# Mizuho Economic Outlook & Analysis

**April 24, 2014**

# *China's Economic Outlook Based on the Presentation at the NPC*

*Taking measures to tackle a potential economic slowdown while pushing through reform*

**< Summary >**

◆ With the weaker major economic indicators of January through February 2014 and the occurrence of a default in the Chinese bond market, the risk of an economic slowdown in China is heightening.

◆ At the National People's Congress, the Chinese government announced that the GDP growth target for 2014 is "around 7.5%." While the newly announced policy aims at diverting China's economic growth from its reliance on investment, it also stresses the importance of job creation to demonstrate its stance to take the necessary measures to prevent an economic slowdown.

◆ In the future, China is expected to continue emphasizing reform, although its policy stance may become relatively accommodative. We expect the Chinese government to implement reformative measures such as relaxing entry barriers for private companies to support the economy and implementing fiscal policy that will contribute to reform.

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## 1. Introduction

With the weaker major economic indicators released for January through February 2014 and the occurrence of a default in the Chinese bond market, the risk of an economic slowdown in China is now greater than ever. Under such circumstances, how does the Chinese government perceive the potential economic slowdown, and how will it respond to the situation? We will try to uncover how the Chinese economy will develop by analyzing this year's economic management policies and target indicators announced at the second session of the 12th National People's Congress ("NPC", equivalent to the national legislature) held from March 5 to 13.

## 2. Risk of Recession is Heightening in China

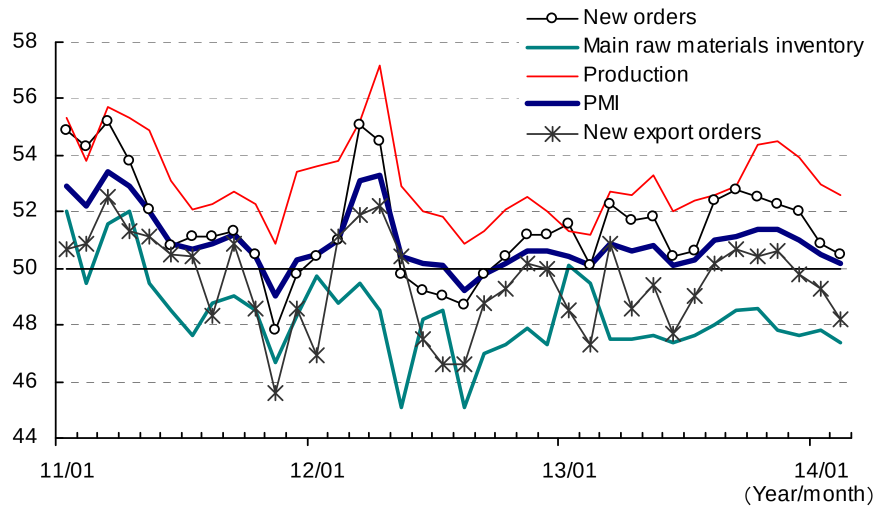
### (1) Major Economic Indicators Point to a Weakening Economy

China's manufacturing PMI of February released on March 1 (by the National Bureau of Statistics) marked 50.2 (50.5 in January). Although it slightly exceeded 50, which is the breaking point for determining whether the economy is expanding or contracting, the figure has declined for three consecutive months, indicating that the Chinese economy is weakening (**Chart 1** on page 2). In addition, China's major economic indicators of January and February, announced on March 14, cooled more than the market estimate, signaling the risk of an economic slowdown (**Chart 2** on page 2).

Looking at each indicator, industrial value-added output rose 8.6% on a real basis during the first two months of 2014 from a year earlier (against +9.7% in December), the weakest level since April 2009. By sector, growth slowed particularly in manufacturing of ferrous metal smelting and pressing, manufacture and processing of non-ferrous metals, and manufacture of automobiles. The growth rate of total retail sales of consumer goods, which represents the trend of consumer spending, also fell to 11.8% in nominal terms from 13.6% in December. This mainly reflected slower growth in sales of housing-related goods, such as furniture and building and decoration materials, as well as automobiles, which had been strong up until then. Furthermore, exports for the first two-month period of 2014 (nominal term, USD basis) fell 1.7% from the same period last year, slipping into negative territory (against +4.3% in December). Although this year's export growth was lowered to reflect last year's inflated export data due to over-invoicing, the new export order index in the manufacturing PMI shown in **Chart 1** has been hovering under 50 for three months in a row, excluding this special factor, reflecting the possibility of weakening exports. On the other hand, China's fixed-asset investment grew 17.9% year-on-year in nominal terms during the first two months of

2014, showing a slight improvement (against +17.1% in December), but growth was mainly fuelled by infrastructure investment, and investment growth in the manufacturing sectors came in lower.

