

China Economics Weekly

What to Expect from Leadership Transition?

- **The new leadership will sit behind the wheel in mid-Nov** – The 18th National Party Congress will convene on 8 Nov 2012. The first plenary session of the Central Committee (possibly to be held on 15 Nov) will select the core of the ruling body—the politburo and the standing committee of the politburo. The new leadership will start influencing economic policies in early Dec, but a major reform agenda will likely be set in the fall of 2013.
- **We may not see an abrupt policy shift in the near term** – Drawing on the experience of the last leadership transition in 2002, the central economic conference in Dec may keep the current macro policy mix (proactive fiscal policy and prudent monetary policy) unchanged to support a growth rebound. Meanwhile, we do not expect fresh stimulus from the new leadership, especially when the growth target is within reach and employment situation is acceptable.
- **Growth target may be set at 7% for 2013** – The measured policy easing this year has confirmed that the Chinese authorities are willing to accept slower growth and the challenges associated with it. The majority of the policy makers appear to agree that China's potential GDP growth rate will fall into the 7-9% range in the next five years, and weak external demand and measures to rebalance the economy would make the actual growth even lower than the potential.
- **Tough reforms are indispensable** – With investment to GDP ratio close to 50% and Gini coefficient estimated at 0.5, the tensions within the economy have reached a critical point. We expect consensus to be built in the following areas by the time of the 3rd plenary session in the fall 2013.
 - Improving investment through interest rate liberalization, development of the bond market, fiscal decentralization, deregulating the state-owned sectors, opening up the capital account, and increasing flexibility of the FX regime.
 - Facilitating job creation and private sector development through deregulation of labor-intensive service sectors and structural tax cut.
 - Supporting smart urbanization through the reform of the *hukou* system, the social welfare system and the land system.
 - Encouraging innovation and private investment by effectively protecting intellectual property rights and property rights in general.

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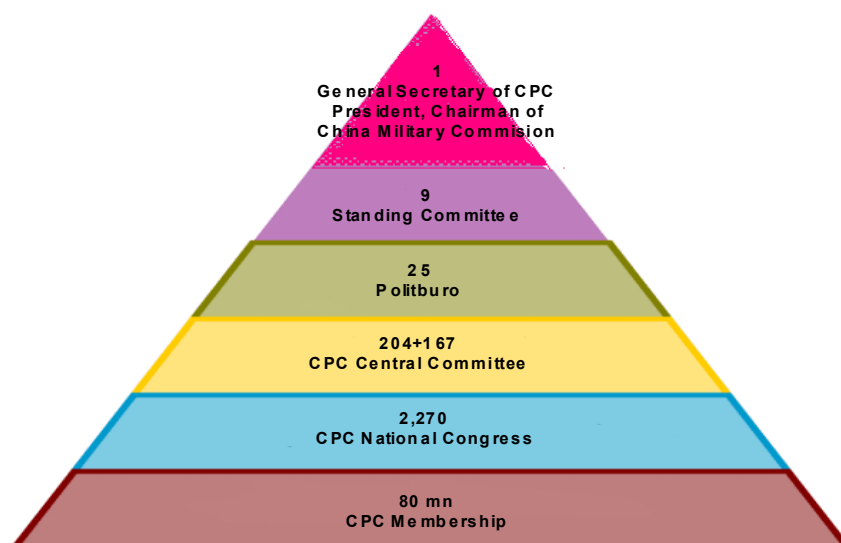
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What to Expect from Leadership Transition?

Near-term policy timeline

The new leadership will sit behind the wheel in mid-Nov – The 18th National Party Congress will convene on 8 Nov 2012. Coincidentally, the 16th Party Congress—during which the current leadership was selected—started on the same day ten years ago and the meetings lasted for seven days. On the last day of the Party Congress, presumably 14 Nov, the Central Committee will be elected. Right after the conclusion of the Party Congress, the first plenary session of the Central Committee will be held (possibly on 15 Nov), and the core of the ruling body—the politburo and the standing committee of the politburo—will be selected. It is widely expected that the number of the standing committee members will be reduced from nine to seven. Mr. Xi Jinping, the current Vice President, is expected to become the head of the standing committee. ↑ In Mar 2013, Mr. Xi is expected to become the head of the state, and Mr. Li Keqiang, the current vice Premier, is expected to become the premier.

