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Research Report on China

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Introduction

The Chinese economy continues to have a strong set of macroeconomic fundamentals and a solid external stance which support the acceptable creditworthiness of the government. Once again, public finances appear to be stable with low official[1] government debt and a balanced budget. Also, inflation, unemployment and real GDP growth remain steady and at very competitive levels; however, the latter, in a declining path. In addition, the Chinese authorities are taking solid strides to propel China into a market-based economy supported by their 'Third Plenum Blueprint'[2]. Potential full interest rate liberalization, real effective appreciation of the CYN and the new budget law, are examples of actions towards the market-based economy goal. On the other hand, halted privatization plans and high levels of credit in the economy, including off-balance sheet assets are concerns that negatively affect the Chinese economic outlook.

Main Economic Indicators of China

Macro indicators	2012	2013	2014
Gross pub. debt, bill CNY	19744	23101	26181
Nominal GDP, bill CNY	52940	58667	63761
Real GDP growth, %	7,763	7,751	7,364
Gross gov. debt/GDP,%	37,3	39,4	41,1
Deficit (surplus)/GDP,%	0,0	-1,1	-1,1
Inflation rate,%	2,5	2,5	1,5
Curr. Account balance/GDP,%	2,568	1,931	2,021

Development indicators	2014
Inequality adj. HDI	0,72
GDP per capita (Thou. of USD)	12,9

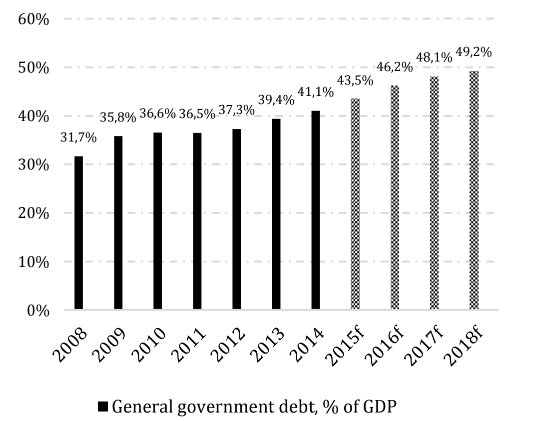
Sources: RAEX (Europe) calculations based on data from World Bank, IMF

Official government debt levels increased slightly in 2014, however, they remain low overall. Official government debt to GDP increased from 2013 to 2014 by 1,7 p.p. to finish at 41,1% at year-end. Even though this increase is not alarming and the debt level is still bearable, the upward trend for this indicator has been steady since 2008 and is projected to continue ascending in the following years (see graph 1). In fact, IMF projections indicate that it may reach around 50% of GDP in 2018. This is the result of a slower economic growth in the country and the increase of local government indebtedness without the use of LGFVs[3]. Even though China's external short-term debt remains high, foreign exchange reserves continue to cover it by more than 500%.

Macroeconomic indicators remain stable and government measures will strengthen China's economy despite real GDP slowdown. Inflation in 2014 stood at 1,5%, 1 p.p. lower than in 2013 when it ended the year at 2,5%. In addition, this indicator has been stable for the past three years, supported by sound monetary policy. Unemployment has also had a steady behavior since 2009 averaging 4,1% in this time span, the same figure posted at the end of 2014. However, real GDP growth in 2014 was lower than initially expected by international organizations driven by stalled real estate prices and overcapacity in the economy; it grew 7,4%

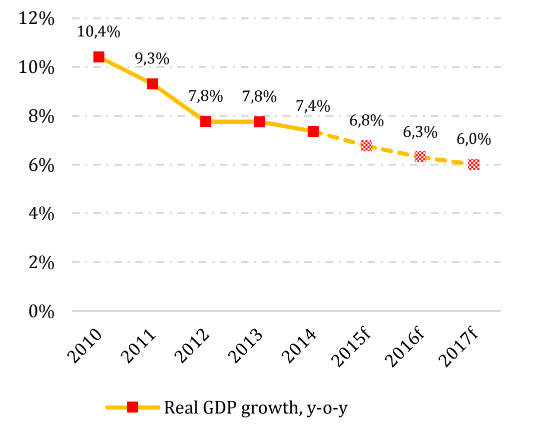
[1] "Official" means that these figures do not include off-budget operations.
[2] The "Third Plenum Blueprint' is a set of social and economic reforms designed by the Chinese authorities and presented at the end of 2013. The set of reforms is mainly focused in transforming China into a market-based economy.
[3] Local government financing vehicles are off-budget entities set up by local governments in order to finance, mainly, infrastructure projects.

