

China Macro View

Takeaways from 2013 China Policy Day

- **China policy insights** – Our annual China Policy Day was held in Shenzhen on 22 March. Below we highlight key takeaways.
- **Government experts are optimistic on growth** – Annual growth of 7.5% is seen as the bottom line of Chinese policymakers. Experts predicted growth of 8-8.5% this year, driven mainly by local govts' incentive to invest and improving external demand. This optimistic view is also relying on two assumptions: benign inflation and innovative sources of funding. In our view, accommodative liquidity conditions should support growth slightly above 8% in 1H, but funding conditions would cap the upside as both fiscal and monetary policies are expected to be less expansionary this year. As the easing bias of policies is gradually removed, growth may fall below 8% in 2H, and we estimate annual GDP growth at 7.8%YoY.
- **PBOC is more cautious about the inflation outlook** – No expert predicted hyper inflation for the year, but the monetary expert cautioned about the uncertainties of inflation in 2H amid unstable inflation expectation. Most agreed the 3.5% inflation target is achievable. We think inflation is not a near-term threat and the mild recovery would help contain inflation. But the possible uptrend of inflation will leave little room for PBOC to maintain the accommodative policy stance.
- **Monetary policy will likely shift to a neutral position** – According to the monetary expert, M2 growth target of 13% reflects a neutral policy stance, and does not mean a tight policy, especially considering that China's potential growth appears lower now and the shadow banking system provides additional financing to the economy. This is consistent with our call since late last year. M2 growth may steadily fall to about 13%, and interest rate levels may rise during the year, most likely through a widening of the deposit rate band when inflation approaches 3.5%.
- **Growth model has yet to be shifted** – The growth rebound so far has been driven by govt-initiated investment programs. A new round of investment boom is likely following the installation of new governments at central and local levels. But this coming cycle is likely facing new challenges: environmental degradation and overcapacity in the manufacturing sector. The govt will introduce emission standards tougher than the legal requirements in 47 cities covering six industries, effective April 1. An urbanization plan for next decade will likely be launched in June, centered on the policy of land use.
- **Rapid home price increases would trigger more policy measures** – Curbing property prices through demand/supply management remains top priority. The existing policies will be further expanded or materialized (e.g. property tax, wider administrative coverage for purchasing restrictions) if home prices continue to rise. We expect the property tax to be tested in more cities this year, possibly with exemption for subsistence level of living space. Over the longer term, we think a healthy housing market would require a new system for land trade and uses.

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Takeaways from 2013 China Policy Day

Our annual China Policy Day was held in Shenzhen on 22 March 2013. Senior experts from National Development and Reform Commission (NDRC), People's Bank of China (PBOC), Ministry of Finance (MOF), Ministry of Housing and Urban-Rural Development (MOHURD), Development Research Center of the State Council and Ministry of Environmental Protection shared their views on China's economic policies following the conclusion of the annual session of the National People's Congress. Below we highlight key takeaways.

Macro Outlook

Above 8% growth is projected – The macro expert from NDRC thinks the key macro theme this year is to manage the balance between inflation and growth while the labor market remains intact. GDP is likely to grow at 8-8.5% this year. In 1Q, GDP growth may reach 8%YoY, equivalent to 1.9%QoQ based on his estimation.

Investment and exports remain the most important drivers – According to the expert, net export contribution to GDP growth is expected to turn positive and any upside from US/developed economic growth would drive export growth above the annual target of 8%YoY. The expert believes 2013 FAI infrastructure investment would accelerate to 25%YoY, thanks to the NDRC project approvals last year and urbanization-related investment such as railway, environment protection. As to the property FAI, despite the faster-than-expected Jan-Feb growth rate, the annual performance may be only slightly better than last year (around 20%YoY) as the uncertainties brought up by the recent tightening measures of the State Council. Investment in manufacturing will likely only grow at the same rate as last year given the overcapacity problem and the energy production cost reduction in North America. Meanwhile, consumption this year is likely to be constrained by the campaign to curb government lavish spending and less effective consumption stimulus measures.

