Macro Keys
What Else Is in Store? – China Policy Outlook

Economics & Macro Strategy
Global

What Else Is in Store?

The first half of 2014 has ended with China's growth momentum seemingly rebounding after a very weak first quarter. Government mini-stimulus measures have helped to support growth and exports seem to be recovering. We estimate that q/q GDP growth picked up to about 7% in Q2 and see it rising further to 8% in Q3.

However, in the face of persistent property market weakness and increasing financial difficulties in parts of the economy, growth momentum looks set to slow in Q4 2014 and into next year. We expect GDP growth to slow to 6.8% in 2015 with the government's policy support offsetting most of the negative drag from the property downturn, but see a 15% risk of growth slowing to 5%+.

What else can the government do to support growth and prevent a hard landing?

We expect the government to continue to raise infrastructure and public service investment, accelerate reforms to facilitate corporate and private sector investment as well as household consumption, maintain a relatively accommodative monetary and credit policy stance, and keep the CNY from further appreciation against the USD. The latter two are helped by the absence of inflationary pressures (we expect CPI inflation to average 2.4% in 2014, down from the previously expected 2.7%).

The government so far remains reluctant to ease property policies significantly. Allowing a serious adjustment in property and related heavy industrial sectors alongside a cleanup of the financial sector may be good for China’s long term economic health, but the adjustment could be very painful in the short term. Therefore, it remains to be seen how weak a level of growth the government can tolerate, especially if the current intensity of policy support turns out to be insufficient.

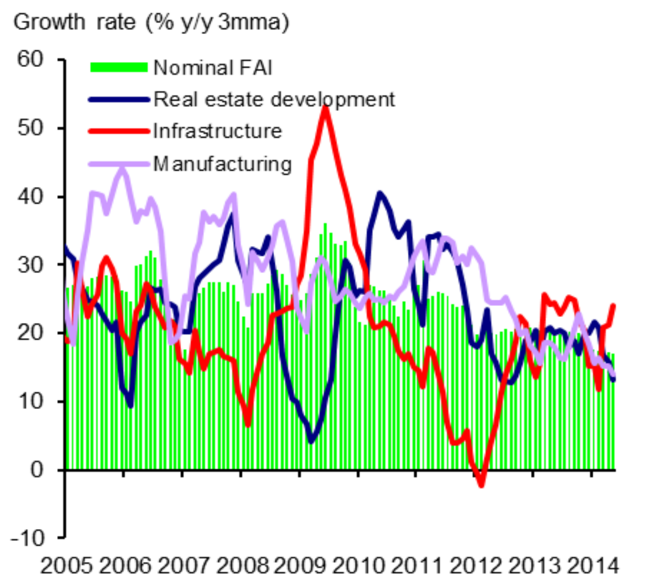
We still anticipate meaningful progress in financial sector reforms this coming year, with measures to lower corporate funding costs and financial risks being adopted as ongoing interest rate liberalization and capital account opening are progressed further.

The state of the economy and concerns

Following a weak start to 2014, economic activity has shown signs of revival. Helped by an export recovery since April and a mini-stimulus that boosted infrastructure investment (Figure 1), q/q GDP growth likely rebounded from an estimated 5.7% in Q1 2014 to 7% in Q2. Raw material and heavy industries have seen a marginal improvement in their inventory cycles, interest rates have come down in recent months, and credit growth has been robust. We expect these factors to continue to lift growth momentum in Q3 to about 8% q/q, although a high base may keep Q3's headline GDP y/y growth more depressed at around 7.2%.

