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China Sets About Fixing What Ain't Broke ….

Nothing defines humans better than their willingness to do irrational things in the pursuit of phenomenally unlikely payoffs. This is the principle behind lotteries, dating, and religion.

– Scott Adams

SUMMARY

… while absolutely ignoring its headlong rush into disaster.

INVESTMENT IMPLICATIONS

Industrial overcapacity is not a serious problem in China today. The massive leverage bubble in the non-industrial economy is. But once again, this year's government work report focuses on the former and pretends the latter doesn't exist.

Supply side? Yeah, right

If you follow China closely, you have already read at least a few summaries of Premier Li Keqiang's annual work report to the National People's Congress – the report that, more than any other official communication, lays out the formal economic policy framework for the coming year.

As a reminder, the main takeaways from this year's report can be summarized in a nutshell:

- China will not resort to wild demand stimulus; rather, it will keep monetary and fiscal policy moderate.
- The main focus, instead, will be structural "supply-side" reform to support and revive the economy.

This all sounds both comforting and reasonable, music to the ears of macro analysts who have been calling for this kind of policy mix for a long while.

Too bad it's not true.

The first point is just wrong, as credit continues to pour into the economy in massive, unsustainable amounts.

And as for the second, the sad truth is that the main line of "supply-side" policy – i.e., fighting industrial overcapacity – is little more than a diverting side show that draws attention from the economy's true problems.

The overcapacity question

Let's start with that last statement. Everybody knows that China's old-school industrial economy is mired in losses as a result of years of reckless investment and capacity expansion, and that the only way to restore profitability and revive the current growth malaise is through a severe culling of redundant factories, mines and jobs – similar to what Premier Zhu Rongji achieved in the late 1990s when he famously shut down tens of thousands of loss-making firms and sent nearly 30 million workers home, setting the stage for China's dramatic economic resurgence in the 2000s.

So if the government can really attack the problems in the biggest "zombie" sectors such as steel, cement, coal and shipbuilding, this would have a far greater positive impact than just endlessly pumping credit through the system.

Right?

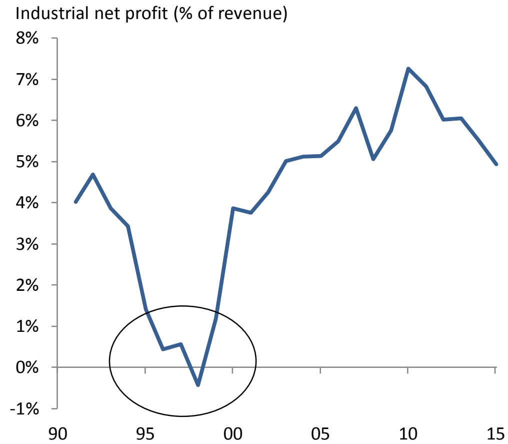
Too small to matter. Ahem … no.

The problem is that at the macro level, those industrial zombies are too small to matter much.

To see why, look no further than Chart 1, showing the path of net profit margins in China's industrial economy over the past 25 years. If you concentrate on the circled portion of the chart you can see what Zhu Rongji was up against two decades ago: a complete and utter collapse of the industrial system, to the point where aggregate profits had disappeared altogether.

Now <u>that</u> was overcapacity.

Chart 1. Industrial profit margins



What, by contrast, do we have today? Today we have an industrial sector that *remains more profitable than it was in 2000-10 on average.*

This can't be right? What about those giant "zombies"?

Oh, they're in the industrial data all right.

It's just that they're not that giant. Keeping in mind that China's economy is now almost the size of the US, and that its industrial statistics alone cover close to half a million firms in 175 broad sectors, let's ask ourselves a question:

How many of those 175 sectors actually report a net loss?

The answer, as of the latest 2015 data, is a paltry nine: heat production, coal mining, ferrous and non-ferrous smelting, steel pressing, iron- and steelmaking, coking and pulp.

Ok, but that's only for outright losses. What about a broader definition of industrial excess capacity, i.e., sectors where profits have almost disappeared – say, with net profit margins that are now under 2%?

This adds another six or seven: petroleum products and other ancillary activity, glass, cement, synthetic materials, chemical fertilizer and sugar.