Figure 1. Current Structure of CPC



Source: Citi Research

The focus will be shifted to economic policies in early Dec – The annual central economic work conference is usually scheduled for early Dec. In 2002, the conference was held during 9-10 Dec. The conference usually sets the macro policy stance and key areas of structural reforms for the following year. Following the conference, ministries involved in economic policy making would set more specific policies in early January. The PBOC, for example, may set the growth target for broad money.

Growth targets and budget will be approved in Mar – During the annual National People's Congress in Mar, the new President and the Premier will be selected. Growth and inflation targets will be set. Fiscal and monetary policy stance will be confirmed, and the budget will be approved.

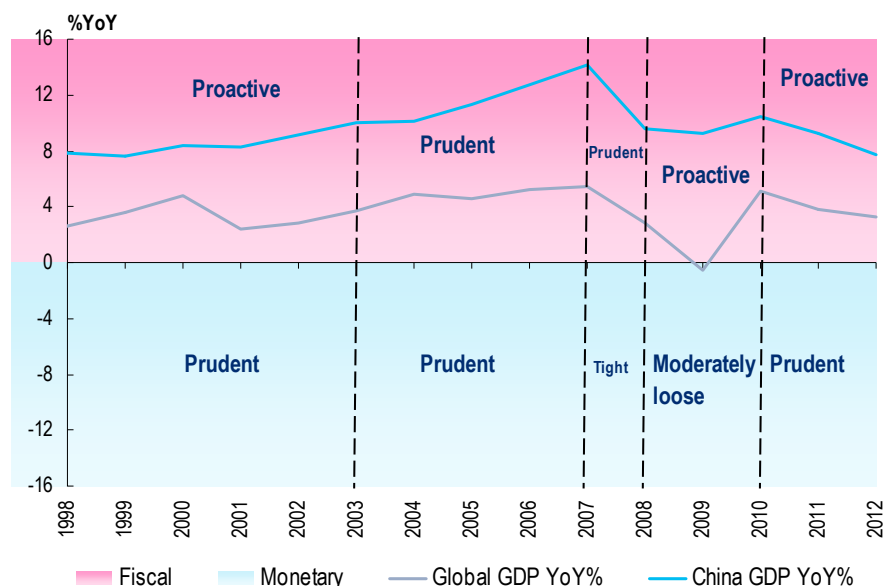
Key reform themes will likely be set at the 3rd plenary session of the Central Committee in the fall of 2013 – According to the historical pattern, major economic reform measures were usually determined at the 3rd plenary session. Since 1998,

the 3rd plenary sessions were all held in the month of Oct. The new leadership will have about one year to brainstorm and build consensus on fundamental reform measures for the next decade.

Revelation from the last transition

The economy started to show upward momentum in 2002 – In the wake of the Asian financial crisis, China's growth fell below 8% in 1998-99, and stayed sluggish at slightly above 8% in 2000-01. The government shifted from the relatively tight fiscal and monetary policy and implemented proactive fiscal policy and prudent monetary policy during 1998-2003. Growth rose above 9% in 2002 amid signs of a global recovery.

Figure 2. GDP growth vs Policy mix



Source: IMF and Citi Research

The new leadership played safe by maintaining the macro policy stance –

During the central economic conference in Dec 2002, the mix of proactive fiscal policy and prudent monetary policy remained unchanged even as growth started to accelerate. The conference also identified key reform areas, including SOEs, the rural economy, financial system and government administration. In Mar 2003, the new government set a conservative growth target of 7%, and emphasized the importance of expanding consumption relative to investment.

The 3rd plenary session advocated "scientific" development – The plenary session was held in Oct 2003 and the theme was to improve the operation of the market economy. It was emphasized that economic development should be sustainable and benefit the households. For that purpose, a balance needs to be struck between urban and rural development, development in the eastern and western regions, and between humans and the environment. Specific reform areas include encouraging private investment in infrastructure and public utility, protecting property rights, allowing the transfer of land between farmers to facilitate large-scale farming, and improving income distribution and the social safety net.