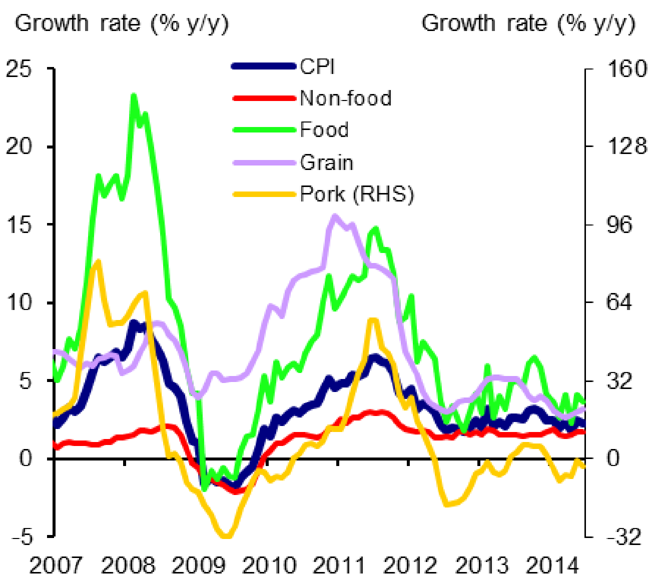
Inflationary pressures have stayed low, thanks to soft food prices, declining commodity prices, and generally weak demand conditions keeping a lid on core manufacturing prices. Indeed, H1 2014's weaker-than-expected food and commodity price growth should help keep full-year average CPI at 2.4%, despite an anticipated rebound in food prices later this year on the back of another hog cycle and global food price revival (Figure 2). Thanks to ongoing domestic resource and utility price adjustments and solid wage growth, we do not expect full-scale deflation. Indeed, we expect PPI inflation to narrow its decline from -1.9% in 2013 to -1.3% in 2014.

Figure 1: Mini-stimulus boosted infrastructure investment



Source: CEIC, UBS estimates

Figure 2: Weak food prices led to low CPI inflation



Source: CEIC, UBS estimates

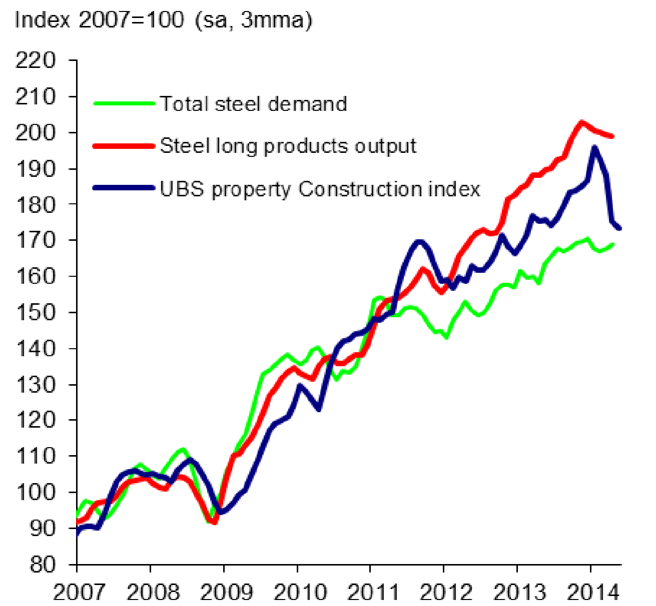
Looking ahead, as China's structural property downshift continues to unfold, we expect the consequent negative drag on the economy to increase in Q4 2014 and into 2015. Given the importance of this sector and its extensive linkages with the rest of the economy (Figure 3&4), China's property downturn will likely expose further excess supply issues in many heavy industrial sectors, which will further reduce corporate revenue growth, cash flow, and incentives to invest. This is why we think current mini-stimulus measures may not be enough, especially towards year-end, to offset this growing negative impact on the economy. Our 6.8% baseline GDP forecast for 2015 assumes further policy support, and we see a 15% risk of growth slowing to 5%+.

We have not seen any major jump in reported cases of shadow credit defaults so far, and banking sector NPLs are rising only modestly, thanks to greater local government involvement and the PBC's careful easing of liquidity and credit conditions (See *China Focus – All Quiet on the Shadow Banking Front,* July 10). As the ongoing property downturn intensifies, problems embedded within recent rapid accumulation of financial leverage may be aggravated, especially via the shadow credit system.

We think the government is well aware of the sustainability question mark over China's current pace of growth, and is worried about the ongoing property downturn. The senior leadership has stated that maintaining growth is still very important, but they have also said they do not want to use strong stimulus measures and revert back to their "old tricks" of relying upon easy money conditions and/or another property bubble.

