Special Interview

Is the Chinese economy heading for a crash? Or is it getting used to the New Normal?

Interview by Esther Oh, Kim Jiyeon

ZHU NING

Profile

Zhu Ning is a Professor of Finance at Shanghai Advanced Institute of Finance (SAIF), a faculty fellow at the Yale University International Center for Finance, and a Special-Term Professor of Finance at University of California, Davis and at Guanghua School of Management, Peking University.

TIME TO ACCEPT ECONOMIC CYCLES WITH GREATER SINCERITY

What made you decide to write *China's Guaranteed Bubble?* As a Chinese financial professional, it might not be easy for you to provide in-depth but provocative analysis of China's current economic practices and potential dangers.

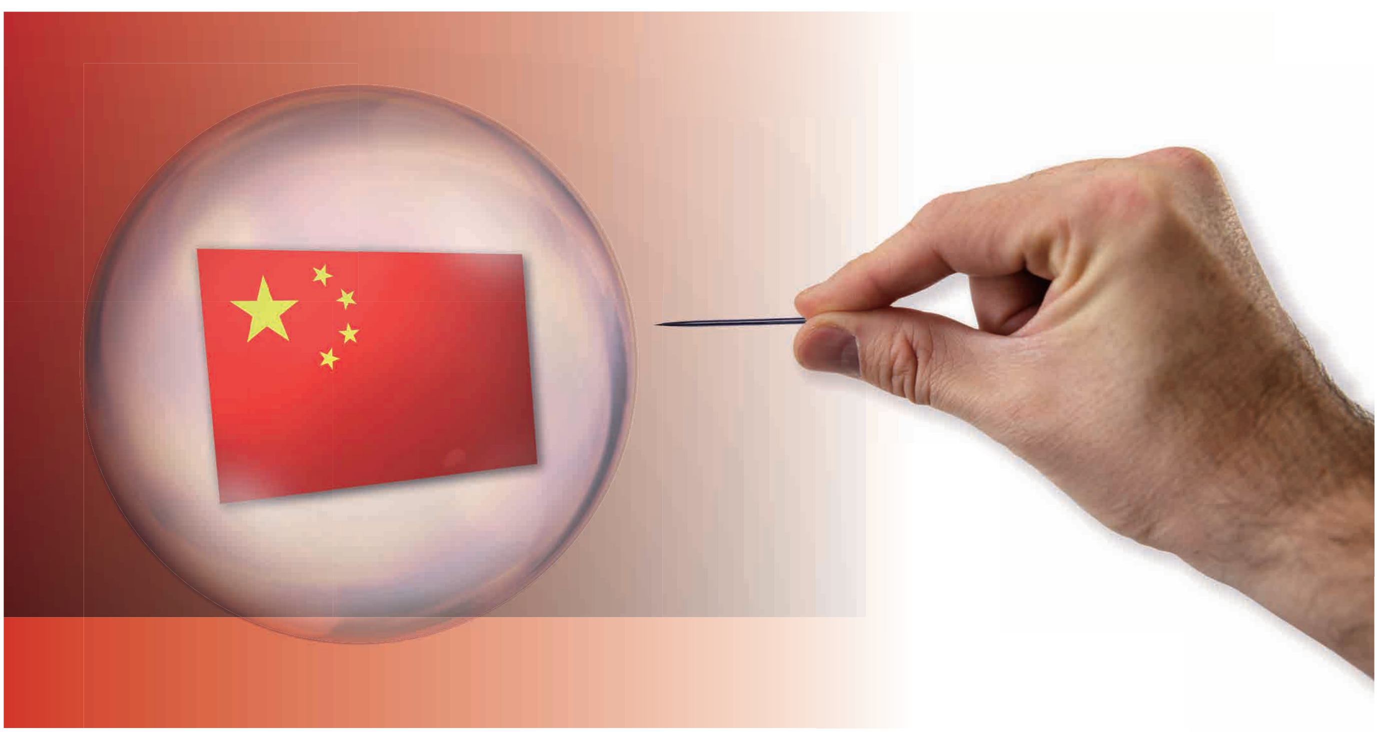
First, I have worked closely with a Nobel laureate, Professor Robert Shiller at Yale University, with whom I have learned an alternative way of looking at the macroeconomy and financial system. The true catalysts are my experiences of visiting the IMF in 2013 and working with the Davos World Economic Forum over the past few years, during which I was surprised to realize how little China's economy and financial markets are being understood by the outside world. In addition, I feel that there was a bubble building when I wrote the book in 2014 and tried to use the book to prevent the bubble escalating into systematic financial risks. It took about a year before the book was finally published, before which Chinese stock market went through its bubble and bust in 2015. Surprisingly, the book was very well received among professionals and government officials.