CPI inflation is projected to stay within 3-3.5% range in 2013 – According to the expert, the relatively benign inflation outlook is supported by favorable agricultural conditions: (1) pork prices remain well-contained; (2) Grain reserves have reached historic highs; (3) soybean harvest in main producer countries is helping to reduce imported inflation.

The economy is in the middle of a moderate up-cycle – Based on historical experience (1992-1997, 2002-2007), the expert believes the government reshuffle will herald another upward economic cycle in 2013. However, in this current cycle, the economy will likely only grow at a moderate pace, constrained by environmental degradation, overcapacity, and the tradeoff between stabilizing growth and containing prices.

Our views – The growth rebound has been supported by government policies and driven by the traditional engines of investment and exports. Without further policy stimulus, the growth recovery would be modest. In fact, as the balance of risks shifts slightly toward inflation, policies may return to a neutral position. Abundant liquidity and credit early in the year should sustain investment and growth in the near term, delivering growth slightly above 8% in 1H. As the policy bias shifts, growth may fall below 8% in 2H. We estimate annual GDP growth at 7.8%YoY, and average inflation slightly below 3%YoY.

Monetary Policy

The monetary expert considers monetary policy more challenging this year –

Last year, reducing downside growth risk was the policy priority and monetary policy played the role to support growth as inflation was not a concern. This year, the government aims to stabilize growth, adjust economic structure, manage inflation expectations and guard against financial risks. For monetary policy, it is more challenging to balance among multiple objectives, especially because there is more uncertainty about inflation momentum in 2H, and the government wants to keep reasonable growth. In other words, the room for maneuver is narrower this year.

Growth downside risk is smaller relative to inflation upside risk – The economy bottomed out last year, and the current growth rate appears to be generating sufficient jobs, with the labor market stable and slightly tight. The rebound has relied on investment and improved exports, with no material change in the growth model. On the other hand, while inflation should be manageable in 1H, prospects are uncertain in 2H. Local governments still have strong incentive to invest; external conditions are another variable, and monetary easing in advanced economies may increase imported inflation; further price reform will also add to inflationary pressure. Inflation expectations remain unstable.

Monetary policy is turning to neutral position – M2 growth target of 13% reflects a neutral policy stance, and does not mean a tight policy, especially considering that China's potential growth appears lower now and the shadow banking system provides additional financing to the economy. In addition, the same level of inflation is now corresponding to a lower growth rate, and PBOC is attaching more importance to the inflation objective. If the credit-dependent growth model is not changed, the market may feel the monetary condition is tight. In case of a new round of investment boom, interest rates would face upward pressure this year.

PBOC will not rely on a single intermediate target – To achieve the ultimate objectives, PBOC chooses broad money (M2) and RMB credit as the intermediate targets. However, due to financial innovation, the relationship between M2 and growth/inflation has become unstable. For total social financing, its relationship with the ultimate objectives has yet to be established partly due to lack of historical data series. As a result, it is not enough to rely solely on the M2 target, and it is difficult to set a target for total social financing to begin with. Meanwhile, experience shows higher interest rates can help bring down money growth. Because of these changes, PBOC is paying more attention to the ultimate objective of inflation/growth.

PBOC has a neutral attitude toward shadow banking – The existence of shadow banking mostly reflects the demand of the real economy to sidestep the restrictions in the banking system. The current risk is mainly liquidity, not default, and should be manageable. Shadow banking has close relationship with the banking system, and the risk profile (including their exposure to the LGFVs and property sector) is also similar.

A change in monetary tool preference does not signal a change in policy – PBOC chooses different monetary tools under different capital flow scenarios. An increase or decrease of the reserve requirement ratio does not represent a change of policy stance. PBOC used RRR hikes when there were large capital inflows and excessive liquidity before 2012. In 2012 when there were outflows, PBOC cut RRR first and then used reverse repos to ensure adequate liquidity. Recently PBOC has resumed the use of repos to mop up excessive liquidity. For policy signaling, PBOC's quarterly monetary policy execution report is an important channel.

