

China Macro View

NPC Outlook: Bottom-Line Thinking in Balancing Growth and Reform

- **Reform may take precedence as long as the bottom-lines are not threatened** – The market focus has shifted to the NPC meetings to be convened on Mar 5, the first since the Party passed a comprehensive reform package last Nov. Facing the trade-off between growth and reform, the government increasingly emphasizes bottom-line thinking. Although the growth target may be kept at 7.5% this year, we think the government is ready to press ahead with substantive reforms and endure some sacrifice of growth, unless (i) quarterly growth falls to or below 7%; and (ii) there is an imminent systemic financial risk.
- **Investment deregulation, financial liberalization and realignment of fiscal relations may top the 2014 reform agenda** – The negative list is likely to be introduced to encourage private investment in financial industry, telecommunications, energy, public utility and railway. Financial reform may feature the establishment of private banks, widening of the RMB trading band, introduction of negotiable CDs, deposit insurance scheme, and QDII2, and securitization of credit assets. Some spending responsibilities may be transferred from local to central government, and local governments may be allowed to issue their own debt subject to quota control.
- **The government may also kick start SOE and urbanization-related reforms** – SOE reform may include allowing private capital participation and setting up state capital operating companies to better manage the state capital. To support urbanization, the government may adopt measures to integrate migrant workers already working and living in urban areas, and lay the groundwork for land reforms.
- **The importance of the growth target is likely to be watered down** – Among the 31 regions in China that just concluded the local NPC meetings, 22 regions lowered growth targets and only one region raised the target. The strong job creation data for 2013 may increase tolerance for lower growth, but we think quarterly growth of 7% would still trigger policy easing, at least in 2014.
- **Macro policies are likely to be less accommodative** – The government may keep the CPI inflation target (average) at 3.5%. Recent PBOC report suggests the central bank is less worried about inflation but concerned about the financial risks associated with rising debt level, and will likely keep the current policy stance with a moderate tightening bias. M2 growth target may be set at 13%, and credit growth is likely to be lower than that of 2013. The official budget deficit may be kept at 2% of GDP (equivalent to Rmb1.3tn). However, the government has made containing local government debt as one of the key tasks. Extra-budgetary financing is likely to be tighter, and overall fiscal policy may become a drag. We are of the view that the generally tighter macro policies may not support the growth target, and therefore maintain our 2014 growth forecast at 7.3%.

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NPC Outlook: Bottom-Line Thinking in Balancing Growth and Reform

The annual National People's Congress (NPC) meetings are scheduled to begin on Mar 5, the first since the Party passed a comprehensive reform package last Nov. During the meetings, which may last 10 days, macro targets (including GDP growth) will be set; the 2014 budget will be approved; and near-term reform priorities will be determined. Facing the trade-off between growth and reform, the government increasingly emphasizes bottom-line thinking. Although the growth target may be kept at 7.5% this year, we think reform would take precedence unless (i) quarterly growth falls to or below 7%; and (ii) there is an imminent systemic financial risk. Monetary policy and broadly defined fiscal policy are likely to be less accommodative compared with 2013, and we think macro policies will only be loosened when the bottom-line is challenged. We are of the view that the generally tighter macro policies may not support the growth target, and therefore maintain our 2014 growth forecast at 7.3%.

What is the bottom line?