Now we're up to around 15 … out of 175. And while some of these sectors are not tiny, they're still a relatively small part of overall industrial activity. Outright loss-makers are only 9% of total sales and employment, and if adding in the low-margin "at risk" group simply brings the shares up another 5pp or so (see Charts 2 and 3).

Chart 2. Loss-making firms (share of sales)

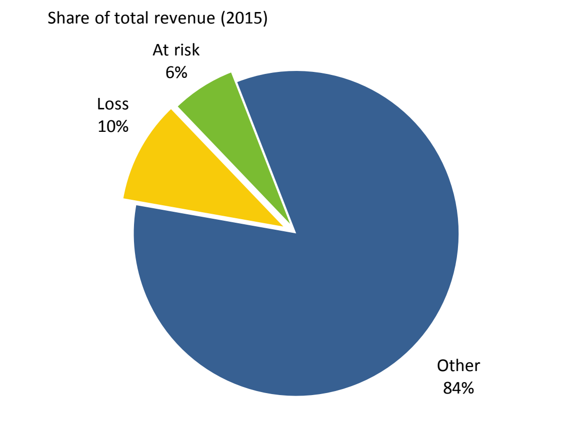
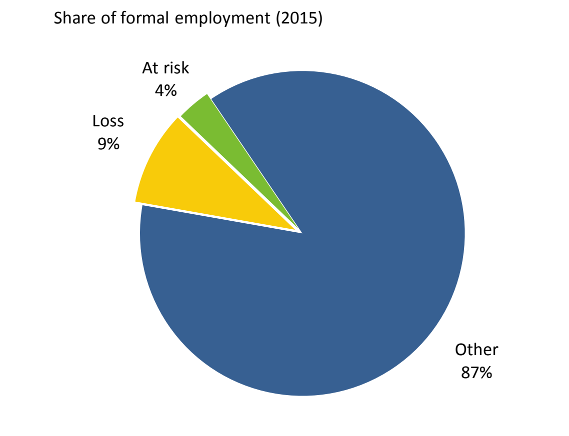


Chart 3. Loss-making firms (share of employment)



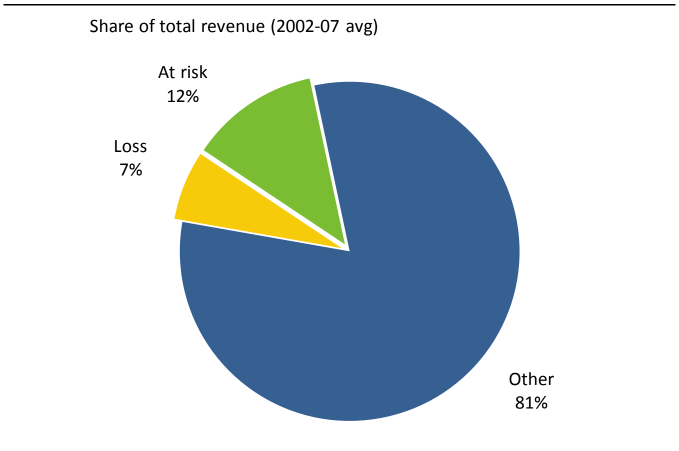
To put these figures in perspective, "ruthlessly" shutting down 20% of outstanding capacity in coal, steel and other loss-making sectors today would mean around 1.7 million jobs … or 0.2% of the labor force. And pushing all of these sectors back into profit would raise aggregate industrial margins in Chart 1 above by … perhaps 0.3pp.

This is not exactly epic. Indeed, it's barely a macro issue at all.

No different from anyone else. Nor, we should add, do China's numbers look very unusual by international standards.

Just to cite our favorite example, take US listed corporate sector – we use NYSE-listed firms – and to avoid claims of data bias we focus on corporate results from the pre-crisis boom years 2002-07. Now, of the total sample reporting figures for that period what was the share of chronic loss-makers, i.e., firms that ran outright net losses in at least three of the six years in question?

Chart 4. US loss-making firms



The answer, as shown in Chart 4 above, is 7% by revenue – nearly the same as in China. And if we add in low-margin "at risk" firms using the same 2% net margin threshold this captures another 12% of the sample, an even greater share than in the mainland.

