Research Report on China

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Main Economic Indicators of China

Macro indicators	2011	2012	2013
Gross pub. debt, bill CNY	17267	19799	23094
Nominal GDP, bill CNY	47262	52940	58667
Real GDP growth, %	9,3	7,7	7,7
Gross gov. debt/GDP,%	36,5	37,4	39,4
Deficit (surplus)/GDP,%	0,6	0,2	-0,9
Inflation rate,%	4,1	2,5	2,5
Curr. Account balance/GDP,%	1,8	2,5	1,9

Development indicators	2013
Inequality adj. HDI	0,71
GDP per capita (Thou. of USD)	11,9

Sources: RAEX (Europe) calculations based on data from World Bank, IMF, Bloomberg

Introduction

China is the largest emerging economy in the world growing at an average rate of 8% in the last several years. Official[1] figures of government debt and budget deficit show a controlled amount of it, well covered short-term obligations and a balanced budget. In addition, macroeconomic indicators for China are solid with low and stable inflation and unemployment. However, one of China's biggest concerns is private credit and debt at the local government level. The amount of private credit and its allocation (construction and Real Estate industries) present potential vulnerabilities to the system due to a prolonged investment driven economy instead of relying on a consumption growth model.

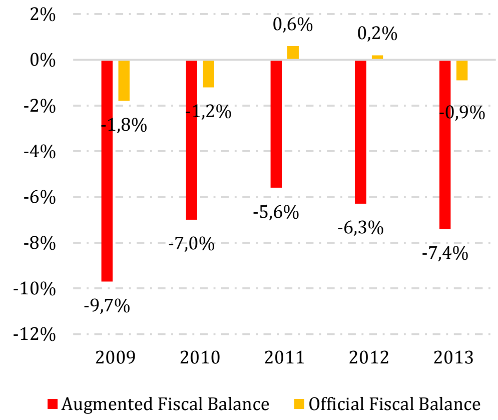
Official government debt levels are moderate. The amount of official debt is 39,4% of GDP, even the augmented debt (including off-budget operations) is at moderate levels (53,7% of GDP according to the IMF). In addition, external and domestic short-term debt is well covered. Even though China's external short-term debt accounts for 85% of the total short-term obligations, foreign exchange reserves represent more than 500% of this amount and more than 100% of gross government debt.

Balanced official budget, but it shows a large deficit when taking into account off-budget operations. In 2013 the government budget presented a deficit of 0,88% of GDP mainly due to increased expenditures and stable revenues. The last six years have been balanced in general with 2009 presenting the higher deficit for China equal to 1,8% of GDP. Nevertheless, when looking at the augmented balance[2] a wide gap can be observed (see graph 1). According to IMF estimations, when including operations by local government financing vehicles[3] (LGFVs), the deficit increases up to 7,4% of GDP, which is substantially different from the official figure. This figure explains the high stimulus and supported growth of the economy from fiscal policy.

Strong and stable macroeconomic indicators, though excessive reliance on investment rather than consumption. Even though China's

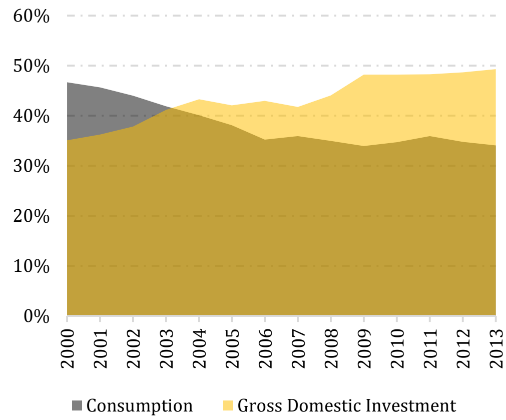
[1] "Official" means that these figures do not include off-budget operations.
[2] Augmented balance includes all funding that is not included in the budget which is done through special financing vehicles especially at the local government level. This is calculated by the IMF.
[3] Local government financing vehicles are off-budget entities set up by local governments in order to finance, mainly, infrastructure projects.