**Chart 1: Manufacturing PMI**

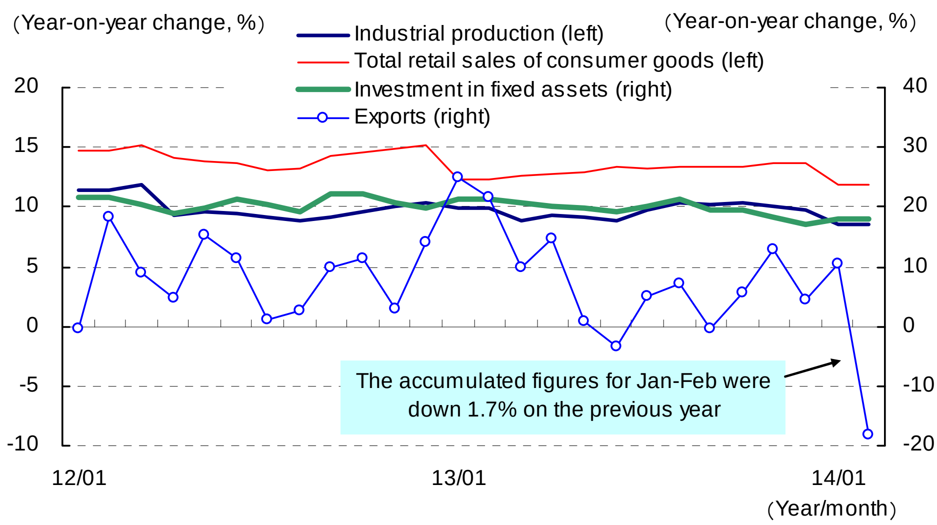



Notes 1. It should be noted that the effects of seasonality have not been totally eliminated from the results.

Notes 2. The survey sample has expanded from 820 to 3,000 since 2013.

Sources: National Bureau of Statistics of China, CEIC

**Chart 2: Major Economic Indicators**




Notes 1. For industrial production and total retail sales of consumer goods, the figures for January and February were aggregated and compared to the same period last year.

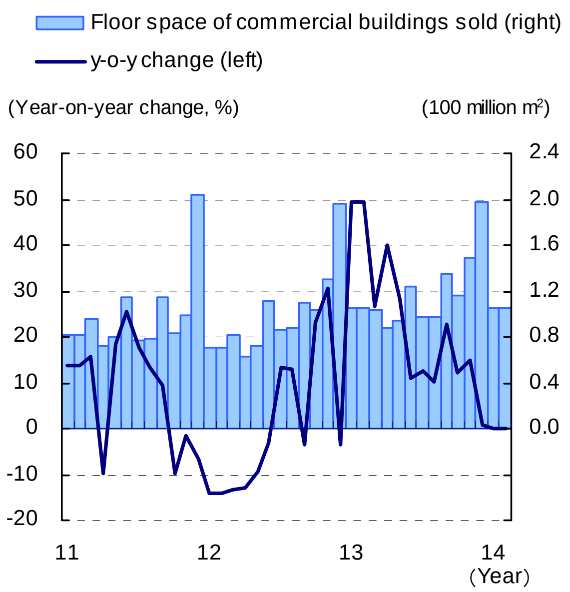
2. For investment in fixed assets, accumulated total since the beginning of the year was converted on a standalone monthly basis.