Broadly similar results hold for European listed firms, and for key neighboring emerging markets as well.

The point here is simple: There's nothing scary or even unusual about having 10% of your corporate economy run losses. This is pretty par for the course.

It's not about the data. What about the quality of the Chinese data? Couldn't it be that the authorities are wildly understating the true state of the industrial economy by cynically misreporting the profit statistics?

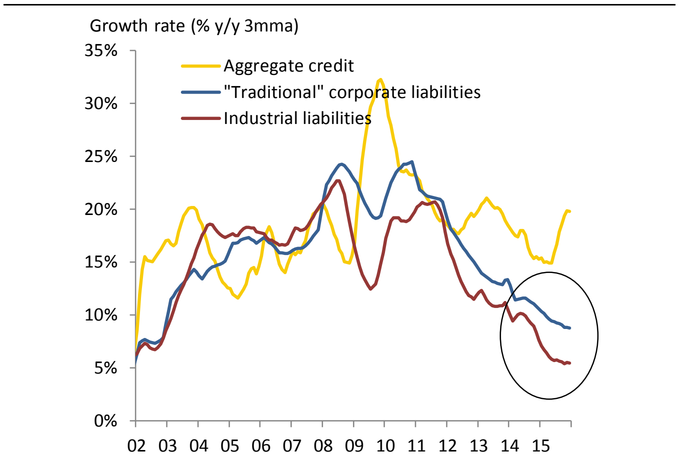
Not as best as we can tell. If you add up the bottom-up figures from all Chinese non-financial listed firms, for example (as we do in the *EM Corporate Chartbook*), you get pretty much the same net margin chart as in Chart 1 above (see the latest *Chartbook* release for further details). There's no big discrepancy here.

It's not about cash flow debt. Ok, but this is only because industrial firms are now borrowing like mad, taking on massive amounts of new debt to prop up cash flow and then "showing" this cash as profit, no?

No. *In fact, industrial enterprises aren't borrowing much at all*.

We've published this chart twice already in the past month, but we simply can't show it enough. The yellow line in Chart 5 below is the growth rate of our broad domestic credit aggregate, and the red line is the growth of total liabilities in the industrial sector:

Chart 5. Who's doing the borrowing?



You see our point. It's *<u>not</u>* industrial firms doing the borrowing.

Summing up. Summing up thus far, it sounds great that the government is turning its attention to industrial restructuring.

But as macroeconomists, we have a hard time caring about this issue one way or the other.

Credit madness

This is all the more true if it diverts attention from the *real* problem in the economy, i.e., the ongoing credit insanity.

We've published the following charts so many times we've lost count, so just the bare bones here: (i) a tremendous increase in new credit flows to the economy over the past few quarters (Chart 6), (ii) a spiraling overall debt/GDP ratio, now *100 percentage points* higher than in 2008 and rising faster than during the 2009 stimulus round (Chart 7), and (iii) as before, borrowing heavily concentrated in policy-driven areas *outside* of the "old-school" corporate sector: infrastructure, local governments and related entities, property, etc.

Chart 6. New flow credit/GDP

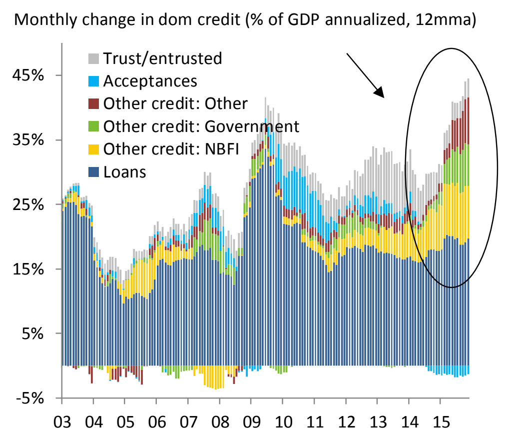
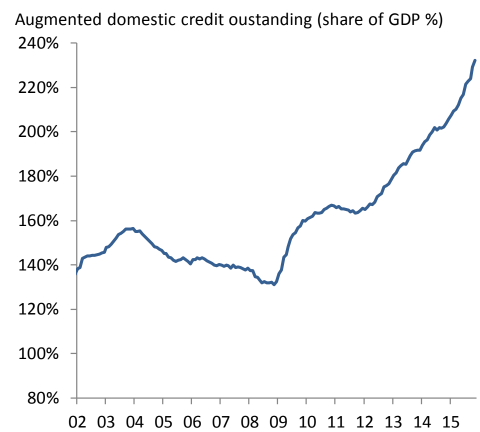


