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China: the never-ending story of growth vs. reforms

The last month has been dominated by three topics: the PBoC's rate cuts, the discussion about the state of the economy and the 5th Plenum of the Communist Party of China. We highlight the news on the five-year-plan, recent changes made to the family planning policy and trends in consumption patterns. As in previous months, all events were overshadowed by the ongoing struggle between growth and reforms – and again, growth seems to win the contest.

HIGHLIGHTS

- *GDP: Q3 growth at 6.9%*
- *Interest rates: six rate cuts in one year*
- *PMI: at 49.8, contracting for the third month in a row*
- *Real estate: rebound in property sales*
- *Consumers: retail sales growth in stable double-digit territory*
- *Overall: no meltdown, but the slowdown continues*

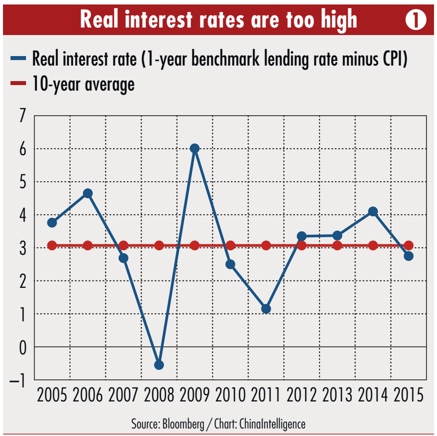
GDP growth slowed to 6.9% in Q3 2015, down from 7% in Q1 and Q2, which was better than expected. The stable GDP figures should boost confidence in the Chinese economy. But they do not, on the contrary. **Rarely has skepticism about the validity of official data been so high:** political pressures to meet the official growth target of 7% and the use of a questionably low GDP deflator were pushing the published data up. In fact, many indicators such as industrial output, investment in real estate, coal consumption and freight volumes point towards a more pronounced slowdown of the economy. Their weakness was underlined by a consumer price inflation of a mere 1.6% and an absolute decline of producer prices of 5.9% in September. The overstating of actual growth is likely to continue, adding to the uncertainty about the true performance of the Chinese economy. But as we say: **«You cannot trust individual figures about China, but you can trust the trend.» And this trend points towards more economic rebalancing and significantly lower growth rates.**

On the other hand, investment-related credit growth, lending and liquidity conditions as well as labor demand have picked up recently. Residential floor space sold in Q3 went up 14.4%, in Q1 it had contracted by 9.8%. This rebound was a consequence of stable underlying demand and the loosening of down-payment requirements in some second and third tier cities.

The manufacturing PMI for October came in at 49.8, unchanged from the last two months, indicating a stable but subdued economic situation. Government spending has yet to gain traction. This official reading is heavily biased in favor of large enterprises and overstates actual conditions. While large firms reported a somewhat increased activity and a PMI of 51, medium-sized companies came in at 48.7, and small firms reported a PMI of only 46.6. **The situation for smaller firms has continued to deteriorate.** The new orders index climbed slightly; the sub-indexes for production and new export orders fell. The non-manufacturing PMI, which includes service-related activities, came in at 53.1, down from 53.4 in September. This was the lowest reading since the financial crisis.

The latest interest rate cuts suggest that **Beijing is not as happy with the economic situation** as official data should indicate. On October 23, the People's Bank of China (PBoC) lowered the 1-year benchmark lending rate by 25 bps to 4.35%, and the corresponding deposit rate by 25 bps to 1.5%. Also, for major banks, the reserve requirement ratio (RRR) was lowered by 50 bps to 17.5%, with an additional 50 bps reduction for targeted banks to support agriculture and lending to small and medium-sized enterprises. The PBoC also **removed the ceiling on the deposit rate,** in line with previous steps towards full interest rate liberalization. But it will take some more time until interest rates will be fully determined by market forces. The PBoC also expanded funding provisions via its medium-term lending facility in order to reduce borrowing costs for firms.

This was the sixth interest rate cut in one year, making the last twelve months the most aggressive period of monetary easing since 2008/09. Yet, real interest rates are still too high considering the slowdown in economic growth (see chart #1). Companies face a severe debt service burden, which will continue to weigh on growth.



Another five years

The communiqué on the 13th five-year-plan was released in the last week of October, after the leadership's 5th Plenum of the Communist Party of China. It outlines the intended economic and social developments until 2020, including annual growth rates. The plan and the exact growth figures will only be communicated in March 2016 at the National People's Congress, but **economic growth is widely expected to be targeted at around 6.5%.**

As outlined in the 12th five-year-plan, GDP should double from 2010 to 2020. To achieve this, an average growth rate of 6.5% per year must be achieved. Premier Li Keqiang confirmed this goal in a speech last week. **This can be taken as a sign of stability – but it is nevertheless disappointing as it cements growth targets** and does not indicate a shift towards indicators which are linked to the rebalancing of the economy, reforms or welfare.