Preventing large-scale unemployment and financial crisis, the bottom-line –

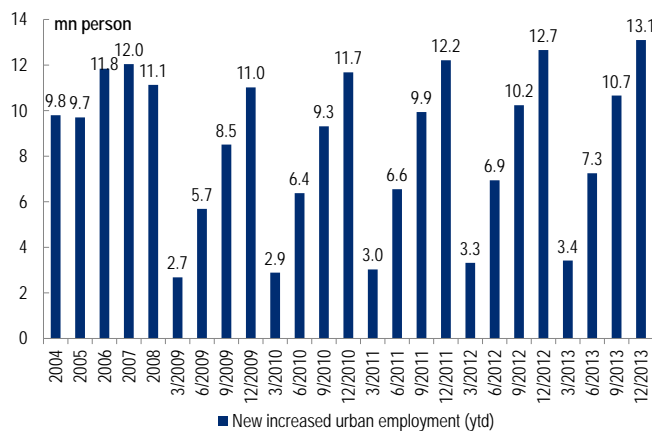
The government introduced a macro framework last Jul at the height of growth and financial uncertainties. The framework features an inflation upper bound and a growth/employment lower bound. The economy is considered to be in a reasonable range as long as the two bounds are not breached. In 2013, the lower bound for growth is set at 7.5% below which the government would take measures to stabilize growth, and the upper bound for inflation at 3.5% (annual average) above which the government would intervene to stabilize prices. We believe concerns about unemployment lie at the heart of the new framework. According to government assessment, 7.2% GDP growth is considered necessary to keep survey-based unemployment rate from rising from the current level (about 5%). The government has also emphasized the need to prevent systemic and regional financial risks.

The government may keep the growth target at around 7.5% – The top leaders have emphasized the need to push ahead with reforms, but see stable economic and social environment as necessary conditions. The Politburo meeting yesterday (24 Feb) concluded that China is well-placed to achieve “medium to high” growth rates in the foreseeable future. Such language suggests the government may keep the growth target unchanged, in large part to help stabilize expectations and avoid a sharp deceleration of investment. The government may also keep the inflation target (average) at 3.5%. Given subdued inflation outlook, the inflation target leaves ample room for introducing price reforms and policy easing measures if necessary.

But we believe the government can tolerate slightly lower growth – The government may again set a target of creating 9 million jobs in 2014. However, the target has become increasingly irrelevant. From 2012 to 2013, while GDP growth remained stable at 7.7%, jobs created increased from 12.7 million to 13.1 million. In other words, the economy's ability to create jobs is strengthening, likely due to fast growth of the service industry. In addition, the labor market supply-demand ratio rose to 1.10 in 4Q 2013,¹ suggesting nationwide labor shortage. We believe growth slightly below 7.5% is unlikely to cause large-scale unemployment, which would allow the government to put stimulus on hold for longer.

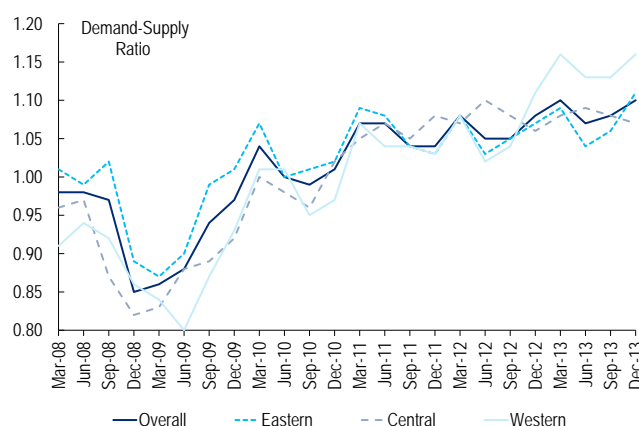
¹ The ratio of the number of vacancies to the number of job seekers.