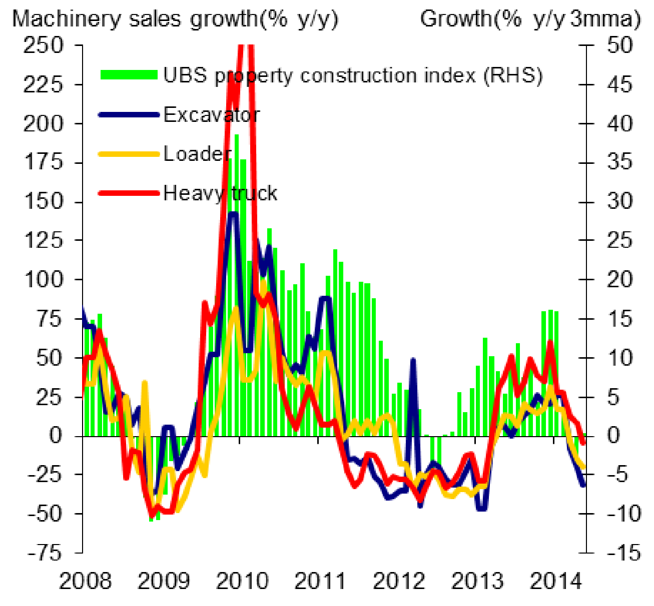
So what more can the government do to support growth in the coming months and year?

Figure 3: Property construction and steel demand



Source: CEIC, UBS estimates

Figure 4: Property and construction machinery



Source: CEIC, UBS estimates

What other policy measures are in store?

Recent statements from President Xi and Premier Li have made it clear that the government still wants to defend growth, and see it as a key support for employment and social stability, and good environment for structural reforms and changing China's growth model. At the same time, the leadership wants to avoid using strong short-term stimulus measures and to push forward with reforms. They want to focus policy support on employment and livelihood conditions, alongside regional development and urbanization. Against this backdrop, we expect growth-support policies this coming year to focus on the following:

<u>Government and government-guided spending</u>

As the most direct way to boost investment and growth, increased investment in infrastructure and public services will be an indispensable part of the policy mix. After extensive use of infrastructure investment in recent years to support growth, however, there are limits to how much more this can be pushed in some areas. We think a lot of room remains for further investment in the areas of: railway, subway, urban public transport, water and waste treatment, urban pipelines, other urban utilities, power transmission, clean energy and environmental projects (accounting for 12-15% of total FAI). For example, China has 103 kilometers of railway in operation as of end 2013, less than half of that in the US. However, investment in roads and highways, ports and power generation may not have as much room left for further investment.

Investment that goes hand in hand with the government's plans to develop China's inland regions, push forward urbanization and improve public services will likely increase. Investment in these spheres could include key development and transportation projects in China's western region, urban and rural public facilities and services, and shanty town renovations.

To support such investment, the government has and will likely continue to find innovative financing measures, including via policy financing institutions, cooperation with the corporate (including private) sector, and further regulatory relaxation.

Reforms to unlock new sources of growth

After the Asian financial crisis, domestic reforms (especially urban housing market reform) and a booming global economy helped China to emerge from deep economic troubles. This time, global demand will unlikely be of as much help, but the Chinese leadership plans to rely on faster reforms to unleash new sources of growth during the period of structural adjustment.

We expect the government to focus on the following growth-positive reforms:

- Lower market entrance barriers and simplify administrative procedures and approvals, especially for the private and services sectors, to facilitate corporate and private investment;
- Public service sector reform: allowing private sector to invest in and provide traditional public services, including utilities, transport, health care, etc, including through public-private partnerships;
- Tax cuts (VAT tax reform, micro business tax cuts, abolishment and reduction of administrative fees and surcharges);
- Social safety net reform – continued expansion of pension coverage and health care insurance coverage and increase in payout ratios;
- Faster implementation of hukou reform in lower tiered cities.

Monetary and credit easing

Liquidity easing: The central bank has refrained from wholesale RRR cuts thus far, relying instead on the use of onlending facilities, the standing liquidity facility, open market operations, FX market intervention, and targeted RRR cuts. A key reason for this is that the PBC may not have wanted to send too strong of a policy easing signal. Another is that the PBC finds it easier to fine-tune liquidity in a higher RRR environment. Going forward, the PBC may soon add to its toolbox a reported new tool – Pledged Supplementary Lending. In addition, in the event of persistent large FX outflows, the PBC may finally cut its still very high RRRs.