Your book gave major coverage to the concept of 'implicit guarantees.' Please briefly introduce what implicit guarantees are.

Guarantees are insurance that one party provide to the other in case something unfavorable happens to the other party. Many governments from various countries use different forms of guarantees to boost economic growth or achieve certain policy objectives. Guarantees prove to be particularly important and effective in addressing some "market failure" problems, where the risk of failing is too grand to overcome by simply market force, and government guarantees to share and hedge some risks help make transactions happen and market complete.

Things are a bit different in China in a way that China has gone a long way transitioning from a central planning economy to a market economy. The sheer bulk size of China's state-owned enterprises (SOE) and the opaque nature of many SOE's operation (many still have their own schools, kindergartens, restaurants, and theaters, among many other things), it is often very difficult to separate the enterprise from the state. Therefore, Chinese governments can provide many more guarantees to enterprises when it comes down to sector development and GDP growth.

I listed three main types of guarantees in China: the policy guarantee, the capital guarantee, and the investment guarantee. Policy guarantee means that government use specific policy to provide insurances and incentive for economic growth and investment, such as Mr. Deng Xiaoping's



claim that "to develop is of paramount importance." The capital guarantee means that the government will provide ample capital to ensure economic growth and investment returns (at least nominal returns). China's M2 increased by about 15 fold in the past 15 years, which is unprecedented even among emerging economies. Such fast growth in capital formation will undoubtedly stimulate further investment and speculation, and economic growth. Thirdly, and more evidently in China during the past few years, are the investment guarantees. These include "explicit" and "implicit" impressions that government give about certain investment areas. The housing market, China's corporate bond market, and the stock market in 2015 all experienced this. Investors in the market believe, or understand, that the government will do everything it can to ensure the rise of the market, or at least to prevent the fall of the market. Such guarantees distort the risk-return trade-off in many finance and economic areas of China.

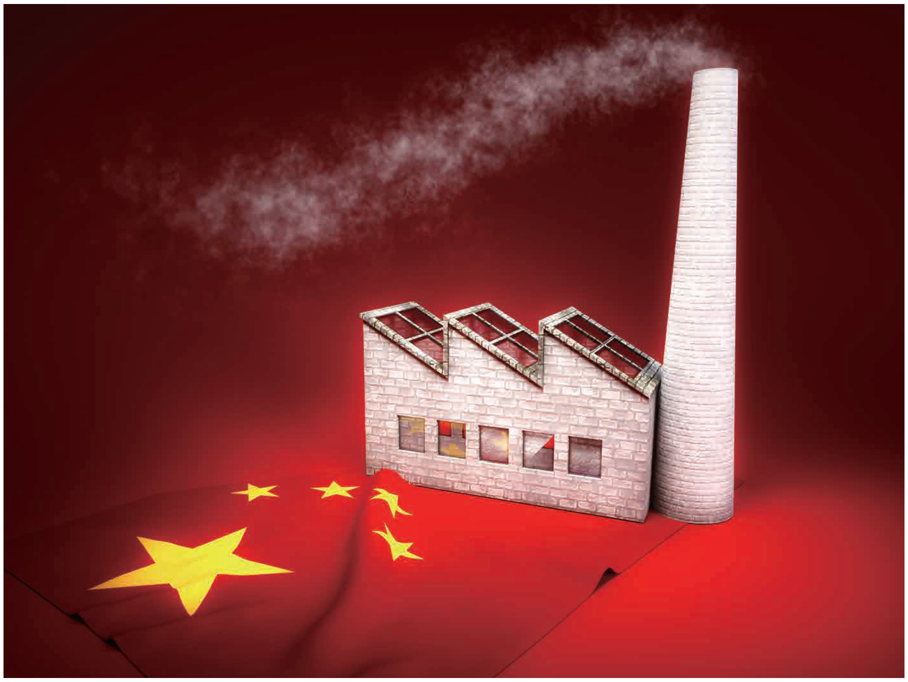
The over-capacity problem, increasing debt problem, and deteriorating earning abilities all somewhat reflect the seriousness of the distortion in China's economy nowadays.