Graph 1: Official vs Augmented Fiscal Balance (% of GDP)



Source: RAEX (Europe) calculations based on data from IMF

Graph 2: Investment vs Consumption (% of GDP)



Source: RAEX (Europe) calculations based on data from World Bank

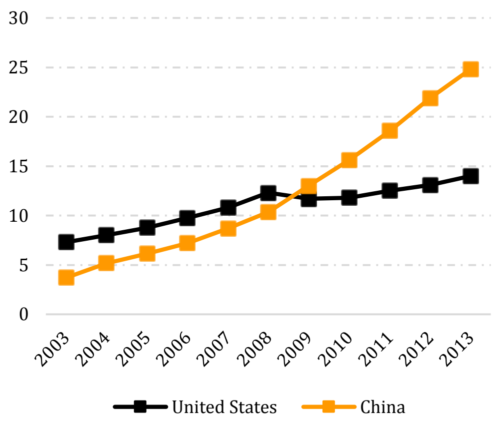
GDP growth has been steadily falling in the last years, its growth rate in 2012 and 2013 has remained robust at 7,7%. At the same time, an inflation rate of 2,5% and an unemployment rate of 4,1% summarize the strong macroeconomic environment surrounding the country. However, this growth has relied basically on investment and credit and not by increased consumption (see graph 2); this cannot be sustained forever. Thus, rebalancing from investment to consumption is one of the main targets of the Chinese authorities.

Monetary policy has been accommodative, however, it seems to be going in the right direction. Through the control of the exchange rate by targeting it to a basket of other currencies and other directed easing measures, the People's bank of China has maintained a relaxed monetary policy. However, early in 2014, the authorities widened the exchange rate band allowing the market to influence the value of the currency with plans of further liberalizing it (which will also provide support regarding the plans of opening the Capital Account, internationalizing the CYN and making it a reserve currency). At the same time, the government is moving towards a more interest rate based system by planning to establish market interest rates. Furthermore, lending rates are now fully liberalized.

Diversified and strong stock market, though corporate bond market remains underdeveloped. The stock market is well developed and diversified in two different exchanges (Shanghai Stock Exchange and the Shenzhen Stock Exchange) which have over 2 700 companies listed combined. With respect to the bond market, this is very large and liquid regarding government bonds, though not the same can be mentioned for the corporate bond market, which is still lagging behind other advanced markets. Therefore, Chinese authorities are trying to develop a more established bond market in order for corporations to finance themselves through markets rather than only bank loans and shadow banking.

Banking system still gripped by government even with financial reform underway. The banking system in China has been slowly changing from a government controlled to a more market based system. Evidence of this is that only three banks remain with full government ownership. However, despite this transformation, the authorities still hold large stakes of ownership in several banks and they control plenty of their activities. Even though a financial reform is in progress, which includes strengthening regulation and supervisory functions, further development of this sector is in jeopardy if government controls prevail and market liberalization continues to be subdued. On the positive side, it is a well

Graph 3: Total Bank Assets (Trill. of USD)



Source: RAEX (Europe) calculations based on data from the Federal Reserve and Statista

distributed sector with a small concentration of assets in a few institutions.

Private debt levels are extremely high, including banking and shadow banking assets. Credit has been increasing since the 2008 financial crisis in order to maintain growth. The amount of private credit has reached very high levels opposite to those from the United States (see graph 3), a country which is regarded to have high amounts of private debt. This credit, either through bank loans or shadow banking, has gone mainly to developers, LGFVs and SOEs which is then invested mostly in Real Estate and construction. Even though piling private credit and boosting Real Estate investment have proven to carry fatal consequences in other countries, there are two reasons that explain why these factors do not represent a risk for China, at least in the short- and medium-term. First of all, as mentioned, an important amount of this credit is going to LGFVs and SOEs, which are likely to receive government support. And secondly, the Chinese government has enough policies, tools and restrictions in place to prevent an economic catastrophe. However, it may represent an issue in the long run if the growth model is not changed.

Conclusion

China has a solid debt stance, even including off-budget funding, and a so far stable position in terms of public finances. Nonetheless, one of China's priorities is to tackle private credit and debt at the local government level. Funding at the local government level is high and uncontrolled due to the fact that it is mainly carried out off-balance sheet and through shadow banking instruments. In addition, several reforms are underway to liberalize the economy in general; including the financial sector, the exchange rate regime and the Capital Account. These changes include adopting a different monetary policy aim by establishing policy rates, which will also aid in controlling the shadow banking system and the adequate allocation of capital. Regarding the need to rebalance the economy from investment to consumption, investment has started to flatten in the last years, though consumption has not picked up as expected. Thus, it is fair to say that one of the biggest questions that remain open regarding the Chinese economy is whether or not China will avoid being stuck in the middle-income trap.