Closely linked to growth targets are objectives of poverty reduction and social welfare: in the next five years 70 more million people shall be lifted out of poverty. How can this be achieved? Through minimum wages, free secondary education for children of poor households and the development of better social security systems.

Next to the priority issue of growth, the government wants to promote innovation and the upgrading of the economy, especially in the manufacturing sector. It aims to increase R&D spending, to modernize the unproductive agricultural sector and to accelerate reforms, including fiscal and financial reforms and the long overdue SOE reform (please see the quarterlydragon #3 from October 1: «SOE's: the low hanging fruit in China's economic reform process?»).

In competitive sectors, there shall be a full liberalization of prices of goods and services. As vague as this seems, it will be interesting to see which sectors will be affected by this policy. Furthermore, the plan emphasizes environmental protection and cleaning up industrial wasteland, water and air. New energy products, renewable technologies and clean-tech in general should continue to benefit from this policy. Also, the consumption share of GDP shall go up (in line with the goals of economic rebalancing), helped by wage growth, improved social insurance, strengthened employment policies and, last but not least, lower administrative hurdles for private companies.

Shopping street in Chengdu.

PHOTOS: JOACHIM RUDOLF

More general objectives on the international stage include playing a more active role in international cooperation and global economic governance – including the RMB's inclusion in the special drawing rights-basket of the International Monetary Fund.

Global integration is expected to be accompanied by rapid growth of overseas investments, an accelerated opening of the markets, more free-trade zones and regional free-trade agreements, and strategies such as the «One Belt One Road» initiative.

How many children do you want?

The announcement of the abolishment of the one-child policy made quite a few headlines: all couples will be allowed to have two children going forward. Despite the international attention, the economic impact of this policy will be very limited, at least in the short term. In November 2013, couples with one child were allowed to have a second child if one parent was an only child. **Then as now, the further relaxation of China's one-child policy is socially welcome but will not trigger a baby or a consumption boom.** And only long-term will it help to partially alleviate the demographic side effects of three decades of rigorous population planning. With this step, the government responded to demographic demands. But it is a sure bet that population planning will continue, as the family planning policy has not been abolished, just loosened.

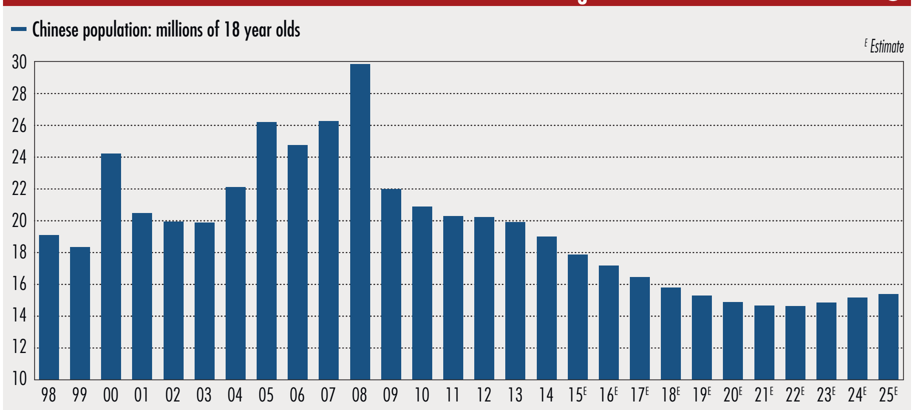
The one-child policy is blamed for the rapidly worsening demographics in China. Although it certainly had an important influence on it and its social consequences were severe and often brutal, in the last twenty years, rapidly rising incomes and better education would have led to a declining fertility rate anyway. Estimates about how the new policy will affect China's fertility ratio vary greatly. While some surveys

Shopping street in Chengdu.

indicate that more than half of all Chinese couples with one child would like to have another child, others suggest that the impact will be much smaller, due to the rising cost of childbearing and schooling, especially in urban areas.

There are two important facts to note. First, the new policy will not reduce the savings rate as the number of additional births will be small. Second, China's labor force continues to decrease (see chart #2). This is a drag on GDP growth. In the next 15 years, the population aged between 15 and 59 years will decline by 9%. **However positive it is that the Party is taking another step out of people's bed Chengdu rooms, more effective reforms that address productivity issues are needed to solve this huge demographic problem.**

Labor force entrants declining 2



Source: U.S. Census Bureau International Database / Chart: ChinaIntelligence

Shop until you drop – or not?

The service sector is key for the Chinese economy and it is largely responsible for the overall economic stability and the controlled slowdown. There are no signs of deterioration of the service sector over the last year. The economy is weaker and is further slowing down, but the resilience of the service sector shows that the rebalancing is under way and that no hard landing is imminent. **For three years now, the service sector has added more to GDP growth than the industry has, a development that will gain strength in the years to come.** Retail sales even improved in the last weeks, showing growth rates in solid double-digit territory.