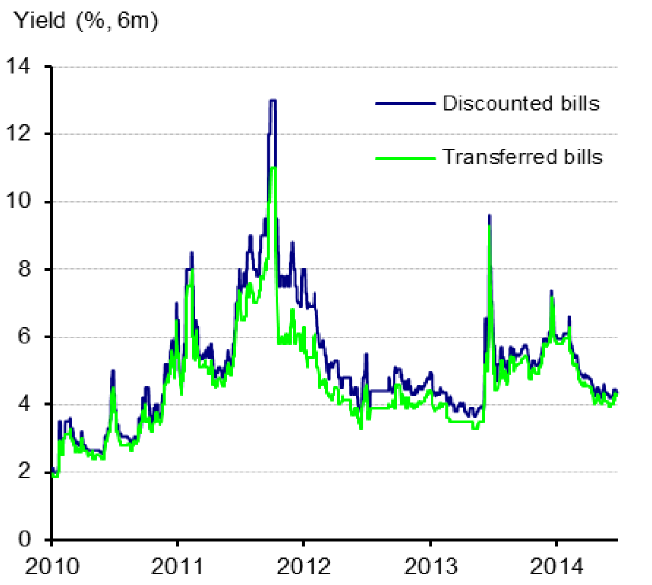
Relaxing credit constraints: CBRC recently relaxed its management of the loan to deposit ratio, widely considered as one of the top constraints on bank lending. More such counter-cyclical macro prudential measures may be adopted to ease credit constraints. These could include easing restrictions on credit flows to certain sectors, loosening certain lending quotas; and encouraging faster development of the ABS market. Moreover, increased bond issuance by local government platforms and large corporates could also free up bank credit for smaller and private companies. Policy bank lending can moreover be raised further.

Reducing borrowing costs: Easier liquidity conditions in recent months have led to lower interbank market rates (Figure 5&6). This matters for corporate bonds, as well as bill discount and transfer rates, the latter being smaller and private companies' marginal cost of funding. That said, the majority of credit continues to be priced off benchmark lending rates, which have not changed. Thanks to falling CPI inflation and inflation expectations, real interest rates have risen. As such, to reduce borrowing costs in the economy, the government has the following options:

- The PBC can cut benchmark interest rates, which despite recent progress on interest rate liberalization, still matter the most for setting borrowing costs in the real economy. However, the PBC may refrain from such action in the name of market-oriented reform and for fear of sending too strong of an easing signal;
- The government can reduce existing layers of financial intermediation as promised. This means increased intermediation through normal bank lending and through government and corporate bonds, reducing the economy's reliance on shadow credit.

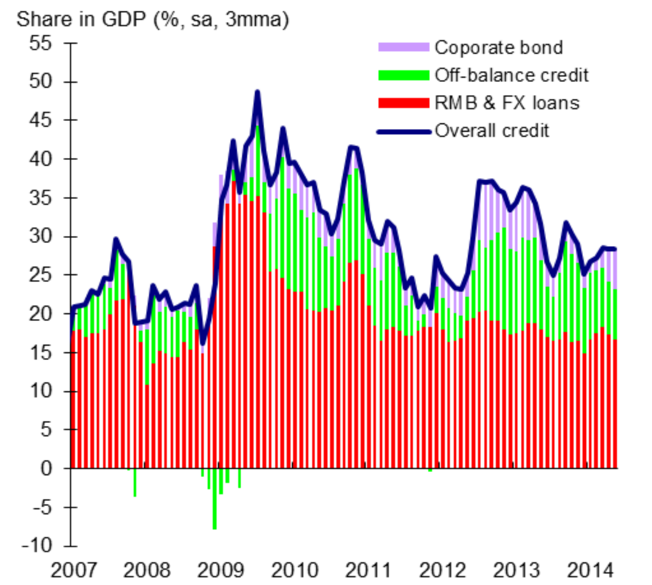
- Also, we expect the government to continue to encourage external borrowing by banks and large corporates to take advantage of cheaper external credit.
- For smaller companies, the government can provide explicit guarantees or interest rate subsidies to help reduce borrowing costs, rather than asking banks to directly shoulder the burden.