What to expect from the incoming leadership

We may not see an abrupt policy shift in the near term – Drawing on the experience of the last leadership transition, the central economic conference may keep the current macro policy mix, i.e., proactive fiscal policy and prudent monetary policy, to support a growth rebound. Although Sep data pointed to positive growth momentum, it is recognized that the foundation of growth still needs to be consolidated, and growth stabilization is still the short-term priority. Meanwhile, we do not expect fresh stimulus from the new leadership, especially when the growth target is within reach and employment situation is acceptable. We continue to think the government will instead make full use of the room under the current policy mix to stabilize the economy.

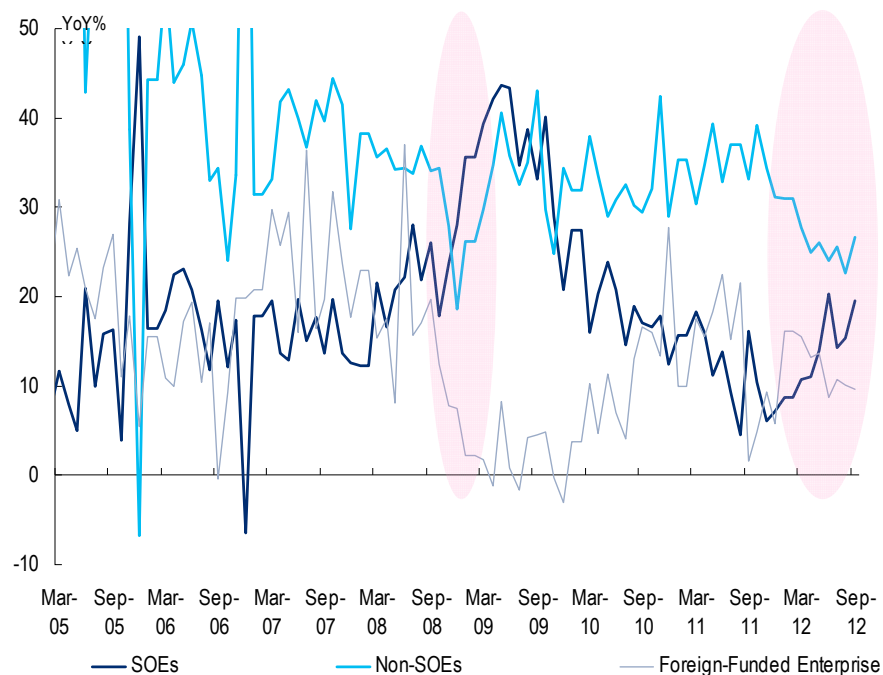
Slower growth is likely to be tolerated, and 7% growth target may be set – The measured policy easing this year has confirmed that the Chinese authorities are willing to accept slower growth and the challenges associated with it. While views are still divided, the majority of the policy makers appear to agree that China's potential GDP growth rate will fall into the 7-9% range in the next five years, and weak external demand and measures to rebalance the economy would make the actual growth even lower than the potential. The official growth target for 2013 may be set at 7% (the minimum the government can accept) during the National People's Congress in Mar, with macro policies supportive of a somewhat higher growth than the target.

Tough reforms are indispensable – With investment to GDP ratio close to 50% and Gini coefficient estimated at 0.5, the tensions within the economy have reached a critical point. From recent remarks made by both the outgoing and incoming leaders, we expect consensus to be built in the following areas by the time of the 3rd plenary session in the fall 2013:

- **Improving investment efficiency** – This is the only choice amid an investment slowdown, and getting the cost of capital right is the key. Interest rate liberalization, development of the bond market, fiscal decentralization, deregulating the state-owned sectors, opening up the capital account, and increasing flexibility in the FX regime are all part of the efforts to improve the efficiency of resource allocation.
- **Facilitating job creation and private sector development** – Manufacturing consolidation is inevitable amid an economic slowdown and capital cost normalization. The deregulation of labor-intensive service sectors (e.g., healthcare, financials, education, transportation and so on) should foster job growth in the future. Structural tax cuts (for example by adopting VAT in the service sector) will likely be promoted to support economic rebalancing.
- **Inventing new growth engines** – All the above efforts will be rewarded only if new growth engines are able to generate sustained growth. Urbanization has the potential to bring the economy forward at the required pace. However, China's urbanization cannot proceed at full speed without critical reforms. The key reform areas are the *hukou* system, the social welfare system and the land system.
- **Protecting intellectual property rights and property rights in general** – Industrial upgrading would require innovation. To encourage research and development, China will have to improve law enforcement and protect intellectual property rights. In addition, protection of property rights is essential to encourage private investment.