You pointed out the implicit bubbles adopted by the Chinese government as one of the fundamental causes of many challenges that China is facing today. However, had the government not intervened, and switched to a free market economy from the beginning, would China have accomplished the remarkable economic growth it has shown in the last 30 years? Some argue that South Asian countries such as Thailand and Indonesia have gone through free market failure, losing their chances to grow because they adopted free economy too early.

Indeed, I have discussed in many parts of the world how important such guarantees have been to China's economic growth miracle during the past three decades. There is no doubt about it. We have witnessed many failed attempts when countries try to transition from a planning economies to a more market-oriented economy. This process is certainly not easy and some countries have managed the transition better than others. For example, Korea is considered one of the more successful examples of the transition. What I try to highlight in the book, nevertheless, is that such changes have to happen at a certain point and China is probably very close to that point if not already past it. The over-capacity problem, increasing debt problem, and deteriorating earning abilities all somewhat reflect the seriousness of the distortion in China's economy nowadays.

You worried that the latest financial innovations and channels such as online MMF and P2P loans can be used to circumvent regulations and trigger unprecedented risks. However, the financial landscape is changing and the financial environment is producing financial innovations. Wouldn't the financial innovation provide China with another chance to grow in the future?

Financial innovations are always a double-edged sword. Innovations such as MMF and P2P are certainly welcome in China, especially given the serious financial repression and distortion that I have mentioned earlier. However, what worries me is that many innovations that should be clearly classified under "shadow banking" and receive some regulatory attention, indeed grew with little regulatory purview. This explains why almost half of the P2P lending platforms vanished since late 2014. Even though the amount may not be large enough to worry the regulators, many



households have been negatively impacted and it casts a shadow on future development of truly healthy financial innovations. The efficacy of the so-called internet financing remains to be seen. Many of the so-called internet financing plans are actually traditional financing under the disguise of internet cover. With such cover and government support, these originally risky and traditional banking business turn into "safe" and "attractive" investment opportunities among investors. The extremely loose monetary policy and rising property prices are now covering up all risks and problems. However, when the tide goes out, we will get to see who has been swimming naked.

Like you mentioned, the enormous impact of the implicit guarantees will be gone someday. If possible, China has to prepare the transition from traditional growth models and find the path to sustainable growth. Can you suggest potential remedies to return China to the path of long-term sustainable growth?

China probably needs do the following three major reforms.

1. Financial reforms. The interest rates in China are heavily regulated, even after the removal of the official savings rate cap in 2015. SOEs receive far greater and cheaper financing than private enterprises, but generate far lower returns.

Stock market listing requirements keep many good companies off the stock market. Lack of investment and financing channel caused many to speculate in whichever areas that can generate sizable returns (art, ancient furniture, jade and gemstones, tea, and of course, real estate). China has to build more "direct financing" channels, where investors and borrowers meet.

2. SOE reforms. China's SOE reform is a key ingredient and challenge of China's economic transition. SOEs are not merely enterprises, they are supplements to China's governments, especially at the subnational level.

So reforming SOEs will be closely related to financial reforms, and also touch the sensitive subject of employment. Part of the social resources allocated to the SOEs play the role of providing stable and in some cases lucrative employment opportunities to those who are connected to the government and SOEs. This is of course not a very efficient way of allocating resources and has to be reformed.

3. Fiscal and taxation reform. Some argue that the current fiscal system based on the 1994 taxation split reform under premier Zhu Rongji is responsible for local governments' incentive to sell off land at high prices and unwillingness to curb housing prices. How to better align the interests and responsibilities of central and local government, provide the right incentive to encourage entrepreneurship and human capital investment, improve the efficiency and disclosure of fiscal expenditures, and discourage financial and property market speculation, should all be on the agenda of next stage reform.