3. Industrial production = real growth rate; total retail sales of consumer goods, investment in fixed assets and exports = nominal growth rates

Sources: National Bureau of Statistics of China, General Administration of Customs, CEIC

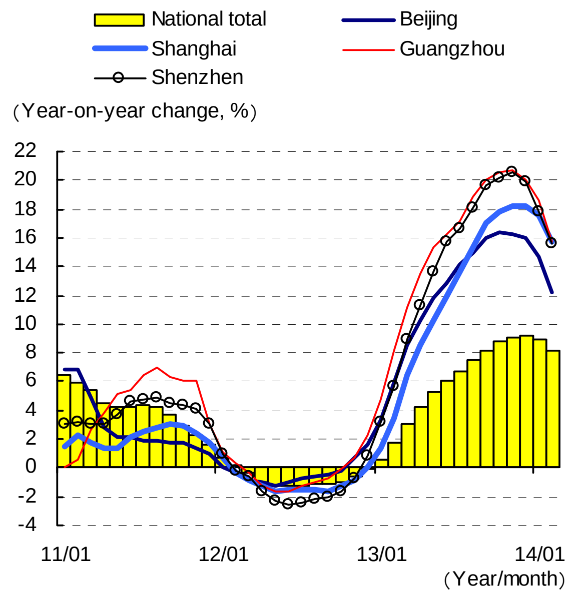
The overheated real estate market has also started to show negative signs. The floor space of commercial buildings sold in the first two months fell 0.1% year-on-year (against +0.7% in December), plunging into negative territory for the first time in one year (**Chart 3**). The growth rate of the residential building sales price indices for February stood at 8.2% (against +9.0% in January), showing that the pace of slowdown has accelerated (**Chart 4**). The declining rate of growth was particularly noted in China's first-tier cities, such as Beijing, Shanghai, Guangzhou and Shenzhen, and since October last year, measures to adjust housing prices seem to have taken effect.

**Chart 3: Floor Space of Commercial Buildings Sold**




Sources: National Bureau of Statistics of China, CEIC

**Chart 4: Sales Price Indices of Sold Residential Buildings**




Note: National total data have been estimated on the price indices of 70 major cities..

Sources: National Bureau of Statistics of China, CEIC

### (2) Default in the Chinese Bond Market

In addition to the weakening major economic indicators, China experienced a bond default on March 7, placing downward pressure on its economy. This was the first bond default since the establishment of the interbank bond market in June 1997.

On March 5, the solar-cell maker Shanghai Chaori Solar Energy Science & Technology Co., warned it would be unable to make an 89.8 million yuan interest payment on a one billion yuan 5-year bond issued in 2012, due to a slump in its business performance. The default occurred just as no bail-out measures, such as bank grace toward repayment, were being taken.

Up until then, there had never been a corporate bond default in China, since troubled Chinese firms had somehow always been bailed out at the last minute. Nonetheless, if such a situation continues, it will extend the moral hazard to other firms and investors, inflating excess investment and debt even further. For this reason, it seems that the Chinese government allowed this default from the standpoint of developing a healthy credit market.

Allowing individual defaults will contribute to the development of the Chinese economy over the long term, but it may also increase instability in the financial market in the short term. It is highly likely that another default will occur on debt issued by firms belonging to sectors suffering from overcapacity, much like Chaori Solar Energy, and companies in the real estate sector facing a downturn in business due to lower growth in the price of real estate.

## 3. Macroeconomic Management Policy Presented at the NPC

The questions are how the Chinese government perceives the rising concerns regarding recession, as described above, and how it intends to respond to such concerns.

In the "Report on the Work of the Government ("the Government Work Report")" announced on March 5, the 2014 target for real GDP growth was set at "around 7.5%," the same level as the preceding year (**Chart 5** on page 5). With regard to basic policy, it was also decided that the Chinese government will continue to adopt "a proactive fiscal policy and a prudent monetary policy." If we focus only on these headlines, they give the impression that no major change has been made to the previous year's policy. But if we conduct a combined analysis of the numerical targets and details of the Government Work Report, as well as Premier Li Keqiang's remarks, we can see how the policy stresses the government's intention to push through reforms to a greater extent compared to the previous year, while recognizing the need to deal with downward pressure on the economy.

### (1) Policy Emphasis to Break Away from Investment-oriented Economic Growth

We can see the Chinese government's stance to lower its reliance on investment to spur economic growth from the reduced target growth rate of fixed asset investment from 18% to 17.5%. Considering that the target was raised from 16% to 18% in 2013, we can infer that the government wants to break away from investment-oriented economic growth and further accumulation of capital stock.