Figure 1. Jobs created increased to 13.1 million in 2013



Source: CEIC and Citi Research

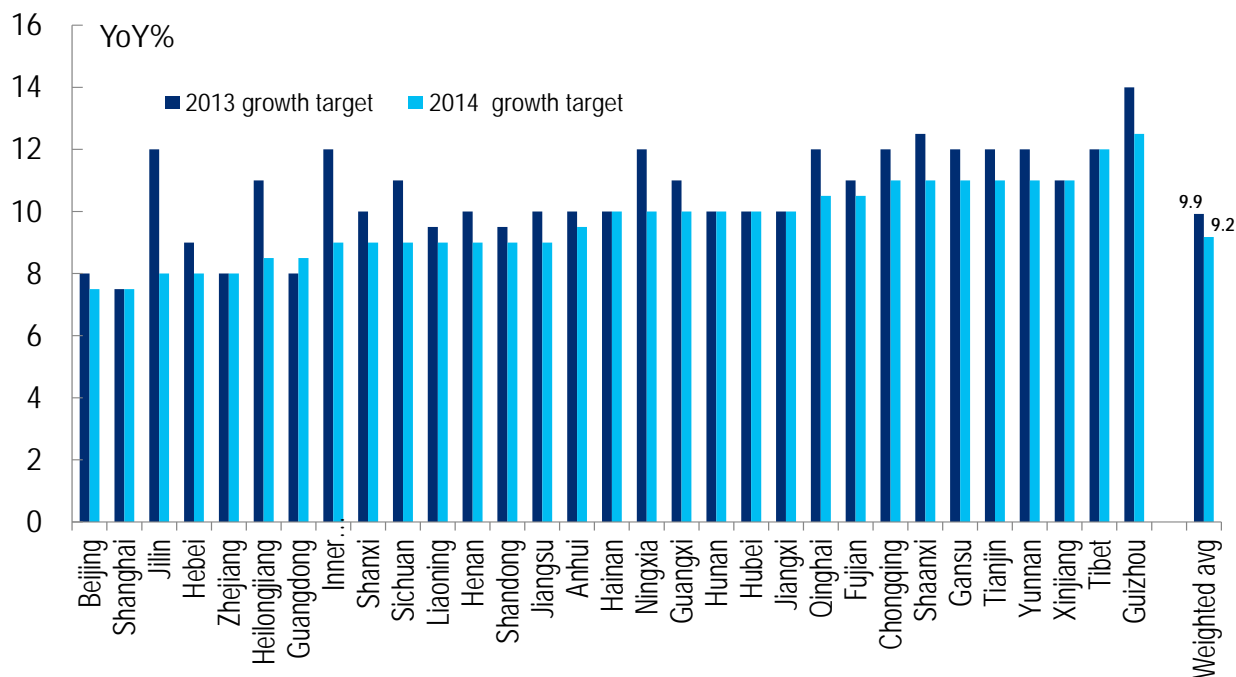
Figure 2. Labor market supply-demand ratio rose to 1.10 in 4Q 2013



Source: CEIC and Citi Research

The importance of growth target is likely to be watered down – Increasingly concerned about excess capacity, high leverage and severe pollution, the current government appears to attach more premium to the quality of growth than the level of growth. The central government has reduced the importance of GDP in evaluating local government officials. Reflecting that, among the 31 regions in China that just concluded the local NPC meetings, 22 regions lowered growth targets for 2014 and only one region raised growth target. As a result, the weighted average growth target has declined from 9.9% in 2013 to 9.2% in 2014.²

Figure 3. Provincial growth target 2013 vs. 2014



Source: Provincial official websites and Citi Research

² Locally reported GDP growth (weighted average) has been consistently higher than the national GDP growth.

Quarterly growth of 7% could be the bottom-line for 2014 – However, we think the government would rather err on the conservative side when it comes to job market stability, and not tolerate growth significantly below the targeted rate of 7.5%. If quarterly growth falls to or below 7%YoY, we expect the government will almost certainly take actions to support growth, even at the cost of temporarily postponing reform.

Systemic financial stress could also trigger policy loosening – The authorities are treading a fine line to moderate the increase in the corporate leverage by gradually tightening monetary and credit conditions. However, the slowing economy and rising cost of capital could lead to a jump in NPLs and default cases, with possible contagion to the whole economy. In time of financial stress (such as liquidity or credit crunch), we expect the government to temporarily loosen liquidity and credit policy to avoid a self-inflicted crisis.

