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Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

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"What Does the Plenum Mean for China's Growth?"

Mark Williams, Capital Economics, November 21, 2013

"How Will We Know if the Plenum Reforms Are on Track?"

Mark Williams, Julian Evans-Pritchard, Capital Economics, November 28, 2013

At China's Third Plenum, the country's leaders agreed on plans to reform the economy. While the near-term impact of the proposed policy changes will be limited, argues Capital Economics' Asia team, the reforms reduce the risk of a "hard landing" for the Chinese economy later this decade. Investors should keep specific benchmarks in mind to determine whether the government is making progress toward implementing the reforms.

The Central Committee of the Chinese Communist Party hosts several plenums, or meetings, during each five-year term. The Third Plenum of the current Central Committee, held in November, ended with the announcement of wide-ranging changes, including relaxation of the "one child" policy, transfer of some state-owned enterprise (SOE) profits to the country's budget, price reform, and formation of privately owned banks, among a broad variety of other proposed reforms.

Investors should not expect immediate impact from the Party's proposed policy changes. China's leaders did not announce a formal timetable for implementation, indicating only that the year 2020 is the target for accomplishing "decisive" reform. Short-term effects will be determined primarily by Chinese policymakers' approach to monetary and credit policy as they attempt to rein in credit growth.

Once implementation begins, the effects will be ambiguous but likely positive. Investment spending should slow in response to tighter budget constraints, higher dividend payouts from SOEs, market pricing of production inputs, and reduced emphasis on headline GDP growth. Household spending, on the other hand, will get a boost from land reform, liberalization of residence permits, and social welfare reform. Private companies will get more opportunities as a result of financial liberalization and easing of investment restrictions.

Looking even further ahead, should the changes be implemented effectively, the main benefit would be reduction in the risk of a hard landing for the Chinese economy as capital misallocation and widespread overcapacity are reined in. Over the medium to long term, the reforms would enable China to sustain stronger economic growth than the country would absent reform.

China still faces grave economic threats from the problems its leaders sought to address in the Third Plenum. How should investors monitor the effectiveness and pace of reform implementation? Near-term signs that the country's leaders are serious about reform would include an announced GDP target below 7.5%, the appointment of credible senior officials to lead the group tasked with implementation, and the opening of additional sectors to foreign investment inside the Shanghai Free-Trade Zone. Over the next year, investors should also look for meaningful progress on financial liberalization, including a deposit insurance scheme and a cap on deposit rates. The establishment of privately owned banks would be another major step forward; many private firms appear eager to enter the sector. On the fiscal side, replacing a tax on business with an increase in the value-added tax, or VAT, would indicate progress as well.

Over the longer term, the two most significant benchmarks for China's progress will be its approach to currency market intervention and reforms related to SOEs. If the People's Bank of China reduces its intervention in the currency market and allows for a more free-floating exchange rate, that would push China's economy toward full integration with

global markets. Finally, attempts by the Party to break up or reduce the influence of the largest, most powerful SOEs, or a willingness to allow smaller, weaker SOEs to default or fail would represent fundamental changes to the country's economic growth model.

"How 'Unbalanced' is the Chinese Economy? Part III, The Data Overhaul"

Yan Wang, BCA Research, December 4, 2013

China's methodology for reporting its national accounts differs significantly from that typically used by other countries. As Chinese authorities move to reform accounting rules in line with common international practices, the size of the country's reported imbalances could fall substantially.

Concerns about a looming "hard landing" in China have focused on the country's high credit growth and high share of GDP allocated to investment spending as compared to other countries. These cross-country comparisons may be problematic, however, as China's method for reporting national accounts differs significantly from other countries' methods. On the heels of the recent Third Plenum, the deputy chief of China's National Bureau of Statistics acknowledged these discrepancies and announced a planned overhaul of the country's national accounts in line with the UN System of National Accounts (SNA) used by all other major economies. This transition will materially change China's reported economic structure by 2015 and has the potential to dispel widely held perceptions about various "imbalances" in China's economy.

China's use of Soviet-style national income accounting until 1985 continues to have an impact today. In keeping with the methods of the former Eastern Bloc countries, the Chinese system uses a "production approach" to estimate GDP instead of the "expenditure approach" most other countries use. Though both approaches comply with SNA rules, there is no reliable framework for estimating the breakdown of Chinese GDP using the more common expenditure approach. China's legacy system plausibly results in systematic underreporting of the sizes of the service sector, the black/gray market, and household income.

The forms of underreporting unique to China lead to especially understated measurements of household economic activity in at least three ways. First, since domestic households primarily consume the service sector's output, its understated size means that household consumption is also underreported. Second, household income data in China omit important variables—stock and options rewards for employees, rural lease transfers, and unreported income go unrecognized. Third, business activity undertaken by households for their own final use is also understated. A notable example is owner-occupied dwellings. In other countries, owner-occupied housing expenditures are commonly based on comparable market rents. In China, officials use the estimated depreciation of the construction costs of homes, typically a much lower value. This alone means that China's reported GDP figures vastly understate housing expenditure.

The upcoming revision of China's reporting standards will lead to dramatic changes in the measured structure and scale of the Chinese economy. First, the imbalance between consumption and capital spending will be narrowed as household housing expenditures are calculated on an "imputed rent" basis and the government's provision of certain other goods and services to the household sector are reflected in households' final demand. BCA Research estimates that household consumption will be revised from its current level of 37% of GDP to closer to 50%. Second, household income as a share of GDP will increase from its current level of 60% as equity compensation, farmland lease transfers, and unreported income show up in the accounts. Third, service

sector activity will get a bump of 2% of GDP as businesses classified as "industrial" only in China, including the utilities sector, are re-categorized. Finally, and perhaps most dramatically, the accounting changes could cause Chinese GDP to be revised upward by as much as 15%. Over time, the combined impact of these changes will also alter investors' perceptions of China and reduce anxiety over the country's economic outlook. ■