You suggested, as a solution, the removal of guarantees the government provides to the economy. Specifically what kind of actions can be taken for much-needed reform? The Chinese government may not be willing to risk the fallout from the removal of its implicit guarantees.

Related to the policy, capital, and investment guarantees, I recommend the following.

Regarding policy guarantees, I think the central party leaders have to send clearer signals for the next stage's goal. China Communist Party has been using GDP growth as the primary goal in evaluating and promoting its cadres. It is this GDP growth tournament mentality that gets China into many of its current challenges. So the new leadership has to come up with a new set of evaluation criteria with which the officials will be evaluated against in the new norm. Maximum growth speed should really be removed for many parts of the country by now.

Regarding the capital guarantees, China's monetary supply and total social financing (TSF) has increased too fast for too long, leading to quickly decreasing efficacy of further monetary easing. And the housing market and stock market has been playing the role of additional monetary supply. Asset bubbles and inflations have been giving way to economic growth speed in China's monetary policy decision process, which would eventually lead to a bubble. After all, bubbles are a monetary phenomenon where too much capital chases too little investment-worthy assets.

Regarding the investment guarantees, governments should play the role of a gate keeper, instead of an active player, in most markets. The CSRC is under the impression that it is responsible for shoring up the stock market and the ministry of housing and construction is under the impression that it is responsible for boosting the housing sector. Too active intervention by the governments will not only disrupt the market's expectation, but create further distortion. Therefore, the government should really have to become more tolerant in the face of losing investors. After all, investors have to learn to make their own judgments and face the consequences of their own decisions. Failures may probably be the most effective way — if not the only way — to teach investors to be careful with their investment decisions and respectful of the market.

The Communist Party of China has acknowledged the market's decisive role in allocating at the 18th central committee, and China is also attempting to reform its bloated state-owned enterprises. Can this be a positive sign implying that government's implicit guarantees are gradually being phased out? Are there any positive signals we can find regarding the removal of implicit guarantees?

Yes, all that has been advocated in the 18th central committee meeting of the China Communist Party is very encouraging. It is the speed of implementation, and sometimes the direction of policy implementation, that make one anxious.

The development of China's corporate bond market, the development of ABS and MBC market, the failure of some P2P and internet financing platform, the default of some corporate bonds issued by SOEs, are all welcome signs that China is trying to gradually taper off its implicit guarantee, under the condition of not rattling the market and ensuring systematic stability. If one were to assume that the total risks remain largely steady, then letting certain local debt default and certain local markets to fall not only send the right signal that China's government will gradually taper off its guarantees, but also help let out some steam off the rising bubble. I would like to see how recent default events pan out and whether some investors really have to learn their lessons with suffering losses. It will not be pleasant or rosy. However, failures may be the only possible way for the whole society to learn to be respectful of risks and take restraints.

Failures may be the only possible way for the whole society to learn to be respectful of risks and take restraints.

The government's guarantee problem does not seem unique to China. Leaders from major economies keep planning to use active fiscal policies to boost economic growth (such as Japan's massive 2016 stimulus package or G-20 Central Bank Governors and Finance Minister Summit meeting last February). What is your opinion on this global trend?

One chapter of the book focused on delineating the guarantees provided by many other countries, in particular developed ones. The recent G-20 meetings have focused primarily on how to put global growth back on track. Before we answer the question of how to reboot the global economy, I feel it is critical that we review how we got here.

The excessive loose monetary policy in reaction to the 1987 stock market crash, 1998-2000 Southeast Asia financial crisis and internet bubble, the 2007-2008 global financial crisis, have probably already pushed traditional and even non-traditional monetary policy to its limit. The long-term growth problem that we are facing now are indeed consequences of various governments' attempts to avoid short-term recession and iron out the wrinkles in economy cycles.

If agree on this assessment, then I think it is about time that government leaders accept economic cycles with greater sincerity, instead of trying more extreme stimulus packages which could result in even greater challenges and risks in the future. Instead of trying to bring the economic growth speed back to their historical average, I think the leaders have to do some serious and difficult soul searching about their own country's politics, about engaging in domestic reforms that would improve quality of life and satisfaction domestically, and improve collaboration internationally. It probably will take some time to get used to, but the "new norm" pretty much means that the global growth will probably get stuck in a medium to low speed for a very long time ahead.