**Chart 5: Major Economic Indicator Targets for 2014**

| Indicator | 2014 | 2013 | |
|---|---|---|---|
| | Target | Target | Result |
| Real GDP growth rate (y-o-y) | Around 7.5% | Around 7.5% | 7.7% |
| Inflation rate (y-o-y) | Around 3.5% | Around 3.5% | 2.6% |
| Investment in fixed assets (y-o-y) | 17.5% | 18% | 19.6% |
| Total retail sales of consumer goods (y-o-y) | 14.5% | 14.5% | 13.1% |
| Total imports and exports (y-o-y) | Around 7.5% | Around 8% | 7.6% |
| M2 growth rate (y-o-y) | Around 13% | Around 13% | 13.6% |
| New urban jobs | Over 10 million | Over 9 million | 13.1 million |
| Urban unemployment rate | Below 4.6% | Below 4.6% | 4.1% |
| Budget deficit | RMB1.35 trillion | RMB1.2 trillion | RMB1.2 trillion |
| As a proportion of GDP | 2.1% | 2.0% | 2.1% |

Note: Highlighted data represent indicators whose target changes form the previous year.
Sources: Created based on the official website of the Central People Government of the People's Republic of China and Xinhua News Agency materials.

In concrete terms, the Government Work Report presented its policy on how to respond to the overcapacity problem and to restrain real estate investment. To solve the overcapacity problem, the government decided to ensure that the target for reducing outdated production capacity, set in the Twelfth Five-Year Plan, is met one year ahead of schedule. The government also presented a numerical target on the reduction of excess production capacity, namely the reduction of outdated production capacity of 27 million metric tons of steel, 42 million metric tons of cement, and 35 million standard containers of plate glass.[1] Hence these sectors are anticipated to see lower growth in investment.

The growth rate of real estate investment is also expected to slow down. The Government Work Report presented a policy to implement different real estate control measures depending on the situation in the respective cities. During the NPC on March 6, Vice Minister Qi Ji of the Ministry of Housing and Urban-Rural Development stated that (1) the government will continue to increase the housing supply for low to middle income earners in the first-tier cities where real estate prices are surging, but will restrain speculative investment, and (2) the government will limit the supply of residential land in cities with a high level of housing inventory in order to accelerate the consumption of such inventory. In light of these policies, we expect housing investment, particularly for

[1] Unit of plate glass used in China. One standard container refers to 2 mm thick plate glass of 10 ㎡ width.

luxury properties, to be restrained in China’s first-tier cities, and growth in real estate investment to slow in cities burdened by excessive housing inventory. In addition, Minister Jiang Daming of the Ministry of Land and Resources announced on March 10 that national property registration rules will be submitted to the state council in June. Since the purpose of this registration system is to strengthen control over speculative property transactions, we believe this will also contribute to curbing real estate investment.

Furthermore, in the press conference held on the last day of the NPC, Premier Li referred to shadow banking that serves as a financial resource for the above mentioned sectors troubled by excessive investment. He said that the government is strengthening its supervision of shadow banking based on the Basel III requirements, and that “China has set a timetable concerning regulation over shadow banking.”

**(2) Taking Measures to Prevent an Economic Slowdown by Stressing Job Creation While Allowing a Certain Amount of Downward Pressure**

As the Chinese government promotes the adjustment of capital stock to emerge from investment-oriented growth, there will be more downward pressure on the Chinese economy. Premier Li looked back on the past and said in the press conference that the greatest challenge last year was the increase in downward pressure on the economy, such as slower growth in fiscal revenue and tightening liquidity. He also added that “We will confront serious challenges this year, and some may be even more complex,” showing his recognition of the ongoing existence of downward pressure. Furthermore, on the subject of the corporate bond default mentioned earlier, he said that although individual defaults cannot be averted, the government will strengthen its supervision to avoid individual defaults from developing into systemic risk. We believe he has taken the stance that a certain level of downward pressure should be tolerated for the purpose of breaking away from investment-oriented growth.