Chart 7. Overall credit/GDP ratio



And at this point, we should add, a leverage boom that is now very obviously heading toward eventual crisis (see our *4 January 2016* report for a more detailed discussion of the likely mechanisms and triggers here).

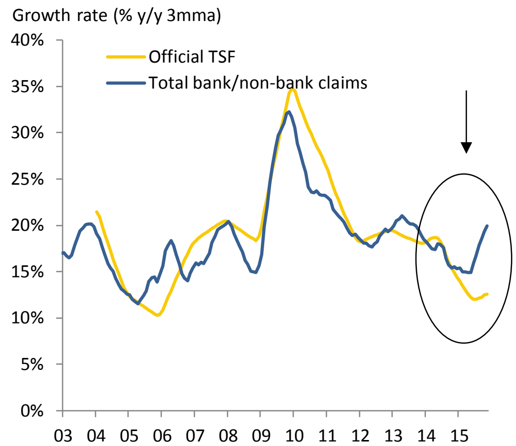
So when the monetary policy stance is described as "moderate" and "prudent" – well, that's just light years from reality.

There are three reactions in particular to the NPC speech from our side:

1. An aggregate "social finance" growth target of 13% y/y might have been very reasonable five years ago when nominal GDP was also expanding at a mid-teen pace – but in today's environment, when nominal growth has fallen to 6% and the outstanding credit base has already exploded, keeping the same target is now hugely expansionary.

2. That's not nearly all. As regular readers know, over the past 18 months our own best estimate for true credit growth in the economy (i.e., augmented domestic claims, see *30 January 2016* for further details) has delinked sharply from the government's official total social finance measure, as more and more activity is now occurring in areas not covered by TSF. This broader aggregate is already growing more than 20% y/y (see Chart 8) – so when the government talks about maintaining 13% TSF growth, under current conditions it's really talking about overall credit growth *three times faster than underlying economic activity*.

Chart 8. Augmented claims vs. TSF



3. And finally, as we noted last week, the government may have disappointed some investors by not committing to a higher formal budget deficit target – but keep in mind that given the highly quasi-fiscal nature of the credit expansion, the true public sector deficit today is *easily higher than 10% of GDP*.

Any way you look at it, the broadest monetary/fiscal policy in China is already set to "wild maximum".

The true "Zhu Rongji moment"

If you would, allow us a quick concluding moment to tie these two discussions – on industrial overcapacity and credit policy respectively – together.

Readers who were around in China in the early 1990s (I think there may be four or five us of left …) will recall that the collapse of corporate margins shown in Chart 1 above did not occur in a vacuum. Rather, it happened only after Premier Zhu effectively shut off the credit taps "cold turkey" in 1994, bringing both money growth and domestic activity to a wrenching halt, whereupon profits duly disappeared.

I.e., the Chinese economy might not have a big overcapacity problem just yet – but on a "credit-adjusted" basis doesn't China nonetheless have a truly massive "latent" capacity and profitability issue, one that would become immediately apparent once deleveraging hits?

Sure. We have no problem with this argument. If China does go into a banking crisis and a sharp recession, there's little doubt that the profit picture will look very considerably worse than it does now.

But this is exactly the point. *You don't get the profit collapse until after you stop the credit bubble*.

And if a 1994-era Zhu Rongji were running the economy today, he would almost certainly not waste time trying to shut down a few coal mines while pumping ever-more-massive amounts of leverage into the system. Rather, his first act would be to turn off the monetary printing presses, letting the chips fall where they may … and only then set about cleaning up the resulting mess.

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This is what we've been waiting for years to see from the current government. But that, of course, would require not only lowering the official growth target below 6.5% but rather abandoning hope of achieving a growth target at all. Which, we now agree, is just not going to happen.

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