Graph 1: Official government debt levels



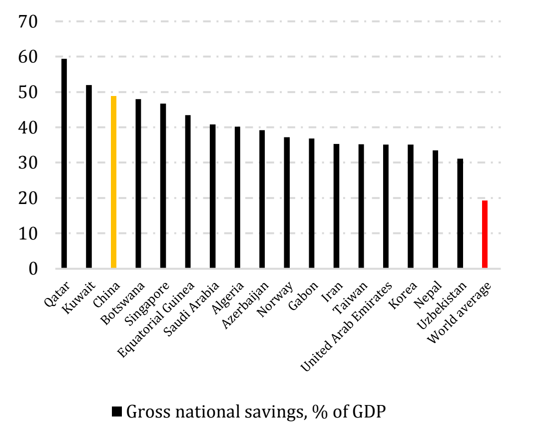
Source: RAEX (Europe) calculations based on data from the IMF

Graph 2: Economic growth in China



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

Graph 3: Top countries regarding national savings



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

missing the 7,5% target from the authorities. In addition, projections show that the decline will continue to deepen, potentially reaching a level of 6,0% in 2017 (see graph 2). Besides the aforementioned factors causing a decline in growth, government's efforts to convert China into a market driven economy have also contributed to slower but more stable growth. The implementation of the 'Third Plenum Blueprint' appears to be going in the right direction, however, there are still reforms in the blueprint which have not been yet put into action. A successful realization of the plan will also support the reduction of excess gross savings in China, the third country with the highest amount of gross savings as a percentage of GDP (see graph 3).

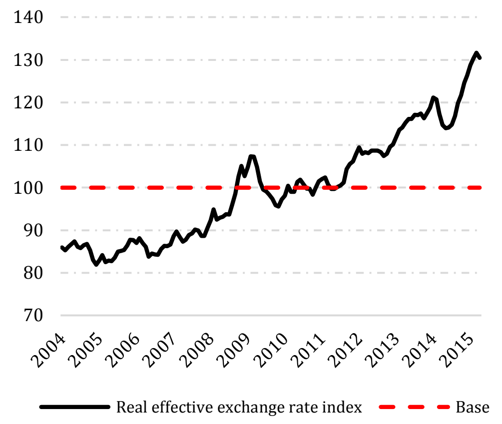
The official budget continues to be balanced and the new budget law will help to reduce unofficial local government indebtedness. The budget deficit in 2014 stood at 1,1% of GDP, low and consistent with the deficit from 2013. However, as mentioned in our previous report for China[4], the deficit is wider when off-budget operations from local governments are taken into account. In this regard, the new budget law will help to narrow the augmented fiscal deficit. This law allows local governments to issue their own bonds, thus, reducing their dependence on high-interest bank loans and the use of LGFVs. These governments will be allowed to refinance around 1 trillion CYN of bank loans with local government bonds with this quota expected to rise up to 3 trillion CYN. Naturally, this measure will alleviate pressure from local governments in the short-term; however, taking into account the amount of local government debt compared with the authorized local bond quotas, sub-national debt remains high.

Monetary policy remains loose and the People's Bank of China (PBC) is still advancing towards achieving a market-based financial system. The PBC continues to cut reserve requirement ratios, one of the main tools used by the Central Bank to conduct monetary policy. The PBC relies heavily on these types of unconventional tools due to the lack of transmission power in adjusting reference interest rates. The fact that banks are reluctant to provide credits to many small and medium enterprises and implicit guarantees towards SOEs, affect the transmission mechanism. However, as mentioned before, China is trying to transform into a more market-oriented system which, in turn, needs market based interest rates. With the full liberalization of lending rates and potential liberalization of the deposit rates, the Chinese financial system will be closer to being driven by the market.

The exchange rate is no longer cataloged as undervalued and the CYN is becoming closer to be part of the IMF's Special Drawing Rights (SDR) basket. The CYN is no longer considered as an undervalued

[4] Research report on China from 15th of January, 2015 (http://raexpert.eu/reports/Research_report_China_15.01.2015.pdf)

Graph 4: Real effective exchange rate of the CYN



Source: RAEX (Europe) calculations based on data from the Bank for International Settlements

currency, in fact it has severely appreciated in real terms in recent years (see graph 4). The recent uplift of currency control systems has contributed to this appreciation. Additionally, the inclusion of the CNY in the IMF's SDR basket is becoming more plausible as time passes by. According to the IMF's Managing Director, the inclusion of the Chinese currency in the SDR basket is just a matter of time.

Plans from the Chinese government to consolidate and merge different SOEs is a step back from expected privatizations. In order to make SOEs more profitable, the Chinese authorities have come up with a plan to consolidate the state-owned sector of the economy. The consolidated companies will then be focused to operate like commercial enterprises. After the companies maximize their returns, they will eventually be prepared to start listing in the stock markets. The plan, however, strengthens the grip of the government on these companies and takes off the table, or at least limits, previous plans for large-scale privatization, an important step towards becoming a market-based economy.

Credit in the economy remains at high levels. As mentioned in the Agency's previous report, "private debt levels are extremely high, including banking and shadow banking assets"[5]. China's banks' total assets as of the first quarter of 2015 amounted to 280,4% of GDP, 22 p.p. higher than at the end of 2013. At the same time, shadow banking continues to grow in an economy where it is becoming harder to sustain such amounts of debt. In this regard, new policies from the government involving local government debt and further liberalization of financial markets shall aid in mitigating these risks.

Conclusion

China's economic position is mainly supported by low and stable inflation and unemployment, continuous and high real GDP growth, a balanced fiscal budget and a satisfactory and reliable external sector. On the other hand, the country is negatively affected by the still large amounts of local government debt, hindered privatization plans and high levels of credit in the economy, for the most part. However, based on an ambitious plan of reforms and clear targets towards becoming a market-based system, the country is in the right direction to have a more balanced, consumer-based economy.

[5] Research report on China from 15th of January, 2015 (http://raexpert.eu/reports/Research_Report_China.pdf)