Figure 5: China's bill rates have come down…



Source: CEIC, UBS estimates

Figure 6: …and credit growth has been robust



Source: CEIC, UBS estimates

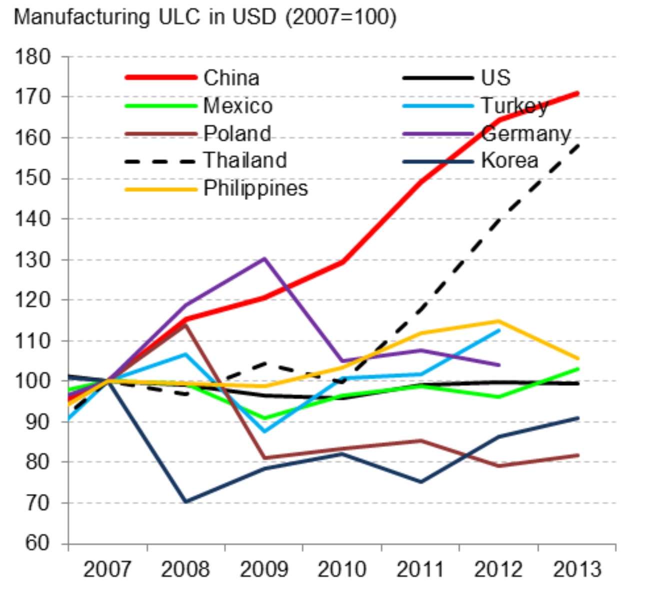
Exchange rate and property policies: difficult to move

Allowing the RMB to depreciate against the USD to help support exports and growth in light of domestic demand weakness may appear an attractive option, especially with the USD on track to strengthen against other major currencies and China expecting to see further upward utility and resource cost adjustments and higher unit labor costs. From an economic fundamentals' point of view, the RMB is no longer under-valued following significant real appreciation and growth in dollar unit labor costs (Figure 7, for more details, see *Is China Losing Competitiveness or Moving Up the Value Chain?*, March 25 2014). In addition, the strong carry inflows seen in 2013 and early 2014 have dissipated; we estimate that China saw net non-FDI capital outflows in both April and May. In other words, appreciation pressures derived from capital flows have turned into depreciation pressures.

However, China continues to face political pressure from the US and other major trading partners, as evidenced by the latest Sino-US Strategic and Economic Dialogue, to appreciate the RMB. Although the Chinese government is resisting such pressures, they do limit the scope of notable depreciation. In addition, the Chinese authorities are actively pursuing RMB internationalization, which demands a relatively strong and stable currency. The concerns of currency depreciation triggering large fluctuations in capital flows and financial risks may also be a concern.

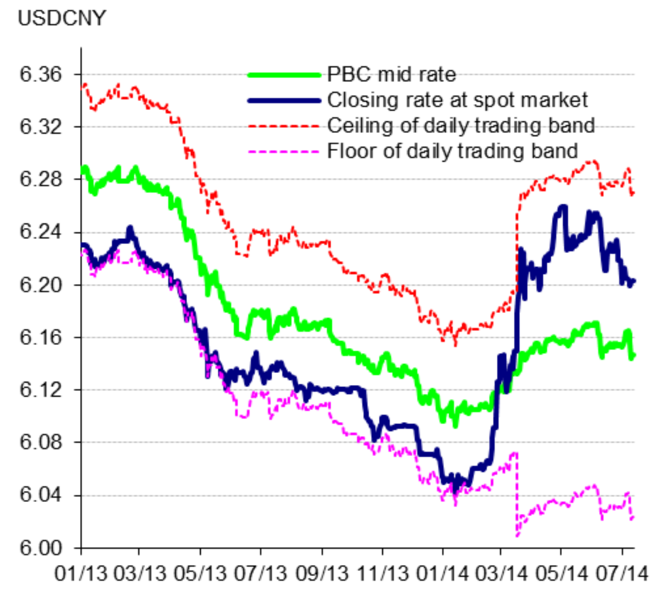
Therefore, we reiterate our call that the USDCNY will likely remain relatively weak but stable, trading at around 6.25 by end 2014 and 6.35 by end 2015. Such a call does not mean that CNY would not sometimes deviate from these rates – but we do not see trend deviation either to the up or downside (Figure 8).

