

## the monthly dragon # 12

April 1, 2016

### Putting a higher priority on growth, rather than reforms – an understandable but dangerous policy

2016 started with softness in many economic indicators (e.g. labor market, retail sales and exports). The soft numbers do not point to a precipitous decline of the economy, but are lower than during the last several years. The March PMIs, on the other hand, are an early sign that the government stimuli are working and that the economy has been stabilized.

Lower economic growth at this stage of China's development would probably be a good thing. But the

National People's Congress prioritized growth over reforms, with official growth targets only reachable if the economy remains credit-driven. There is an abundance of liquidity, from private and government sources, in China's economy, which forcefully supports the most important economic sector: real estate. But this may lead to a further debt build-up. While China's debt is not one of the country's big problems today, it may become so if the debt increase continues.

#### HIGHLIGHTS

- ▶ **GDP:** 2016 growth expected at around 6%
- ▶ **Signs of softness in the labor market**
- ▶ **PMI:** at 50.2 in March, the best reading since November 2014 and above expectations
- ▶ **Interest rates:** expect one more rate cut of 25 bps in 2016, after the six cuts since November 2014
- ▶ **RMB:** further gradual weakness vs. the USD likely; the new trade-weighted index for the RMB, introduced by the PBoC, will become more visible
- ▶ **Equities:** cheap H-shares
- ▶ **Overall:** no meltdown, signs of economic stabilization, but the slowdown continues

#### Five-year plan 2016–2020: no major surprises

The official five-year plan for 2016–2020 has been ratified, with many quantitative objectives. There are no major surprises or changes to the outline published in October 2015. The main objectives are **further urbanization** (with a goal of 60% in 2020 vs. 56.1% in 2015, meaning approx. 11 million people moving from a rural to an urban environment – per year), **better social services** for the most disadvantaged people of China's society and a focus on **education and human capital development**.

Apart from some implementation specifications (e.g. the new strategic board on the Shanghai stock exchange, envisioned to allow high-tech companies to list without profitability, is not mentioned verbatim anymore and can thus be considered to have been relegated to the back burner), the **focal points of the plan include the following groups of topics:**

- ▶ economics and finance (7 of 32 focal points deal with these topics),
- ▶ the environment (6),
- ▶ the social and pension system (5),
- ▶ the education system (4),
- ▶ the healthcare system (4), and
- ▶ the legal system, agriculture, the military and online media each are the topic of one to two focal points.

If the five-year plan is implemented as drafted, China will take a turn for the better and the economy's long-term basis will become more solid. Shorter-term, however, changes and reforms always bring with them the danger of minor disruptions, which may be felt in the economy. This is why none of the targeted reforms will be implemented in one big step. The **implementation process is always gradual**, starts out with a trial in a clearly limited experimental zone, followed by analysis of the trial, adaptations to the reform process and, ultimately, step-by-step implementation nationwide.

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**Signs of economic stabilization in a downtrend**

Several economic figures have exhibited softness at the beginning of 2016. One area is the all-important labor market, which has experienced a drop in demand in 2015 and early 2016 not seen in the years before (see chart #1). In addition, labor demand in both the construction and manufacturing sectors experienced wild swings, a problem by itself. Another area of softness can be seen in the purchasing managers' data of the last years (see chart #2). Both the National Bureau of Statistics' official PMI (focusing on larger companies, many of them state-controlled) and the Caixin/Markit PMI (surveying smaller and mid-size companies) have trended downward in the last 18 months. Surveys of export-oriented companies in March also reflect a subdued outlook. Retail sales continue to grow, but at rates below the ones seen in previous years. **Consumer confidence has not been affected too much yet**, although it is below the levels of the past few years. Most data are pointing to a further slowdown of China's economy, but not to a collapse of economic activity. March PMI data were higher than expected, a **first sign of the targeted, stimulus-driven stabilization** of the economy.

**Abundant liquidity available**

Official figures and anecdotal observations show that a lot of money is available in the Chinese economy, from the government but also from private sources. The growth rates of the liquidity available have come down from the insane levels right after the global financial crisis. Chart #3 shows the growth of «Total Social Financing (TSF)» over the last decade. TSF is a money-added concept, indicating total funds the real economy obtained from the financial system over a certain period of time. It sums up total fundraising by Chinese non-state entities, including individuals and non-financial cor-

porates. It excludes proceeds from government bonds.

