Macro Update: Key Policy Points from PM Li's NPC Press Event

PRC Macro

New Signals, Omissions and Open Questions

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This morning Beijing time (3/15) PM Li held his annual press conference to conclude the NPC. The first impression from watching PM Li's presser was that he did not come across like someone who was about to be purged from the premiership any time soon. There have been plenty of rumors about his pending demotion, as well as speculation over health problems that might force him into a lower office, but he looked much better this year than last. Although in general Li is considered to be one of the worst PMs where it comes to making big public speeches, he handled the press conference today quite well. In this short note we summarize Li's important policy messages, and note some important omissions.

Eight Takeaways, in No Particular Order

Li's major points are bolded below, followed by our interpretation.

1. Beijing will work hard to cut taxes and fees by up to RMB 1 trillion or more.

This is a marked increase over the RMB 550 billion cited in his government work report, implying that there is room for reductions to payroll taxes, and potentially a temporary VAT reduction. This would increase the official deficit by ~70 basis points over the 3% ceiling.

2. Beijing will create a "bond market connect" program with Hong Kong.

Beijing has been pressing hard to get Chinese bonds in major indexes, and would like to see more portfolio inflows to replenish reserves, and to give the government more leeway where it comes to other reforms, like allowing FIE profit repatriation and experiments with limited capital account convertibility in FTZs. A question domestic investors have been asking is which bond market will Beijing will open for the "bond connect" program. There are two bond markets in China, the exchange market and interbank market. The former is regulated by CSRC and reserved for NBFs and retail investors, and the latter is only open to commercial banks and large state-owned brokers. The interbank bond market accounts for roughly 80% of onshore bond trading, and more importantly commercial bank bonds, CGBs and policy bank bonds can be only issued and traded in the interbank market. In contrast, corporate bonds and some local government bonds are traded on the exchange market. Initially, we thought the bond connect referred just to the exchange market, because the "stock connect" programs are coordinated between CSRC and HKEX. But, the latest news suggests that Beijing may open both the interbank and exchange bond markets: just after PM Li's press conference the PBOC website posted a note indicating PBOC officials have been actively working with HK counterparts to facilitate such a program. This would be bullish for the prospective scope of bond market opening. However, there are still plenty of details for the PBOC to clarify, such as possible tax exemptions, cross-border settlement, daily quotas, new hedging tools and how to handle cross-border defaults. Domestic investors could see this as a way to hedge RMB risks, and if so, could be dominated by southbound flows.

3. China's FX reserves are adequate; China will maintain the stability of the RMB exchange rate within a reasonable range, does not hope to boost exports via depreciation, and does not want to get into trade wars.

This is a positive signal where it comes to efforts to manage China's relationships with the US and Europe in that there may be room for voluntary restraints on exports to make targeted reductions to surpluses. Given concerns over employment, there is only so much Beijing can do here, but it may make some token gestures. Where it comes to the exchange rate, we think that China will be more assertive this year where it comes to pushing the SDR, and this was implied in new language about the RMB's contribution to global currency stability in PM Li's earlier work report. Where it comes to managing the demands of the Trump administration, and a weak yen and won, China will likely try to leverage the US relationship to divide and conquer others, and try to strengthen currencies that have been lowered aggressively against the dollar.

4. The Chinese economy will not experience a hard landing, and can maintain stable long-term growth at a moderately high level.

This echoes the Lin Yifu perspective on the economy, which advocates strong investment in the supply side and is rooted in a very optimistic view of prospective productivity gains. This underpins PM Li's "Made in China 2025" agenda as well as broader goals to become a true manufacturing power. We see this as positive for R&D/innovation related spending, and corporate capex in industries associated with these programs and as mentioned above. Beijing will likely become more aggressive with corporate tax cuts as part of evolving competition with the US to retain manufacturing jobs.

Also, it is interesting to point out an apparent conflict between this year's lower growth target and a higher job creation target. The job creation target in 2016 was 10 million while the economy grew at 6.7% YoY, whereas after dialing back the growth target to 6.5% YoY this year Beijing set a job creation target of 11 million. In our view, this contradiction may suggest that Beijing may become more serious where it comes to corporate deleveraging and capacity cuts (including shuttering "zombie companies"), and wants to see an extra million jobs as a social buffer.