Financial reform will continue – As a result of interest rate reform last year and financial deepening, the role of the market is increasing in interest rate determination. As the pricing ability and corporate governance of the financial institutions and PBOC's ability to guide interest rates improve, interest rates will be liberalized further. On RMB internationalization, the hurdles for using RMB will continued to be dismantled, but how fast RMB can become an international currency will depend on the choice of the market.

Our views – We think PBOC has signaled more caution about the inflation prospects among the government agencies, partly to manage inflation expectation. While the risk of hyper inflation is low, we expect inflation to trend up from 2Q, which leaves little room to PBOC to maintain the easing bias. As we have long argued, monetary policy stance will gradually become neutral, meaning tighter than last year but by no means austere especially considering the financing outside the banking system. M2 growth may steadily fall to about 13%, and interest rate level may rise during the year most likely through a widening of the deposit rate band when inflation approaches 3.5%.

Fiscal Policy

Growth of 7.5% is regarded as the bottom line for 2013 – According to the fiscal expert, China is on the way to achieving a growth rate 8% or slightly above in 2013, supported by motivations of the new government to perform and the deepening urbanization drive. The senior leaders have reached a consensus that 7.5% growth will be the bottom line, given declining local government revenues, irregularities in tax collections and associated social problems experienced in 2012. The government's tolerable up-limit for CPI is 4%.

Rising budget deficits to fund social welfare and infrastructure development – The government targets a budget deficit at RMB1.2tn in 2013, an increase of RMB400bn over 2012. The reform on converting sales tax to VAT for the service industry is estimated to cost RMB200bn, and another RMB200bn will be used for financing rural irrigation, affordable housing, education, public health and urban infrastructure development. Affordable houses will need to be increased by 10 million in the next few years. The increased fiscal deficit will be funded by bond issuance. The government leverage level is considered acceptable.

Fiscal revenues will pick up – Following a slow growth in fiscal revenues in Jan-Feb of 1.6%YoY, fiscal revenues are expected to rise to 9.2% for the whole year, higher than GDP growth.

Fiscal system reform will be pushed ahead – The pilot reform on reducing government layers for budgeting and fiscal transfers will move ahead; and the same for the pilots on resource and property taxes. Reforms on resource taxes are urgently needed to improve efficiency for electricity, water and coal usage. The government will provide subsidies to compensate low-income groups, while middle-income earners are expected to change their behavior. The key for fiscal reforms is to align fiscal resources and responsibilities for the local governments, but there is no clear indication of reform in this area.

Our view – According to our estimate based on widely accepted methodology, the budget deficit for 2012 was 2.4% of GDP, and the executed fiscal deficit was 2.0% of GDP. With approved budget deficit for 2013 at 2% of GDP, the fiscal policy would not be more expansionary on 2013. A more conservative fiscal and monetary policy mix would cap growth upside.

Property Outlook

Curbing property prices through demand/supply management remains top priority – According to the property expert, the government continues to give full support to the social housing program, planning to invest around Rmb1.3tn in total this year, compared with Rmb1tn in 2012. On the policy front, the existing policies issued will be further expanded or materialized (e.g. property tax, wider administrative coverage for purchasing restrictions). Meanwhile, the authority will be more cautious on drafting new property measures going forward, learning lessons from the "five general guidelines" recently issued by the State Council which triggered a rush in home purchases.

Rapid home price increases would trigger more policy measures – The property expert thinks above all, the government definitely would not like to see a constant increase in property prices. They would introduce more tightening in case of price increases. In the longer term, the expert suggested the new government should expand the property tax over all regions as soon as possible, while abolishing the old policies and introducing a wholly new set of property guidelines to correct market expectations.

Our view – We maintain our view that a property tax is indispensable to curb speculative demand and manage price expectations. We expect the tax to be tested in more cities this year, possibly with an exemption for subsistence level of living space.