If all this liquidity were used sensibly, it could help the stabilization of the economy and finance a lot of economically beneficial infrastructure. In reality, a lot of it will be used to fund questionable projects, and extend and pay interest on loans outstanding to companies with marginal chances of success. In any case, **the money flow into real estate remains assured.**

**A slowdown of China's economy would only be natural**

A slowdown of the economy is normal at China's stage of development, since China has a **stagnating labor force, severe overcapacities in some sectors and much increased labor costs** compared to 10 or 15 years ago. So the name of the game now should be the process of **upgrading the economy**, through various reforms. Therefore, a slowdown in growth would not be a reason to worry – except for the government's reaction to a slowing economy. **The self-imposed goal of doubling the size of China's GDP from 2010 to 2020** put Beijing in a bind. This led to the announcement of a GDP growth target of between 6.5% and 7% for 2016. Similar goals may be announced for the coming years, because arithmetically the goal of doubling GDP can only be reached with approximately such growth rates year after year.

And herein lies the problem. To reach such growth rates, two things may be necessary: keeping the various stimuli up, through providing liquidity and increasing debt on the one side, and by NOT tackling some of the overcapacity issues in industries like steel, coal, cement and glass too forcefully – despite rhetoric to the contrary. Our quarterlydragon #4 («**Deleveraging? 明天 ming tian, tomorrow!**») deals with the topic of China's debt in detail.

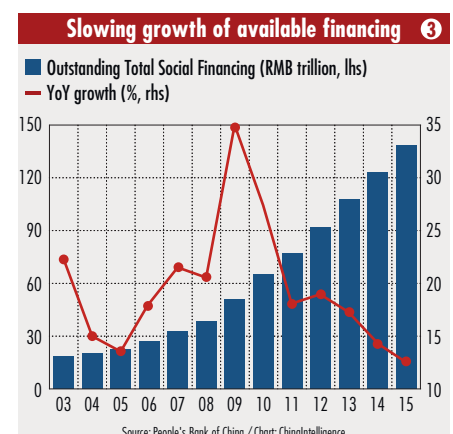
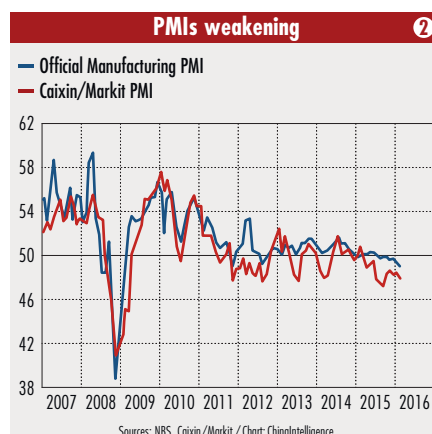
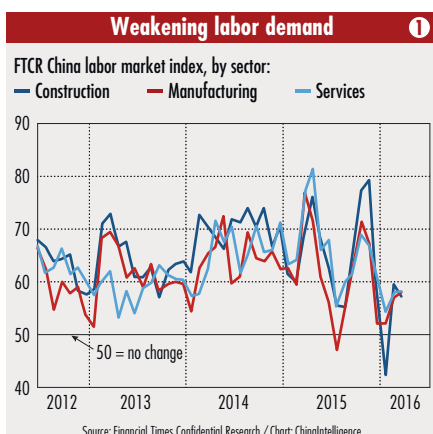
Emphasizing economic growth stimuli more than reforms is tempting, of course. In

addition, the market forces in many areas of China's economy are strong by themselves, the consumer, e-commerce and healthcare sectors are expanding rapidly. But stressing short-term economic growth may also mean that reforms are tackled too timidly, keep the costs of inefficient resource allocation higher and longer than necessary. «**Growth-compatible reforms**» may be the result, which are not what China needs in some sectors of the economy.

**Reduction of grotesque overcapacities**

Indications were that the government finally was ready to bite the bullet on starting to reduce some of the industrial overcapacities. **The reform of state-owned enterprises (SOEs) climbed the central government's agenda again in 2015.** As an example of intended implementations, the provincial governor of Hebei announced that 240 of the 400 steel producers in this Northern province would be shut down by 2020. Since Hebei produces about one quarter of all of China's steel, this could be significant. Similar cuts to production were announced for cement, coal and glass. The result would be the loss of tens of billions of US-Dollar equivalents of revenues in the province and the loss of more than one million jobs. Needless to say, that large amounts of outstanding loans to the producing companies to be shut would have to be written off.

If these restructurings really came to pass, this would be a sign that there is an increased willingness to restructure at least some of the **155'000 state-owned enterprises (SOEs) in the hands of all the provincial and city governments**, reduce overcapacities and stop the ongoing extension of vast amounts of bank loans to unproductive enterprises. This would be a step in the direction of a more efficient use of money with a positive long-



term effect for China. But at this time it is not clear how forcefully such restructurings will be executed – «growth compatibility» may demand softened actions.