However, attention should be paid to the fact that his policy to accept a certain level of economic slowdown is subject to the condition that confines this slowdown within the scope where enough jobs will be created and the national income will rise. When Premier Li was asked for the minimum economic growth rate acceptable to the government, he replied “around 7.5%” to allow room for slight deviation from 7.5%, and also stated that the lower limit of acceptable economic growth should be the level where sufficient growth in employment and national income can be secured. His policy to focus on job creation while allowing a certain amount of downward pressure is evident from the new target for the number of newly-employed in urban areas, which was raised to 10 million from 9 million.

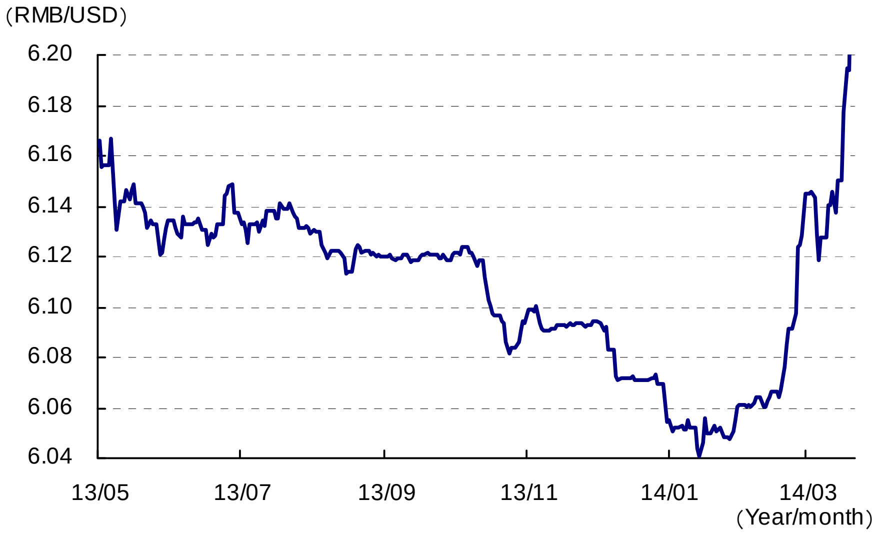
China's urban unemployment rate was 4.1% in 2013, meeting the target of "below 4.6%." The job opening-to-application ratio in the 2013 October-December period stood at 1.1 to exceed 1.0, indicating that the current employment situation is relatively favorable. One reason why Premier Li places such emphasis on job creation is because more people are expected to lose their jobs as a result of the accelerated elimination of sectors suffering from overcapacity, and also because 7.27 million college and graduate school graduates will join the labor market this year, marking the greatest number ever. Another reason why the Chinese government places emphasis on job creation is its policy to carry out "people-centered urbanization," a policy aimed at securing jobs for rural migrants (those with a rural *hukou* household registration) who have moved to cities ultimately to improve their wellbeing. The Government Work Report also points out the need to solve "three tasks, each concerning 100 million people," which are "granting urban residency to around 100 million rural people who have moved to cities," "rebuilding rundown city areas and villages inside cities where around 100 million people live," and "guiding the urbanization of around 100 million rural residents of the central and western regions in cities there." Also on March 16, China unveiled "National New-type Urbanization Plan (2014-2020)", a plan much anticipated since last year. The Chinese leadership acknowledges the need to secure enough employment to execute this plan effectively. According to media coverage, Premier Li said in October 2013 that "to create 10 million new jobs, the Chinese economy needs to grow at least by 7.2%." If the government has set 7.2% as its lowest rate of economic growth, it can be presumed that a gradual slowdown of the economy will be tolerated. However, amid greater downward pressure placed on the economy, we believe China will carry out macroeconomic management aimed more at preventing an economic slowdown than in past years.

For example, the sudden depreciation of the yuan from the latter half of February (**Chart 6** on page 8) may be understood as part of the nation's economic stimulus measures. In addition to the steady rise in labor costs, the faster-than-expected appreciation of the yuan at 3% last year made the operating environment for export-related sectors more challenging. Under such circumstances, it is highly possible that the Chinese government intervened to support the economy by prompting the People's Bank of China to instruct Chinese banks to buy US dollars and sell the yuan in order to lower the value of the yuan or stop the yuan's appreciation.[2]

[2] The policy of letting the yuan fall in value on foreign exchange markets from late February can be interpreted as an experimental move toward reform on widening the yuan's trading range in both directions. There is a possibility that the Chinese government was testing how the market would respond to a cheaper yuan by resetting the yuan appreciation trend that had continued for some time. There is also a possibility that it tried to restrain speculative trading in anticipation of a mid- term appreciation of the yuan. In fact, the yuan trading range in two ways widened from 1% to 2% effective on March 17.

