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China Macroeconomic Outlook 2Q14

The Balance Between Growth and Reform

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Overview:

Our long-term output gap analysis shows the overcapacity problem has not been significantly alleviated in China and the quality of growth is still unsatisfactory. The previous stress on economic growth has led to expansion in aggregate supply in the medium to long term, despite the short-term boost to aggregate demand. Problems such as local government debt and employment have emerged as a result.

Economic growth in Q1 and the bleak employment outlook for fresh graduates in Q2 require forward-looking consideration of policy fine-tuning. Stimulus measures such as structural tax cuts, shantytowns rebuilding, and railway construction from last year stay intact this year. The limited room for monetary policy maneuver and the government debt problem have led to limited source of capital to ensure economic growth, which means policies with limited strength should be to the point.

We believe this round of policy fine-tuning will be of limited effect. China's central government focuses more on the development of reforms and changes in the employment situation. We cut the full-year growth forecast to 7.3%, 7.5%/7.2%/7.3% for the next three quarters.

Reform is a good remedy to China's economic problems. Growth and reform will exist in the form of unity of opposites in China.

Economic Growth Forecast Revised Downwards to 7.3%

We forecast the future trend of China's economy from the perspectives of output gap as well as the balance between reform and growth stabilization. The basic conclusion is that if continuing with the current strength of reform, China's economic growth will further retreat in 2014. However, China economy may face an inflection point of output gap in 2015, which will help improve market sentiment.

1. When will the economy recover in the long period?

How much is the potential output of China economy in future? How much would be the negative output gap resulting from the economic correction? How long will the negative output gap last? When will the economy start improving? We further forecast the potential output by 2020 with the production function. According to the production function, the potential growth of future years will be determined by the real capital, the potential employment and the trend of total factor productivity. According to the trend of historical changes, for the potential contribution towards GDP growth from the growth of capital reserve being higher than the growth of employment, we found the former would be roughly 32 times the latter, while the change of capital reserve and the actual total fixed capital formation is in direct proportion. That is to say the change of "investment" indicators will have a much greater influence towards the potential GDP YoY changes in future than the change of labor indicators.

The table below is the comparisons of the forecast potential output under different scenarios of the actual total fixed capital formation in future.

Table 1: Comparisons of potential GDP growth using different figures of the actual total fixed capital formation growth

Year	Potential GDP Capital formation 6%	Potential GDP 8%	Potential GDP 10%	Potential GDP 12%	Potential GDP 15%
2011	10.36	10.36	10.36	10.36	10.36
2012	10.15	10.15	10.15	10.15	10.15
2013	9.14	9.14	9.14	9.14	9.14
2014	8.05	8.19	8.45	8.72	9.12
2015	7.59	7.82	8.31	8.80	9.55
2016	7.20	7.52	8.19	8.86	9.90
2017	6.88	7.28	8.08	8.91	10.21
2018	6.61	7.07	8.00	8.96	10.46
2019	6.39	6.89	7.92	8.99	10.67
2020	6.20	6.74	7.86	9.02	10.84

Source: CMS
Note: 2011 and 2012 are actual figures. Inside brackets are the actual total fixed capital formation growth.

We assume China GDP will maintain an average growth of 8% (an optimistic forecast) by 2020. As such we can estimate the actual output in 2012-2020. Combining with the potential output in the forecast of the above table, we can estimate the output gap in these few years.

If the future economic growth is to maintain at the level of 8% and the output gap not enlarging continuously, we must lower the current potential output level. Stop relying on investment-driven logic all the time and use investment of higher efficiency to replace the less efficient. The chart below shows the output gap when the actual total fixed capital formation falling to 7% and 8%. In 2015 the output gap will bottom out. The negative output gap will start narrowing and the economy will start improving.

The premise for the above forecast is the assumption that the macroeconomic policy of the government will be more focused towards structural adjustment and promoting reform. If the adjustment is inappropriate, the gap will be widened continuously and China's economy may also experience a lost decade. As such, even the actual growth maintained at above 7%, it still could not be called "good" growth. What could be seen would be the low efficiency of company operations and the continual increase of actual unemployment rate. Social instability will also increase.

The two main variables affecting the potential output are employment and capital, while the population of economic activities will not change significantly due to the emergence of the so-called demographic dividend turning point. We need to understand what the demographic dividend turning point affects is the economic structure, but its contribution of influence upon the potential output will be limited, which will be partially reflected on the total factor productivity. Therefore, how to adjust the main indicator of capital, namely the total capital formation (or what we normally call "investment"), will be a daunting task.