**Temporary stability in the investment world**

After tremendous volatility in all the Renminbi-denominated investment markets over the last 12 months (equities, bonds and the Renminbi exchange rate), the last

two months have been relatively stable. The currency outflows appear to have subsided a bit. The new head of the China Securities Regulatory Commission will take his time to announce meaningful measures. The opening of China’s domestic bond market to international investors announced in early March is an important event, which will lead to an influx of foreign capital into the Renminbi bond market over time. And the Hong Kong – Shenzhen

Stock Connect scheme still is expected to go live in 2016.

H-shares (HKD-denominated shares of Chinese companies, listed in Hong Kong) still provide the **cheapest way to participate in China’s economy via investments in public equities**. Consensus estimated for the offshore indices MSCI China and HSCEI are for price-to-earnings ratios of less than 10x and price-to-book ratios of less than 1x for 2016.

Important Indicators						
	March 2016	Feb 2016	Dec 2015	June 2015	Dec 2014	Sep 2014
Quarterly GDP, growth yoy (%)	–	–	6,8	7,0	7,3	7,3
Retail sales of consumer goods, growth yoy (%)	–	10,2	11,1	10,6	11,5	10,8
Official Consumer Confidence Index	–	104,4	103,7	105,5	105,8	105,4
FICR Labor Demand yoy Index	–	59,8	57,0	63,2	72,6	68,1
Real estate floor space newly started, growth yoy (%)	–	13,7	–14,0	–15,8	–10,7	–9,3
FICR mom Home Price Index	–	62,4	58,0	61,0	51,5	50,0
CPI, growth yoy (%)	–	2,3	1,6	1,4	1,5	1,6
PPI, growth yoy (%)	–	–4,9	–5,9	–4,8	–3,3	–1,8
PMI manufacturing (official)	50,2	49,0	49,7	50,2	50,1	51,1
Caixin/Markit PMI	49,7	48,0	48,2	49,4	49,6	50,2
Fixed-asset investments, growth yoy (%)	–	10,2	10,0	11,4	15,7	16,1
Required ReserveRatio (large banks) (%)	17,5	17,5	17,0	18,5	19,5	19,5
Benchmark rate for 1-year loans (%)	4,35	4,35	4,35	4,85	5,60	6,00
Benchmark rate for 1-year deposits (%)	1,50	1,50	1,50	2,00	2,75	3,00
New total social financing, growth yoy (%)	–	–42,7	6,9	–6,8	35,0	–26,0
New bank loans, growth yoy (%)	–	–29,1	19,4	22,7	44,0	9,0
Exports, growth yoy (%)	–	–25,4	–1,4	1,6	9,7	15,3
Imports, growth yoy (%)	–	–13,8	–7,6	–6,8	–2,4	7,0
Trade balance (USD billion)	–	32,6	59,4	46,5	49,6	30,9
Electricity consumption, growth yoy (%)	–	2,0	0,5	1,3	3,8	3,9
Freight Traffic, growth yoy (%)	–	–	4,4	4,2	7,1	7,7
Iron ore imports (million tons)	–	73,6	96,3	75,0	86,9	84,7
Coal imports (millions tons)	–	13,5	17,6	16,6	27,2	21,2
Crude oil imports (million tons)	–	31,8	33,2	29,5	30,4	27,6
CSI 300 (China Equity Index)	3 218	2 877	3 731	4 473	3 534	2 451
RMB trade-weighted, nominal, indexed (2010=100)	–	123,9	125,9	126,0	121,5	116,0
RMB / USD spot	6,45	6,55	6,49	6,20	6,20	6,15

Source: ChinaIntelligence

**Key developments we expect for 2016/17**

We expect political, economic and financial stability despite all the looming challenges. Regarding some key topics our expectations are:

- ▶ GDP growth: 2016: around 6%, 2017: around 5.5%, below 5% for 2018–2020.
- ▶ Labor market: stable to slightly weaker, but with continued wage growth of between 4–7% p.a., at the lower end for high-wage earners, at the higher end for low-wage earners.
- ▶ Interest rates: one additional cut in the benchmark rates in 2016, each by 25 bps.
- ▶ No big stimulus program, but a multitude of smaller and targeted measures and reforms to support the economy, including making ample liquidity available to the financial system..
- ▶ RMB: further weakness vs. the USD, leading to RMB/USD near 7.00 by year-end 2016.
- ▶ Retail sales growth: approx. 10% p.a.

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