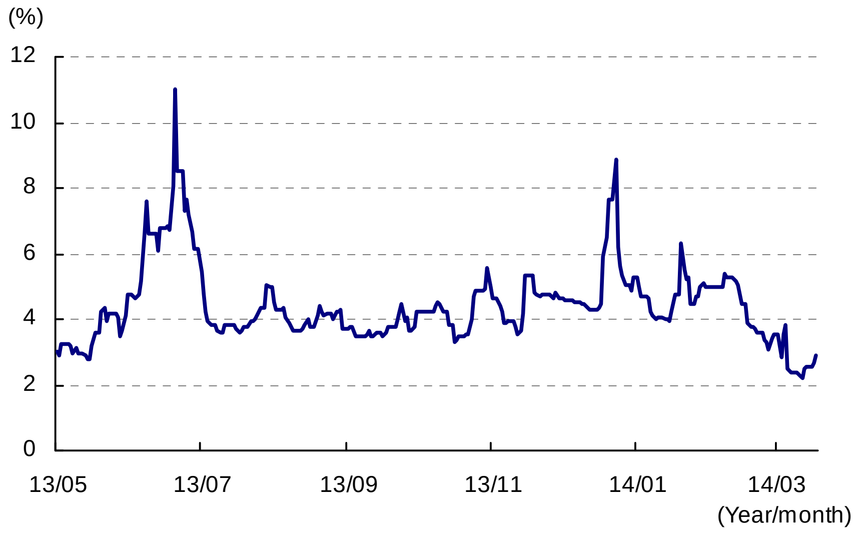
Moreover, interbank interest rates have also been stable since the latter half of February (**Chart 7**). Since the second half of last year, the People's Bank of China has tightened liquidity to restrain the unruly expansion of shadow banking, but such a move has stopped for a while now. As mentioned earlier, default is indispensable in order to avoid moral hazard, but the government decided to relax market liquidity to prevent individual defaults from developing into systemic risk.

**Chart 6: US Dollar-China Renminbi Exchange Rate**




Note: Daily data up to March 21
Source: Bloomberg

**Chart 7: Shanghai Interbank Offered Rate (SHIBOR)**




Note: 7-day SHIBOR. Daily data up to March 21
Source: Bloomberg

## 4. Policy Measures to Realize Both Reform and Soft Landing of the Economy and Accompanying Issues

### (1) Possibility of Supporting the Economy Through Reform and Implementing Fiscal Policy that Contributes to Reform

As the Chinese government seeks to allow a certain amount of downward pressure on the economy while securing sufficient job creation, we can see its intention to avoid adopting short-term stimulus measures, such as fiscal policy measures and monetary easing. In this context, Premier Li stated that “Last year, without taking additional short-term stimulus measures, we succeeded in meeting the economic target. Why can’t we do it this year?”

In light of China’s low fiscal deficit ratio, high level of foreign reserves, and high reserve requirement ratio, there should be ample room for adopting stimulus measures. But the Chinese government seems reluctant to take such measures, worried that it may trigger excessive investment once again leading to an accumulation of capital stock.

Then, how does the Chinese government intend to realize a soft landing of the economy amid the presence of downward pressure?

One method is to support the economy from the supply side through reform. A typical example would be to relax entrance barriers for private companies. Also, in the case of increasing pubic spending, the government will most likely try to invest in those areas directly connected to improving the wellbeing of the nation’s people as efficiently as possible. When the hike in short-term interbank interest rates last July heightened the risk of a sudden economic downturn, the Chinese government announced a series of support measures; its main purpose was not to dramatically change the course of the economy, but to prevent a substantial drop in economic activity and to make adjustments to the economic structure. In concrete terms, measures taken included tax reductions targeting small and micro-sized companies and an acceleration of railway construction to develop poor districts in the mid-western region.[3] Therefore, even when economic slowdown is anticipated, if the degree of slowdown is somewhat limited, the Chinese government will likely restrain its fiscal spending to the extent that it will not significantly deviate from the fiscal deficit target. And such money will be spent on social security, environmental preservation, basic transportation infrastructure to narrow the gap between different regions, and other areas that will contribute to improving the wellbeing of the nation’s people.