Macro policies likely less accommodative

Unchanged policy tone but effectively tighter policies in 2014 – The Premier has repeatedly emphasized that there is no room to increase the budget deficit, and monetary policy will neither be loosened nor tightened. Yesterday's Politburo meeting reiterated the pledge to maintain a proactive fiscal policy and prudent monetary policy. Monetary policy has already been tightened relative to 1H of 2013 and enhanced regulation of the shadow banking suggests the tightening bias of the credit policy is here to stay. On the fiscal policy side, containing local government debt would constrain extra-budgetary financing and spending.

Budget deficit may be kept at 2% of GDP (or Rmb1.3tn) with built-in automatic stabilizer – The public finance fiscal stance should be broadly neutral compared with that of 2013. Based on recent remarks by the Finance Minister, the focus of the budgeting process will likely be shifted from the size of budget deficit to the determination of spending growth; the spending growth may no longer be pegged to GDP growth; and the budget revenue may no longer be a binding task but an indicative target. The purpose is to reduce the “procyclicality” of the fiscal policy.³ If GDP growth disappoints, the government would allow the fiscal revenue to fall short of the target, which may result in higher-than-budgeted deficit since spending will be implemented according to the budget; if GDP outperforms, higher-than-budgeted fiscal revenue would lead to smaller fiscal deficit. The fiscal policy would therefore act as an automatic stabilizer, reducing economic volatility.

But the broadly defined fiscal policy could be tighter – Apart from activity under the public finance budget, the local governments also spend with financing from land sales and LGFV debt issuance. For example, the recent government debt audit shows local government debt increased from 30.6% of GDP at end-2012 to 31.4% of GDP at end-Jun 2013, tantamount to an expansion of extra-budgetary deficit of 0.8ppt of GDP. Tighter control of local government debt would lead to smaller extra-budgetary deficit.

³ Up to now, tax revenue is a binding task. In times of overheating, tax revenue tends to overshoot the target and the tax bureaus have the incentive to postpone tax collection to avoid creating a high base for the next year, which is equivalent to a tax cut; in times when GDP growth disappoints, tax bureaus would advance tax collection to meet the target, effectively increasing tax burden. This tends to magnify the fluctuation of the economy.

Figure 4. Overview of general government debt (In billions of RMB, unless indicated otherwise)

Time	Government level	Direct gov liabilities	Contingent gov liabilities		Total	Debt/GDP (percent) 1/
			Gov guaranteed debt	Debt that may receive gov relief		
End-2012	Central gov	9,438	284	2,162	11,883	22.9
	Local gov	9,628	2,487	3,771	15,886	30.6
	Total	19,066	2,771	5,933	27,769	53.5
End-Jun 2013	Central gov	9,813	260	2,311	12,384	21.7
	Local gov	10,886	2,666	4,339	17,891	31.4
	Total	20,699	2,926	6,650	30,275	53.1

Sources: National Auditing Office and Citi Research. Note: 1/ The debt ratios for 2013 is based on forecasted GDP (roughly Rmb57tn).

PBOC may keep the moderate tightening bias of monetary policy – The Monetary Policy Report (4Q 2013) released early this month suggests the central bank becomes less worried about inflation but remains concerned about financial risks associated with rising debt levels. PBOC calls for tolerance of reasonable interest rate volatility in the context of policy adjustment, interest rate liberalization and Fed tapering. The central bank pledges to maintain prudent monetary policy by “stabilizing total money supply and optimizing credit structure.” We think the current policy stance is likely to be kept as long as the government’s bottom-line is not threatened. More specifically,

- M2 growth target may be kept at 13%. M2 growth had been above 14% except for Dec in 2013.
- While PBOC does not announce credit quota, we forecast RMB new lending at Rmb9.5tn (Rmb8.9tn in 2013), with credit outstanding growing by slightly above 13% (14.1% in 2013).
- The CBRC’s 2014 planning meeting identified wealth management, trust, micro finance and financing guarantee business as four areas where risks need to be contained. Enhanced regulation of the shadow banking may bring down the growth of total social financing (TSF). We forecast TSF of RMB17-18tn for 2014 (Rmb17.3tn in 2013), with TSF outstanding estimated to grow by roughly 15% (about 17% in 2013).