From our estimation model of potential output, we can also see "investment" is a "double-edged sword." Reducing the low efficiency investments reasonably and creating mechanisms for high efficiency investments concurrently will lead to the narrowing of long period output gap, hence the economy can recover. Yet, there is risk for the further widening of the short period output gap. This is also a dilemma faced by the leadership.

Secondly, another important point of supply-side management is to change the relative positions of potential output and actual output by improving the growth of total factor productivity and employment (labor force participation rate). Under the current dilemma of investment and labor force supply, China is also facing a situation of entering the moderate income trap, while the improvement of total factor productivity will be the last magic weapon to step across this trap, helping China find a new relative advantage and approach the frontier of technological innovation curve. The striding out of the moderate income trap will be transmitted to the demand side, driving consumption and import/export, which will bring about the increase of actual output, hence the narrowing of output gap and the "improving" of economy. The improvement of total factor productivity is a long-term target. There is still a long way ahead.

Lastly is the demand-side management. To increase consumption, one needs to focus on taxation reform, while the import/export figures will rely even more on global trade and the global distribution of labor market, which is relatively passive. From a long-term perspective, it is surely important to fuel domestic demand, but China is still in the development stage and investment cannot be completely suppressed as well. In other words, the regulation of investment is not equivalent to "do not invest", but rather guiding funds to the higher efficiency investment divisions, i.e. structural adjustment. Since this kind of adjustment cannot be achieved by means of "financial suppression" (i.e. raising the effective interest rates), the target of the leadership should be expanding the spread between investment returns and market interest rates in order to increase the marginal returns of the real economy, instead of just allowing the funds to stay at the low efficiency divisions. In fact this is the same as the financial deepening theory, only it is more appropriate for the current economic background. This not only can avoid the imbalance in capital allocation brought by the low interest rates, but also provide the necessary enticement for those with surplus capital as well as the necessary encouragement for the thrift. Although this is a long-term target, increasing people's livelihood and social security spending as well as reducing private sector costs like residents and business taxes, or the income distribution reform, are achievable in the mid-term.

2. Key Estimated Economic Data for China 2014

Currently, there are two kinds of opinion as to whether the government will launch economic stimulation policies, one is that economic downturn at the beginning of the year and worsening employment shall call for growth stabilization policies. From our interpretation on the government work reports of the National People's Congress and the Chinese People's Political Consultative Conference, we believe that the central government may increase their toleration on economic downturn, unveiling their determination on giving up short-term benefits in exchange for "structural reform" for long-term sustainable growth. As long as the economy runs within a reasonable range, the government will focus firmly on changing methodologies and adjusting structure. Comprehensive reformation indicates that the growth model fuelled by investment cannot sustain. From our analysis on output gap, it can be seen that growth stabilization and reform promotion are not contradictory. Reformation is conducive to the sustainable mid- and long-term economic growth, whilst the short-term impact may be negative. Employment preservation is an objective of growth stabilization, and the condition of labor market determines the pace of reformation.

Firstly, major categories of large-scale investment fell in the first two months of 1Q14, downward pressure is still expected whilst infrastructure investment may help stabilize growth in the first year of reformation.

The NDRC has determined the target growth of fixed asset investment for 2014 as 17.5%, which is 0.5 ppt lower than the 18.0% for 2013. Economic growth for 1Q14 is expected to further decrease and the pain of further reformation has begun to emerge. The data released have revealed that growth of investment in infrastructure, manufacturing and real estate have slowed down.

Looking into 2Q14, negative factors mainly include moderate downturn of domestic economy. In addition, further decrease in the profit of the principal business of industrial enterprises restricts improvement in manufacturing investment. Recently, data has showed significant decrease in the sources of domestic funding and self-raised funds for property industry, indicating pressure on the growth in lending for property development and non-standard business. On the other hand, increase in mortgage loans was also slowed as banks tightened lending related to properties. Future investment in the property sector was suppressed as property sales and new construction have decreased, and some of the demand was put on hold. Pressure on property prices is formed with the control on property sector changing from demand restriction to increase in supply. Therefore, we believe that investment in property development will continue to move on a downward path as both demand and sales are under higher pressure, although increased renovation in shanty towns is likely to have cushion effect.