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[3] For details, refer to Shingo Ito and Yoshino Tamai, “Will China return to a high growth track? - Analysis of a series of economic policies and their purpose -” (in Japanese) in the August 30, 2013 issue of Mizuho Insight, Mizuho Research Institute.

As a matter of the fact, on March 13 the National Development and Reform Commission approved plans for five railway projects with planned investment totaling 142.4 billion yuan.[4] In addition, the State Council Standing Committee held on March 19 stressed that the government "will announce already defined measures to expand domestic demand and achieve stable growth as soon as possible, expedite the launch of important investment projects and construction works, and spend the budget in a timely manner" with a view to maintaining the economy within a rational range (which refers to a situation where the economy is neither overheating nor receding, hovering above the "lower limit," meaning creating stable growth and job security, and below the "upper limit," meaning keeping inflation in check). We believe the Chinese government will accelerate work on important projects that will be financed by central government investment, including government-subsidized housing for low-mid income earners, agriculture projects, major water conservation projects, railways in central and western China, environmental protection and social programs.

### (2) Combined Achievement of Reform and Soft Landing Requires Policy Coordination

Even though the policy stance has become relatively accommodative, it does not mean there will be changes in the policy to deepen reform. The Government Work Report also stresses that "reform is the top priority for the government's work this year," and has revealed that it will deepen reform of the administrative system, fiscal and tax systems, and the financial system.

Signs of reform have already emerged, particularly in the financial sector. In the press conference of the banking regulator held on the sidelines of the NPC, People's Bank of China governor, Zhou Xiaochuan, said he personally believes that China will probably liberalize bank deposit rates in one to two years. It should be noted that a timeline for freeing bank deposit rates was indicated for the first time.

The move toward liberalization of interest rates in China started when the interbank call market was liberalized in 1996. Since China abolished the floor on lending rates in July 2013, the only remaining interest rate restriction is the ceiling on deposit rates. The presence of such a ceiling keeps real interest rates low and produces harmful effects, such as the mass production of low-quality investment projects and overheated speculation in high-yield financial products and real estate by households trying to compensate for the loss of deposit value due to inflation. It also weakens the function of

[4] The five railways with construction permission are Hongliuhe – Naomaohu (Xinjiang Uygur Autonomous Region), Harbin – Mudanjiang (Heilongjiang Province), Harbin – Jiamusi (Heilongjiang Province), Qingdao (Shandong Province) – Lianyungang (Jiangsu Province) and Hangzhou (Zhejiang Province) – Huangshan (Anhui Province).

the competitive principle and allows inefficient financial institutions to survive. Removing the deposit rate ceiling is a necessary reform to eliminate such harmful effects and to correct the inefficient distribution of funds.

On the other hand, fully liberalized deposit rates run the risk of intensified competition among banks to acquire deposits by pushing up deposit rates, driving banks to invest in high-risk-high-return products in an attempt to compensate for narrower interest margins, which will in turn increase the risk of bankruptcy in the end. To prevent the occurrence of such a situation, the government will not only strengthen supervision and control, but will also start preparing for the creation of a safety net. For example, the establishment of a deposit insurance system is incorporated in the Government Work Report.

The problem is when to implement the deposit insurance system. If the system is introduced amid a string of corporate bankruptcies and disruptions in the financial market, the market may consider that the situation has worsened to the extent that the government will have to speed up the liquidation of failed banks, and this may spread anxiety in the market. The Chinese government must pay attention to the pace of emerging from investment-oriented growth and the timing of the impact of its economic measures, and ensure the proper arrangement of various policies when introducing the deposit insurance system. The government’s skills related to communication with the market will also be tested.

The biggest task for the government during the first year of the Xi Jinping administration in 2013 was to prepare a reform plan, and from the second year onward it will be the execution of its plan in concrete terms. We need to closely watch China’s future policy management to see how the nation will deal with the difficult task of deepening reform amid the presence of downward pressure on the economy.