Figure 7: China's dollar unit labour costs have risen sharply



Source: CEIC, Haver, UBS estimates

Figure 8: No trend deviation for the CNY either to the up or downside



Source: Bloomberg, UBS estimates

On property policies, the government has so far remained very reluctant to ease significantly although the downturn in the property markets is making local governments' lives increasingly difficult in some areas. While the central government may have reluctantly given limited discretion to local governments to ease home purchase restrictions in a low key fashion, so far its own efforts have focused mostly on increasing shanty town renovation.

We can think of a number of reasons for this reluctance: the government may not want to refuel a property boom in light of still very elevated property prices and associated public discontent; it is hard to make a 180 degree turn from property tightening to total outright relaxation without suffering an external demand crisis as happened in 2008; and it would be contrary to the government's stated objective of moving to strengthen the real economy and carry out a structural transition.

Nevertheless, we think there could be policy measures to support first time home buyers (for example, PBC's reported moral suasion to speed up such mortgage approvals); continued discretion for some cities to ease home purchase restrictions; provision of indirect support by increasing overall credit availability; and acceleration of hukou reform to help digest housing inventories in lower tier cities.

However, unless the economy is heading for a nose dive, we think the government will probably refrain from removing all property purchase restrictions and cutting down payment requirements for second mortgages too significantly. Therefore, we think these measures will be slow in coming as the "last resort".

How to boost consumption?

Given that the government wants to move away from investment-led growth and increase the importance of consumption, are there ways to boost consumption especially in light of stricter controls of public consumption and anti-corruption?

In the short term, it is not easy to boost consumption in China. The most important determinant of consumption is income, and income growth moves in line with GDP growth, which in the short term is most affected by investment. So indirectly, the government's measures to protect investment and GDP growth will also support consumption. More directly, measures to boost employment growth through tax cuts for small and micro businesses, moves to open up services sector for private investment, and social safety net measures will also help to either increase labor income or reduce saving rate, and hence, help consumption growth. There is virtually no room for income tax cuts, since a very small share of people pay income tax in China, with income tax accounting for 1% of GDP.

A potentially important way to boost consumption is to increase the supply of consumer goods and services where shortages and bottlenecks exist. For example, it is widely known that health care services are in short supply, so more investment in this area, with the help of private sector, can boost health care consumption. Similarly, leisure and tourism consumption is constrained not only by logistics and facilities, but also by the lack of paid leave. Reforms in this area may also help.

Financial sector reform and interest rate liberalization

As pointed out by PBC governor Zhou Xiaochuan, interest rate liberalization may be accompanied by a period of higher interest rates, even if such developments may not be welcomed amidst an economic slowdown and increasing financial sector risks. Does this mean that interest rate liberalization and financial sector reforms in general will be postponed or suspended?

Not in our view. The government and central bank seem determined to push through planned reforms, and the Governor re-iterated last week that he expects interest rates to be fully liberalized within two years. As such, we expect further developments on this front in 2014:

- Liberalization of rates for large certificate of deposits for corporate and households;
- Continued expansion of money market funds with improved regulations;
- Gradual development of a policy interest rate and a mechanism for an interest rate corridor;
- Establishment of a formal deposit insurance scheme.

In order to mitigate the rise in interest rate levels and volatility, we believe the government and central bank will (i) adopt a relatively accommodative monetary policy stance to keep market interest rates adequately low; (ii) use innovative instruments and improved communications to prevent any sudden surge and excessive volatility in market rates; (iii) encourage external borrowing by banks and large corporates to take advantage of low interest rates abroad; and (iv) even consider a cut in benchmark interest rates.

Meanwhile, to beef up China's banking sector strength and develop its non-bank financial sector, we expect the government to (i) open up ways for banks to raise capital, including through preferred shares; (ii) establish an exit mechanism for failed financial institutions; (iii) accelerate the development of its domestic bond and credit markets; and (iv) accelerate reforms in the equity market by ensuring a smooth re-launch of the ongoing IPO reforms for example.

Regarding the further opening of China's capital account, the already announced "mutual market access" program between the Shanghai and Hong Kong stock exchanges will be an important development this year, FDI procedures are gradually being simplified and we have seen increased foreign borrowing by Chinese banks and corporates. That said, the government is also aware of the vulnerability of the Chinese economy and financial system to increased volatility in FX flows, and so may proceed cautiously on this front.