Chart of the week

Figure 3. China – FAI by enterprise types



Source: CEIC, NBS and Citi Research

Fixed asset investment is one of the most closely monitored indicators of economic activity in China given the weight of investment in total GDP. Dating back to 2008, the investment by both non-stated owned companies (non-SOEs) and foreign-funded enterprises fell sharply right after the global financial crisis while SOE's investments jumped thanks to the large-scale stimulus. After that, although the growth of foreign-funded enterprise investment remained sluggish due to global economic plight, non-SOEs FAI growth gained momentum. It seems that the history is about to repeat itself. As seen from the shade area on the chart, SOE again played an important role in stabilizing the economic growth. SOE FAI growth has rebounded to 20%YoY in September from about 6% a year ago. An early sign of rebound has also emerged in non-SOEs FAI.

Key Data Ahead

Figure 4. Data release

Date	Event	For	Citi	Survey	Prior	Comment
27-Oct	Industrial Profits YTD YoY	Sep	--	--	-3.10	
1-Nov	Manufacturing PMI	Oct	50.5	50.4	49.8	Accommodative monetary policy and proactive fiscal policy is supportive of a mild rebound in the 4Q. We estimate that Oct official manufacturing PMI would increase by 0.7ppt to 50.5, returning to expansion following two months of contraction.
1-Nov	HSBC Manufacturing PMI	Oct	--	49.1	47.9	
3-Nov	Non-manufacturing PMI	Oct	--	--	53.7	

Source: Bloomberg and Citi Research

Macro and Market Outlook

Figure 5. China Forecasts vs. Consensus

Annual	2012		2013		Quarterly	3Q12		4Q12		1Q13		2Q13		3Q13		4Q13	
	Citi	Survey	Citi	Survey		Citi	Survey	Citi	Survey	Citi	Survey	Citi	Survey	Citi	Survey	Citi	Survey
GDP (YoY%)	7.7	7.7	7.6	8.1		7.4	7.3	7.8	7.7	8.0	7.9	7.8	8	7.5	8.2	7.3	7.95
CPI (YoY%)	2.7	2.8	3.2	3.3		1.9	2.5	2.4	2.5	2.7	3.0	3.1	3.4	3.5	3.6	3.5	3.4
IP (YoY%)	10.0	10.1	9.9	11.0		9.1		10.0		10.5		10.2		9.6		9.1	
Exports (YoY%)	7.3	6.6	8.2	9.5		4.5		6.8		5.0		8.0		9.0		10.0	
Imports (YoY%)	5.3	6.0	11.1	11.3		1.4		6.5		8.0		11.0		12.0		13.0	
Trade Balance (\$US bn)	201.8	175.1	164.8	159.4		79.4		52.8		-12.2		60.7		72.7		43.5	
FX reserve (\$US bn)	3360		3450			3290		3360		3328		3368		3421		3450	
Current Account (as % GDP)	2.0	2.6	1.5	2.3													
Fiscal Account (as % GDP)	-2.4	-2.0	-1.5	-2.0													
1Y lending rate (eop)	6.00	6.00	6.25	6.00		6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.25	6.00	6.25	6.00
1Y deposit rate (eop)	3.00		3.25			3.00		3.00		3.00		3.00		3.25		3.25	
USDCNY (eop)	6.25	6.31	6.25	6.21		6.28	6.35	6.25	6.31	6.27	6.29	6.30	6.27	6.28	6.24	6.25	6.21
5Y Government bond Yield	3.14		3.37			3.24		3.24		3.24		3.24		3.49		3.49	