Nevertheless, there are also mixed signals coming from the service sector. While some firms are doing well, others are struggling – a consequence of structural changes in the economy and some restructuring within the service sector itself. There is a pronounced shift from «brick and mortar» retailers towards booming e-commerce players. The stock market bubble that boosted financial services in H1 2015, was a drag in Q3. **Household spending is strong, but it cannot compensate fully for the decline in the industrial sector.**

China has a robust middle class that consumes heavily. This is especially true for the richer coastal provinces and urban centers. These consumers are expected to lead the economy back on an expansion track and their spending patterns are (astonishingly) resilient. **But recent surveys have shown some reluctance among lower-income as well as wealthy households to spend more and more.** Especially luxury goods are in less demand due to the deteriorating economy.

On the other side, consumption is supported by robust income growth and the fact that over 80% of the Chinese own the apartment they are living in – and property prices are stable to higher, which leads to a significant wealth effect. But it seems that even Chinese do not shop till they drop.

What does this mean:

- Economic growth is slowing and the officially reported GDP growth rate during H2 2015 will drop further below the government's target of 7%.
- Consumers appear to keep spending, based on their positive attitude towards the economic environment.
- Property prices are increasing slightly and are likely to edge higher due to inventory constraints.

- The impact of the RMB devaluation in August on the real economy will be small, but may pave the way to further RMB weakness vs. the USD.
- Industrial activity is weak, the PMI reading of 49.8 keeps this indicator in contraction territory.
- The soft economy will motivate the government to implement further stimulus measures and reforms across a variety of areas. The abolishment of the bank deposit rate ceiling is the most recent example of the government's determination to further liberalize financial markets.

Important Indicators

	Oct 2015	Sept 2015	June 2015	March 2015	Dec 2014	Sep 2014
Quarterly GDP, growth yoy (%)	–	6.9	7.0	7.0	7.3	7.3
Retail sales of consumer goods, growth yoy, real (%)	–	10.8	10.6	10.2	11.5	10.8
Official Consumer Confidence Index	–	105.6	105.5	107.1	105.8	105.4
FTCR Labor Demand yoy Index	–	67.3	63.2	76.0	72.6	68.1
Real estate floor space newly started, growth yoy (%)	–	–12.6	–15.8	–18.4	–10.7	–9.3
FTCR mom Home Price Index	–	59.5	61.0	55.0	51.5	50.0
CPI, growth yoy (%)	–	1.6	1.4	1.4	1.5	1.6
PPI, growth yoy (%)		–5.9	–4.8	–4.6	–3.3	–1.8
PMI manufacturing	**49.8**	49.8	50.2	50.1	50.1	51.1
Caixin/Markit PMI	**48.3**	47.2	49.4	49.6	49.6	50.2
Fixed-asset investments, growth yoy (%)	–	10.3	11.4	13.5	15.7	16.1
Required ReserveRatio (large banks) (%)	**17.5**	18.0	18.5	19.5	19.5	19.5
Benchmark rate for 1-year loans (%)	**4.35**	4.60	4.85	5.35	5.60	6.00
Benchmark rate for 1-year deposits (%)	**1.50**	1.75	2.00	2.50	2.75	3.00
New total social financing, growth yoy (%)	–	14.5	–6.8	–44.0	35.0	–26.0
New bank loans, growth yoy (%)	–	21.3	23.0	–5.1	44.0	9.0
Exports, growth yoy (%)	–	–3.7	2.8	–15.0	9.7	15.3
Imports, growth yoy (%)	–	–20.4	–6.1	–12.7	–2.4	7.0
Trade balance (USD billion)	–	60.3	46.5	30.8	49.6	30.9
Electricity consumption, growth yoy (%)	–	0.8	1.3	0.8	3.8	3.9
Freight Traffic, growth yoy (%)	–	4.1	4.2	4.5	7.1	7.7
Iron ore imprts (million tons)	–	86.1	75.0	80.5	86.9	84.7
Coal imports (millions tons)	–	17.8	16.6	17.0	27.2	21.2
Crude oil imports (million tons)	–	27.9	29.5	26.8	30.4	27.6
Bloomberg Commodities Index (BCOM)	**90.93**	87.82	102.69	98.12	104.33	118.69
CSI 300 (China Equity Index)	**3'366**	3'203	4'473	4'051	3'534	2'451
RMB trade-weighted, nominal, indexed (2010=100)	–	125.9	126.0	126.1	121.5	116.0
RMB / USD spot	**6.37**	6.36	6.20	6.21	6.20	6.15

Source: ChinaIntelligence

Key developments we expect for the coming 12–24 months

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

- *GDP growth: 2015 year-end run rate of around 6.5%, 2016: 5.5% to 6%, 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 by the Chinese New Year 2016, by 25 bps.*
- *No big stimulus program, but a multitude of smaller and targeted measures and reforms to support the economy.*
- *Real estate prices: a stabilization of prices and demand throughout 2016.*
- *RMB: further weakness of approx. 5% during the coming 12 months from the current rate of 6.32 RMB per USD.*
- *Retail sales growth: approx. 10% p.a.*

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