In sum, investment in property and manufacturing sectors can hardly improve. We estimate that the increase in fixed asset investment for 2014 will decrease to around 18.1%. The central government stated in the government work reports of the National People's Congress and Chinese People's Political Consultative Conference that the key areas of investment in the budget are "security housing, agriculture, major water resources development, mid-western railways, energy saving and environmental protection and social programs". It is expected that infrastructure investment will help stabilizing growth in the year, and the pace of growing will still be stable.

Secondly, limited effect of micro-stimulation policy while steady growth and promoting reform in long-term play.

Recently the State Council has been mulling to launch a series of "micro-stimulation" policy, hoping to maintain the situation of steady economic growth through a gentle approach. The steady growth policy mainly focuses on expanding the scope of taxation benefits for the small and micro enterprises, accelerating the infrastructure of railway and the transformation process of shantytowns appropriately. Effect of the policy will be determined by the policy efforts and the market responses ultimately. From our analysis of output gap, one can also see if launching a large scale stimulation policy, it will not be beneficial to the market clearing on the supply side and the period of economic depression will drag on, while the fundamental purpose of steady growth is to preserve employment. Early in the reform, facing the declining aggregate demand, the pressure of steady growth increases. The launch of micro-stimulation policy by the government is also reasonable, but under the large frame of reform, effect of this round of micro-stimulation policy may be limited.

Thirdly, state-owned enterprise reform to provide long-term catalyst for reform.

The reform of state-owned enterprises is for increasing the liquidity of state-owned capital. This will make the passing in and out of the state-owned capital more orderly, and at the same time introducing private capital to participate in market competition, hence achieving the purpose of improving the external competitive environment of enterprises. This is a good design mechanism, but not a “structural” reform, of which the purpose is to fully bring the market invisible hands into play. It will be beneficial to the restoring of government debts and the recovery of economy in the long-term. It is a long-term effective catalyst of reform.

Finally, limited boost from consumption and foreign demand on domestic economy.

Although the market generally thinks the driving effect of foreign demand on exports in 2014 will be better than in 2013, the negative growth of 1Q exports has already warned us not to be over optimistic. The increase of global demand is not seen to be a very strong process at present. In fact, other countries are also facing this problem. For example, the unexpected widening of the U.S. current account deficit in February was due to the exports slump of the month. As for consumption, the falling of economic growth and the low quality of growth are obviously very difficult to stimulate the increase of consumer spending of the residents, while the consumer spending of government departments will be under even stricter supervision. As such, the annual consumption will be hardly bright.

In summary, owing to the reform demands and anti-risk targets, the policy efforts of steady growth are limited. The short-term falling of investment will drag down the economy, but is beneficial to the long-term economic transformation. The economic GDP growth forecast in 2014 could be 7.3%. We expect the economic trend of the year to be high first and low later, with quarterly GDP growth estimates of 7.4%，7.5%，7.2%，7.3%. Listed below are other forecast figures:

Table 2: China’s major macroeconomic figures and forecasts (YoY growth %)

Indicator	2013	2014E	Q1	Q2	Q3	Q4
GDP	7.7	7.3	7.4	7.5	7.2	7.3
CPI	2.6	2.6	2.3	2.6	2.5	2.4
PPI	-1.9	-0.6	-1.9	-1.0	0.3	0.1
Retail sales of consumer goods	13.1	12.6	12.0	12.3	12.7	13.2
Industrial value added	9.7	9.1	8.7	9.1	9.0	9.3
Export	7.9	7.2	-3.4	7.7	11.9	11.4
Import	7.3	8.3	1.6	9.3	10.9	10.5
Fixed-asset investment	19.6	18.1	17.6	19.0	18.5	18.1
M2	13.6	12.8	12.1	12.4	12.6	12.8
Balance of RMB loans	14.1	13.2	13.9	14.2	13.4	13.2
1-year deposit rate (%)	3.00	3.00	3.00	3.00	3.00	3.00
1-year lending rate (%)	6.00	6.00	6.00	6.00	6.00	6.00
Exchange rate (USD-CNY)	6.05	6.00	6.21	6.12	6.05	6.00

Source: National Bureau of Statistics, CMS (HK)

Investment Ratings

Rating	Definition
OVERWEIGHT	Expected to outperform the market index by > 10% over the next 12 months
NEUTRAL	Expected to outperform or underperform the market index by 10% or less over the next 12 months
UNDERWEIGHT	Expected to underperform the market index by >10% over the next 12 months

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