Source: Bloomberg, Consensus Economics and Citi Research estimates

Figure 6. Other Interest Rate / FX Forecasts

	26-Oct	2012 1Q	2012 2Q	2012 3Q	2012 4Q F	2013 1Q F	2013 2Q F	2013 3Q F	2013 4Q F
US Fed Fund Rate	0.17	0.25	0.25	0.09	0.25	0.25	0.25	0.25	0.25
10 Treasury	1.78	2.04	1.82	1.64	1.65	1.75	2.00	2.25	2.55
EUR/USD	1.29	1.33	1.27	1.29	1.31	1.28	1.25	1.23	1.22
USD/JPY	79.94	83	80	78	79	79	79	79	79

Source: Bloomberg and Citi Research estimates

Figure 7. China – Real Economy Data

%YoY	2008 1Q	2008 2Q	2008 3Q	2008 4Q	2009 1Q	2009 2Q	2009 3Q	2009 4Q	2010 1Q	2010 2Q	2010 3Q	2010 4Q	2011 1Q	2011 2Q	2011 3Q	2011 4Q	2012 1Q	2012 2Q	2012 3Q
Real GDP	11.3	10.8	9.7	7.6	6.6	8.2	9.7	11.4	12.1	10.3	9.6	9.8	9.7	9.5	9.1	8.9	8.1	7.6	7.4
Nominal GDP	21.1	21.1	19.4	13.2	5.3	5.7	8.6	13.0	18.3	17.7	17.6	17.6	17.5	17.8	18.1	16.6	11.2	9.6	9.5
CPI	8.0	7.8	5.3	2.5	-0.6	-1.5	-1.3	0.7	2.2	2.9	3.5	4.7	5.1	5.7	6.3	4.6	3.8	2.9	1.9
PPI	6.9	8.4	9.7	2.5	-4.6	-7.2	-7.7	-2.1	5.2	6.8	4.5	5.7	7.1	6.9	7.1	3.1	0.1	-1.4	-3.3
Exports	21.4	22.4	23.0	4.3	-19.7	-23.4	-20.3	0.2	28.7	40.9	32.2	24.9	26.4	22.0	20.6	14.3	7.6	10.5	4.5
Imports	28.9	32.7	25.7	-9.1	-30.9	-20.2	-11.6	22.7	64.8	43.6	27.3	29.8	33.0	23.1	24.9	20.1	6.9	6.5	1.4
Trade Balance (bn USD)	41.4	58.2	83.3	114.3	62.5	34.9	39.3	61.5	14.5	41.2	65.6	63.1	-0.7	46.7	63.8	48.1	1.1	68.8	79.4
IP	16.6	15.9	13.0	6.4	9.7	9.0	12.3	17.9	15.5	16.0	13.5	13.3	14.9	13.9	13.8	12.8	11.6	9.5	9.1
Retail Sales	20.6	22.2	23.2	20.6	15.0	15.0	15.4	16.5	17.9	18.5	18.4	18.8	16.3	17.2	17.3	17.5	14.8	13.9	13.5
FAI	25.9	27.2	28.8	23.3	28.6	35.9	32.9	26.2	26.4	25.2	23.1	23.9	25.0	26.0	24.0	21.2	20.9	20.8	21.0
Electricity Consumption	13.1	10.2	6.3	-5.5	-4.0	-0.7	8.0	22.8	24.1	19.3	12.2	6.0	12.5	11.6	11.4	11.5	6.8	4.3	3.8
Steel Product Production	12.2	10.5	-1.4	-7.1	2.8	8.0	27.6	39.5	28.6	24.0	8.5	3.0	13.7	7.7	14.3	9.0	6.5	7.0	4.3
Cement Production	6.2	8.7	3.6	2.5	9.2	15.8	23.6	18.2	19.7	16.2	13.2	14.7	10.1	20.5	15.1	11.6	7.3	4.9	8.9
Baltic Index	50.0	52.7	-66.0	-91.5	-80.0	-60.8	-31.0	288.2	85.6	-36.0	10.2	-41.0	-49.0	-41.3	-22.4	-2.0	-39.0	-28.9	-59.7
Cargo Carried Railway	8.6	7.2	8.8	-2.6	-5.9	-1.1	0.6	12.2	17.8	7.4	7.4	4.4	6.8	10.1	7.6	7.5	4.0	1.7	-8.9
Cargo Carried by Airline	14.5	6.6	-2.3	-8.6	-12.6	-0.3	17.5	35.5	48.2	32.9	18.0	14.0	1.0	-0.6	-0.7	-3.6	-6.7	-3.4	0.4
Cargo Carried by Highways	10.7	15.0	15.1	6.3	8.4	11.4	20.3	13.7	23.4	17.9	14.8	14.9	14.5	14.9	15.2	19.1	13.6	14.4	14.0

