded and to isolate any such risks from their operations.

Regarding the equity market, reform efforts include improving the quality of financial statements and transparency of IPO applicants, increasing the role of institutional investors and strengthening delisting rules for poorly performing companies. These efforts will not bring results overnight, but it is encouraging that the government is making continued effort to reform the financial industry.

Greater Role for Hong Kong Will Help

In this regard, Hong Kong can help bridge the funding gap. Hong Kong's banking and equity sectors continue to play a leading role as a fund raising centre in China. The QFII scheme also helps to channel funds into Mainland projects. Meanwhile, the development of offshore Rmb business paves the way for using Rmb funds accumulated in Hong Kong to meet the financing needs of Mainland companies. With the fast pace of liberalization of the capital account, Hong Kong could do a lot more to relieve the stresses in the country's financial system.

Facing the urgency to accelerate development in the service industry, it is appropriate for the country to consider a twin engine approach of pushing through reform while at the same time bringing in greater involvement of Hong Kong. Hong Kong is an advanced service economy. Our Mainland counterparts could duplicate our success by adopting our blueprint. However, this will require greater access for Hong Kong's service industry to the Mainland market. The two administrations have already agreed to remove all barriers to trade in services between the Mainland and Hong Kong by 2015. The focus now should be on ensuring that the implementation matches the promise.