Land Policy

The land acquisition and use system at the core of China's urbanization drive – According to the land expert, China's urbanization so far has been based on a land acquisition and use system which provides local governments with a monopolistic power in land acquisition and use. Under the system, local governments acquired rural collective land at cheap prices, and then sold the land for higher prices. The local governments have used the profits from land sales and bank loans (often using land or future land income as collateral) to develop urban infrastructure and industrial parks for higher GDP growth.

Low land-use efficiency, social conflicts and unrest are byproducts – The current model of land acquisition and uses has led to low efficiency in land use. About 40% of the collective land acquired has been allocated for industrial uses at relatively cheap prices to attract inward investment, with a low land utilization ratio. This is much higher than the international average of 15%. Another 20-30% has been used for urban infrastructure including metro highways, large city squares, and government buildings. Rural residential land has kept expanding as migrant workers and their families built up new houses in their villages. The low compensation paid to farmers for land acquisition has led to conflicts between local officials and farmers.

An unsustainable land use and local financial system – Local governments have to sell their acquired land for residential and commercial property development (20-30% of the total land acquired only) at higher prices to finance local infrastructure, which has helped to push up urban property prices. Local government revenues from land sales have recorded high but unstable growth. A decline in such revenues would have a direct effect on local government spending on infrastructure. With a large amount of bank loans using land as collateral, a decline in land prices and/or a decline in revenues from land sales increases bank

risks. It appears that the income from land sales in the coastal areas has trended down, as is the ratio of land sale income in total local government revenues.

New urbanization drive requires a new system for land trade and uses – A new integrated urban and rural land market should be established. The local government monopoly in land acquisition and sales should be removed. For land acquisition, the compensation to farmers should be raised significantly, and those farmers who gave up their land should be able to access urban social security systems and benefits. With integrated urban and rural land markets, the land owners (legal users) should be able to trade directly on the market and obtain their income from land sales. Under such a model, part of the income from land sales should be used for urban infrastructure development. The local governments should impose capital gains tax on land and properties to replace the one-off gain from land sales.

Our view – We agree with the expert that the current land acquisition and use system is not sustainable, and a new urbanization drive needs a reformed land-use system. We also think land title is a key to the reform in the land system. Farmers could be offered land title or more permanent, tradable use rights for their land so as to protect their interests. An integrated urban and rural market cannot be created without a more clarified land title for China's rural residential and farm land.

Environment Policy

The environment tax will enter legislation procedure this year – According to the environment expert, the new tax will consolidate pollution fees and natural resource tax, and is not only targeted at pollution, but also the use of environment capacity.

The expert expects more bottom-up initiatives to control car emissions – To contain emissions, big cities will continue to control the total number of cars, upgrade emissions standard (Beijing has adopted European standard #5 and other cities may follow), and raise gasoline standards. Public transportation will be encouraged to replace private cars.

Government will use both regulation and price measures to change behavior – The government will strictly implement restrictive industrial policies aimed at reducing pollution. In response to recent smog incidents, the government will introduce emissions standard tougher than the legal requirements in 47 cities covering six industries, effective April 1. On the other hand, the cost of higher environmental standards will have to be shared, and higher natural resource prices are a trend. For example, apart from higher gasoline prices, cities will gradually introduce tiered water prices and increase sewage disposal fees. The government is also adopting policies favoring green products in government procurement, which makes up 30% of total procurement.

Social funding would be needed to support environment-related investment – It is estimated that environment investment would reach RMB3tn during the 12th Five-Year Plan. This is a very rough calculation as environment investment cannot be defined clearly. According to international experience, it takes 1.5% of GDP of spending to maintain the environment and 3% of GDP to improve the environment, suggesting 3tn is the low end. Most of the investment is expected to be made by enterprises themselves. Fiscal funding will be used to address regional issues. Credit and innovative financial instruments would be needed to support the investment.

Appendix A-1

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