Source: Bloomberg, CEIC and Citi Research

Figure 8. China – Monetary Data

%YoY	2008 1Q	2008 2Q	2008 3Q	2008 4Q	2009 1Q	2009 2Q	2009 3Q	2009 4Q	2010 1Q	2010 2Q	2010 3Q	2010 4Q	2011 1Q	2011 2Q	2011 3Q	2011 4Q	2012 1Q	2012 2Q	2012 3Q
M1	18.3	14.2	9.4	9.1	17.0	24.8	29.5	32.4	29.9	24.6	20.9	21.2	15.0	13.1	8.9	7.9	4.4	4.7	7.3
M2	16.3	17.4	15.3	17.8	25.5	28.5	29.3	27.7	22.5	18.5	19.0	19.7	16.6	15.9	13.0	13.6	13.4	13.6	14.8
Loan	14.8	14.1	14.5	18.7	29.8	34.4	34.2	31.7	21.8	18.2	18.5	19.9	17.9	16.9	15.9	15.8	15.7	16.0	16.3
FX Reserve (\$US bn)	1682	1809	1906	1946	1954	2132	2273	2399	2447	2454	2648	2847	3045	3197	3202	3181	3305	3240	3290
Position for FX Purchase (tn RMB)	14.2	15.4	16.3	16.8	17.3	17.8	18.5	19.3	20.1	20.6	21.3	22.6	23.7	24.7	25.5	25.4	25.6	25.7	25.8
Bond Issuance *																			
Gov't Bond	1149	2810	2325	2331	1049	5969	5817	3582	2300	5558	5356	4668	3260	5114	4544	2500	2180	4749	4673
Corporate Bond	1401	1466	2221	2843	3258	4444	3849	3961	3827	4363	4160	2851	5722	4574	5003	6870	6714	7673	10561
Gov't Supported Bond	-	-	200	600	-	-	300	700	-	-	1540	350	-	-	-	1000	-	200	850