Low-risk reforms first

We see a good chance for substantive reforms to proceed in 2014 – The central economic work conference last Dec called for reforms in an orderly way: (i) in areas where the direction is clear, local governments and line ministries should accelerate reforms in 2014; (ii) in areas where decisions need to be made at the central level, reform plans should be formulated and measures introduced in 2014; (iii) in uncharted territories, pilot programs could be used to distill lessons and build consensus; and (iv) in areas where legislative changes are needed, the process should be activated at the earliest possible dates. Apart from the reform-leading group at the central level (headed by President Xi), local governments and line ministries also established similar teams to oversee reforms, which will likely improve policy implementation.

We expect tangible progress in investment, financial, and fiscal reforms in 2014 –Based on recent statements from the government and our assessment of the degree of preparedness, we think the following reforms are likely to be introduced this year:

- **Investment deregulation.** Under the stewardship of the Premier, government agencies are expected to publish the list of matters that are still subject to administrative approval. Economic agents can make their own decisions without approval for matters outside the so-called negative list. This is a major step in deregulating investment, and the government may open the financial industry, telecommunications, energy, public utility and railways for private investment.
- **Financial reforms.** (i) CBRC has indicated 3-5 private banks will be approved to introduce more competition. (ii) The floating band of RMB exchange rate is likely to be widened from the current $\pm 1\%$ to $\pm 2\%$ when the market expectation about the currency becomes more balanced. (iii) Negotiable certificate of deposits (NCDs), which are not subject to rate control, have been introduced in the interbank market, and may be offered to enterprises and households; long term (for example 5-year) deposit rates may also be liberalized. (iv) The deposit insurance scheme, prefunded with differentiated premiums, will be likely to be introduced, covering all deposit-taking institutions. (v) Quota under QFII, RQFII and QDII is likely to be further increased, and QDII2 (for qualified individuals) may be introduced. (vi) Securitization of credit assets may be further encouraged and related quota increased.
- **Fiscal reforms.** (i) The 2014 budget is likely to be compiled based on the realignment of central and local government functions (事权) and spending responsibilities, with the central government taking on more responsibilities. (ii) The 75%/25% distribution of VAT between the central and local governments may be changed to compensate for local governments' loss of business tax revenue as a result of the ongoing VAT reform, and the VAT rate structure may be simplified. (iii) Property tax pilot program is likely to be expanded to a few more cities. (iv) Specific tax on natural resources (such as coal) is likely to be made ad valorem, and environment protection charges will probably be changed to taxes. (v) More local governments are likely to be allowed to issue debt to finance urban development, subject to a quota system.

The government may kick start SOE reforms – We think Sinopec's recent announcement marked the beginning of reforms aimed at encouraging crossing holding of SOE shares by the private capital. The government may establish several state capital operating companies (following the example of Temasek) to better manage the state capital. The government may also raise the profit surrender ratio for SOEs by 5ppts to beef up the social safety net.

Urbanization-related reforms are likely to be introduced – The government aims to promote people-oriented urbanization, steadily increasing the share of population holding hukou, improving the efficiency of land use and energy use, and reducing pollution. Possible measures include:

- Integrating migrant workers already working and living in urban areas: (i) fully relaxing hukou restrictions in towns and small cities; (ii) gradually relaxing hukou restrictions in medium-sized cities; (iii) setting conditions for obtaining hukou in large cities; but (iv) strictly controlling the size of population in mega cities. In particular, the government may adopt policies to allow children of migrant workers to go to school in cities.
- Laying the groundwork for land reform, starting with clarifying the asset rights of farmers with regard to their farming land and collectively-owned construction land, before experimenting with collateral and transfer of such rights.
- Establishing policy banks specializing in urban infrastructure and residential housing.

Appendix A-1

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