5. The financial system is safe overall, and systemic risk events will not occur.

In other words, greater stability comes ahead of stronger efforts at deleveraging, and PBOC policy will be forthcoming accordingly. Also, PM Li mentioned that he will use a targeted approach to containing financial contagion effects, which, in our view, suggests future risk events will be addressed on case-on-case basis. He further stressed a limited tolerance for SOE bond defaults and many domestic bond investors interpret this as a signal that Beijing will not accept LGFV and central SOE bond defaults.

Here we think it is important to watch the PBOC and commercial balance sheet data closely, as the PBOC has probably been doing a lot more than it has announced in terms of official new policy frameworks. Two important measures are the level of reserve deposits with the PBOC compared to headline RRR policy levels, and the gap between total PBOC claims on banks and the sum of relending facility balances and OMO. In addition, we want to stress that this is still a year for Beijing to maintain reflationary pressure in the economy, although the need has become less urgent.

Capacity cuts have never meant deep cuts to output, but are rather a way to consolidate production in upstream industries in the hands of a select few SOEs, and in doing so strengthen their price setting power (aka cartels in some jurisdictions). A big part of this is financial, as in many cases banks have to figure out what to do with underlying bad loans before the firms in question can write off the assets.

The scheme has been considered a success by policy makers in that they will expand the program to other sectors, such as cement and aluminum. For Chinese policy makers, they are fully appreciative of the fact that SOE deleveraging and debt restructuring (such as debt-equity swaps and arranged enterprise marriages) can be only achieved in a reflationary environment and we expect they would move relatively faster to capitalize on the reflationary trend this year.

Related to capacity consolidation in upstream industries is the puzzle over why ripping PPI has not passed through to CPI. One explanation we found interesting is that since PPI reflation has mostly taken place in upstream sectors often controlled by SOEs and slated for "supply side reforms", survivors in these sectors now have more pricing power. However, downstream consumer product oriented manufacturing and services sectors are comparatively more competitive and often dominated by private businesses. Therefore, the burden of price increases in upstream industries has been shifted to downstream private businesses who – in the absence of price collusion (which has been tried in paper and certain electronics sectors) – cannot raise prices due to competitive pressures. We think it is a generalization, but not a stretch, to propose that Beijing is subsidizing SOE margins with private sector profits.

6. This year Beijing's priority is employment growth first, and the central government has adequate tools to spur employment and large scale unemployment will not occur.

This could lead to pro-employment incentives, which have been used in the past to absorb new graduates and displaced workers back into the labor force. This includes encouraging college start-ups and social funds to support service sector innovation and job creation. This could also signal payroll tax cuts (probably modest, at 1 percentage point), and should be accompanied by token central and regional government funds and subsidies to assist workers displaced by consolidation and shuttering "zombie" firms. This seems to beg the question of whether the jobs growth target is really all about employment. In part, employment growth can be taken as a proxy for nominal income flows, and thus the only way for the regime to escape the gravity of the current debt overhang.

7. Where it comes to concerns over China's 70-year leases on and underpinning the property market, they can be extended easily, and concerned ministries are working on making sure that this will not affect property values.

Two things stand out here: first is that this is not the kind of commitment that a standing PM should make for procedural or legal reasons. An extension of property rights can be only proposed and approved by the NPC (after approval from the Poltiburo Standing Committee). We think the reason Li made this comment in such a hasty manner (normally he would not make such a mistake because one of Xi's signature campaigns has been the rule of law) is because he wants to ensure that the average household feels safe about the future value of its property.

A second observation is that policy makers throughout this NPC season have been intentionally avoiding questions regarding containing price increases in housing markets. For instance, PM Li did not answer questions about price increases and purchase restrictions, and PBOC governor Zhou Xiaochuan even hinted that the share of mortgages to total bank loans still has a lot of room to increase. We interpret such avoidance as tacit support for property prices this year.

8. The US and China are engaging in high-level dialogue and are working to reduce tensions on the Korean peninsula, and China is committed to a non-nuclear Korean peninsula.

Li confirmed again that Xi and Trump will likely meet soon, probably in April. Potential issues on the agenda will likely include: 1) a renewal of existing bilateral dialogues and diplomatic channels; 2) ensuring that Trump taked the "one China" pledge in exchange for concessions on FX and trade policy, a "deal" clouded by rumors of new arms sales agreement(s) with Taiwan; 3) China may agree to strengthen its economic sanctions on North Korea, mostly likely in exchange for delays to US missile defense initiatives in Asia. Here, however, China has largely failed, and it is unclear what else Beijing can or will do.