* In 100mn RMB

Source: CEIC, WIND and Citi Research

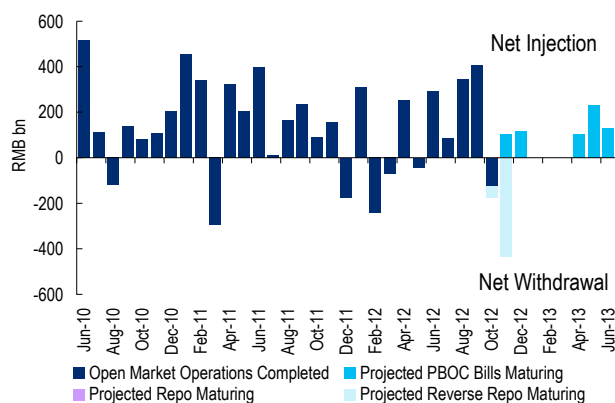
Figure 9. China Market Snapshot

	26-Oct	1 Week change	YTD change	12 months Change		26-Oct	1 Week change	YTD change	12 months Change
Foreign Exchange					Interbank Rate, %				
USD/CNY	6.24	(0.01)	(0.05)	(0.11)	1D SHIBOR	3.32	1.12	(0.09)	(0.68)
EUR/CNY	8.07	(0.09)	(0.06)	(0.78)	7D SHIBOR	3.59	0.90	(1.99)	(0.51)
100JPY/CNY	7.81	(0.07)	(0.37)	(0.53)	1M SHIBOR	4.60	1.12	(1.39)	(0.55)
1M Vol, USD/CNY	1.59	0.07	(1.23)	(1.80)	3M SHIBOR	3.71	0.00	(1.76)	(1.92)
3M Vol, USD/CNY	1.80	0.02	(1.30)	(1.66)	6M SHIBOR	4.09	(0.00)	(1.34)	(1.33)
					1Y SHIBOR	4.40	(0.00)	(0.84)	(0.85)
Forward					Repo Rate, %				
USD/CNY 3M Forward, onshore	6.30	(0.01)	(0.05)	(0.11)	1D Interbank Repo Rate	3.46	1.26	0.05	(0.55)
USD/CNY 12M Forward, onshore	6.39	(0.01)	(0.05)	(0.11)	7D Interbank Repo Rate	3.72	1.02	(2.03)	(0.33)
USD/CNY 3M NDF	6.30	(0.03)	(0.11)	(0.19)	1M Interbank Repo Rate	4.00	0.65	(1.99)	(1.16)
USD/CNY 12M NDF	6.35	(0.03)	(0.09)	(0.16)	3M Interbank Repo Rate	4.20	0.20	(1.25)	(1.49)
PBOC Benchmark Rate, %					IRS, %				
Demand Deposit	0.35	-	(0.15)	(0.15)	3M IRS	3.31	0.23	(0.34)	(0.40)
3M Deposit	2.60	-	(0.50)	(0.50)	1Y IRS	3.20	0.08	0.28	(0.44)
6M Deposit	2.80	-	(0.50)	(0.50)	2Y IRS	3.21	0.08	0.54	(0.38)
1Y Deposit	3.00	-	(0.50)	(0.50)	5Y IRS	3.33	0.05	0.52	(0.34)
2Y Deposit	3.75	-	(0.65)	(0.65)	10Y IRS	3.48	0.05	0.54	(0.28)
3Y Deposit	4.25	-	(0.75)	(0.75)	IRS Curve, bp				
5Y Deposit	4.75	-	(0.75)	(0.75)	2Y-3M	320.75	7.50	53.50	(38.25)
6M Lending	5.60	-	(0.50)	(0.50)	5Y-2Y	11.75	(2.75)	(2.00)	4.75
1Y Lending	6.00	-	(0.56)	(0.56)	10-2Y	27.25	(2.50)	-	10.25
1-3Y Lending	6.15	-	(0.50)	(0.50)	10-5Y	15.50	0.25	2.00	5.50
3-5Y Lending	6.40	-	(0.50)	(0.50)	Stock Market				
5+Y Lending	6.55	-	(0.50)	(0.50)	Shanghai Composite	2,066	(62)	(133)	(361)
Govn Bond, %					- Turnover, RMB bn	56	(10)	13	(28)
PBOC 3M	2.65	-	0.45	-	Shenzhen Composite	841	(37)	(26)	(172)
PBOC 6M	2.70	-	0.37	-	- Turnover, RMB bn	21	(6)	4	(11)
CGB 1Y	2.93	0.08	0.31	(0.16)	HSCEI	10,450	(187)	513	399
CGB 2Y	2.96	0.02	0.10	(0.53)	- Turnover, HKD bn	13	(8)	8	(2)
CGB 5Y	3.23	0.02	0.15	(0.35)	Other Indicator				
CGB 10Y	3.55	0.02	0.11	(0.18)	5Y Sovereign CDS	82.99	-	(59.00)	(54.06)
Govn Bond Yield Curve, bp					Required Reserve Ratio	19.50	-	(1.00)	(1.50)
2Y-3M	31.00	2.00	(35.00)	-					
5Y-2Y	27.00	-	5.00	18.00					
10-2Y	59.00	-	1.00	35.00					
10-5Y	32.00	-	(4.00)	17.00					

Source: Bloomberg and Citi Research

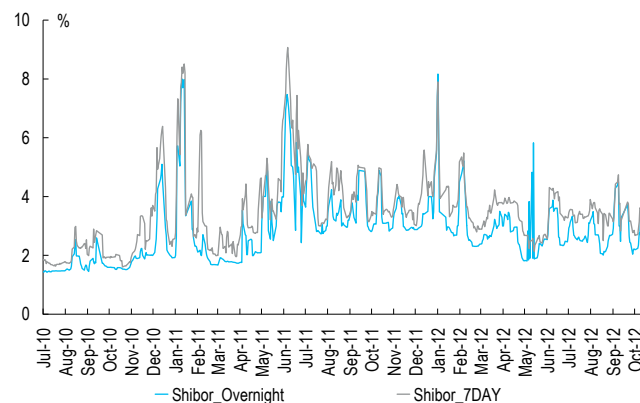
Liquidity Conditions

Figure 10. PBOC Open-Market Operations



Source: POBC, CEIC and Citi Research

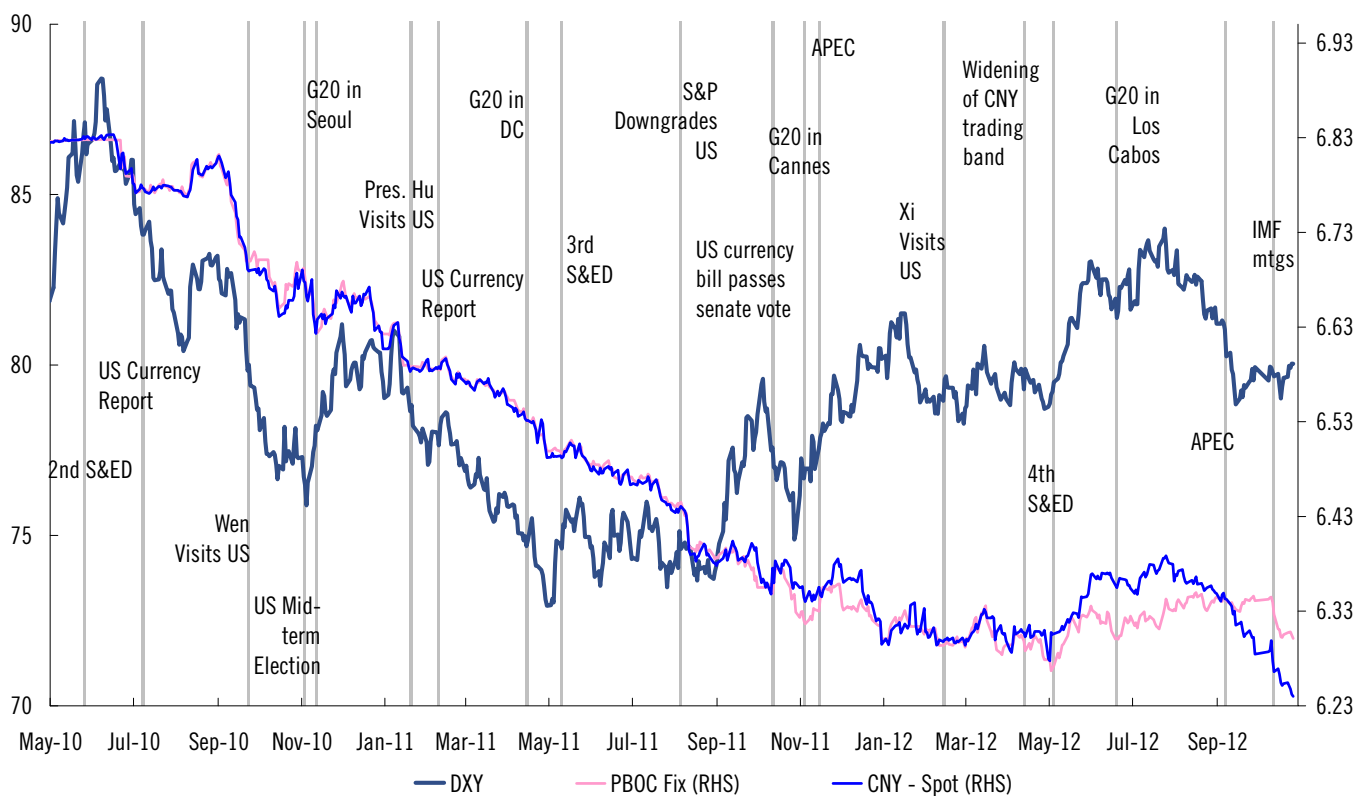
Figure 11. China Interbank Rates



Source: Bloomberg and Citi Research

FX Markets

Figure 12. USDCNY



Source: Bloomberg and Citi Research

Appendix A-1

Analyst Certification

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