# ECONOMIC ANALYSIS (SUMMARY)

## A. Summary

1. Although slowing more than expected in the first 9 months of 2015, economic growth in the People's Republic of China (PRC) remains steady and is forecast to average 6.8% for the year. Export demand, slowed by delayed recovery in the developed economies, should strengthen over the forecast period and, together with robust consumption growth, cushion the impact of decelerating investment growth.

## B. Economic Performance

2. Economic growth moderated from 7.3% year on year in 2014 to 6.9% in the first 9 months of 2015, which is in line with the government's target for the full year of about 7.0% growth. Labor markets remained healthy, as evidenced by the creation of 10.7 million urban jobs during the period, notably in services, and continued strong wage growth.

3. Services remained the key growth driver on the supply side, and domestic rebalancing from industry to services made further progress. Service sector growth accelerated from 8.1% year on year in 2014 to 8.4% in the first 9 months of 2015. Growth was most pronounced in financial and real estate services. Industry (including construction, manufacturing, and mining) expanded by 6.0% year on year in the first 9 months of 2015, down from 7.3% in 2014 as a whole. The slowdown resulted from continued moderation of growth in construction, reflecting decelerating investment. This dampened demand for heavy equipment, mining products, and electricity, which helped reduce energy consumption per unit of gross domestic product (GDP) by 5.7% year on year. Within manufacturing, consumer-oriented enterprises did much better than heavy industries.

4. On the demand side, consumption remained robust and contributed 4.0 percentage points to GDP growth in the first 9 months of 2015. The contribution of investment was 3.0 percentage points, and of net exports –0.1 point. Consumption was bolstered by upbeat consumer expectations and real disposable income growth of 7.7%. Rural households continued to enjoy faster income growth than urban households, helping to trim income disparities and support consumption and retail sales. Although housing sales revived, real estate investment growth remained weak with an abundance of unsold floor space, and growth in new housing starts languished deep in negative territory. Government support for infrastructure, shanty town redevelopment, and social housing construction could not fully compensate for decelerating private housing investment. Robust investment growth in better-performing and less capital-intensive areas of manufacturing and services could not outweigh the deceleration of investment in the more capital-intensive heavy industries, which face persistent excess capacity and a highly uncertain business outlook. Important structural changes are taking place in the PRC economy, and growth is becoming less investment driven. These changes and other demand-side constraints, such as limits on private investors' access to important areas of infrastructure and social service provision, are the main factors slowing investment growth—more so than financing constraints.

5. Price pressures remained moderate as the impact of rising food prices was dampened by declines in commodity prices. Consumer price inflation edged up during the year, quashing lingering deflation concerns. Driven by rising pork and vegetable prices, headline consumer inflation stepped up from 1.2% year on year in the first quarter of 2015 to 1.4% in the second

quarter and 1.7% in the third quarter. Core inflation rose from 1.4% in the first quarter to 1.6% in the second quarter and 1.7% in the third quarter. Meanwhile, producer price deflation deepened from 4.6% in the first quarter to 4.7% in the second quarter and 5.7% in the third quarter. This trend reflected further weakness in global commodity prices rather than in domestic demand.

6. Growth in the consolidated budgetary revenue of the central and local governments accelerated from 6.6% year on year in the first half of 2015 to 7.6% in the first 9 months. It remained below the budget target for the full year, however, as a significant decline in the value of imports held import and resource tax revenues short of the budget, and as small and medium-sized companies received additional tax relief. Growth in consolidated budgetary expenditure also accelerated, from 11.8% to 16.4% over the same periods, which exceeded the target for the full year. A sign that fiscal policy had likely become more expansionary was shrinkage in the consolidated budget balance, to a deficit of 1.3% of GDP in the first 9 months of 2015 from a surplus of 0.6% a year earlier. Local governments' off-budget spending has apparently remained substantial, as in the past, though data are scarce. This lack of information continues to frustrate a comprehensive assessment of fiscal policy. The revised budget law prohibits off-budget spending by local governments, which has been financed mainly through nonbank financing vehicles. However, the quota for issuance of bonds by local governments to finance deficits remains at only CNY600 million, which is too low to finance all off-budget spending if these expenditures are put on budget this year.

7. The broad money supply (M2) grew by 11.3% year on year in the first 9 months of 2015, or 4.7 percentage points faster than nominal GDP, the same difference as in the first 9 months of 2014. This suggests that economic activity is not constrained by credit, and that debt and its associated risks continue to mount, though less rapidly than before 2014. The People's Bank of China cut regulatory reserve requirements and benchmark loan and deposit rates on several occasions and injected liquidity into the banking system, intending to stabilize money supply in light of capital outflows. Money market rates fell to historic lows as a result. Year on year, M2 growth moderated from 11.7% in the fourth quarter of 2014 to 10.5% in the first quarter of 2015 and 10.1% in the second quarter, as credit demand further weakened, but jumped to 13.2% in the third quarter.

8. The renminbi, which had weakened somewhat against the US dollar in early 2015, subsequently strengthened amid market-driven fluctuations around the benchmark rate. It has weakened again since 11 August 2015, when the government moved to make the official exchange rate more market oriented and transparent by basing its determination on daily market quotes. This was another step toward full exchange rate flexibility, which is a declared policy objective. However, as the dollar has risen against other currencies since 2014, the renminbi has appreciated strongly in tandem in terms of its nominal effective rate (against a trade-weighted basket of currencies) and its real effective rate (taking inflation into account).

9. Exports fell by 1.6% year on year in dollar terms in the first 9 months of 2015 as broader global demand softened. However, real export growth was stronger than the dollar figures suggest, given the weakness of other invoicing currencies like the euro and the yen. There is no clear evidence to suggest that the PRC is losing global market share. A stronger renminbi might have narrowed the competitive edge of the PRC relative to other emerging economies, but exports have grown in line with external demand and PRC merchandise trade surpluses are at historic highs. The PRC paid less for imports in the first 9 months of 2015 as their value fell by 15.2% year on year, mainly because of lower commodity prices but also important structural changes—imports of raw materials have been declining as domestic demand for construction materials and energy weakens.

10. The trends in exports and imports left a trade surplus of $427 billion in the first half of 2015, up by more than 80% over the same period in 2014. Despite a sharp increase in the services deficit that reflects substantial overseas expenditure by outbound tourists, the PRC current account surplus likely increased strongly too. Net inflows of foreign direct investment remained strong, but net outflows of portfolio and other investment pushed the overall balance of payments into deficit. Gross international reserves declined accordingly but remained sizeable at $3.54 trillion at the end of September 2015.

11. After a pronounced stock market rally, which boosted the A-share indexes of Shanghai and Shenzhen by more than 90% from November 2014 to May 2015, both markets experienced corrections. Concerned about capital market and finance sector stability, the government took a number of measures—it further cut benchmark interest rates and regulatory reserve requirements, relaxed rules on margin financing, restricted short selling, suspended some initial public offerings, strengthened the capital of the China Securities Finance Corporation (which provides refinancing to market participants) and pledged central bank liquidity support for it, bought exchange trade funds through the government investment company Central Huijin, convinced other securities and insurance companies to invest in shares, and initiated a share buyback program for state-owned enterprises. These measures have helped to arrest the fall in share prices for the time being, but their longer-term impact remains uncertain.

## C. Economic Prospects

12. The economy decelerated more than expected in the first half of 2015, as structural changes gained traction and initially slowed growth, and as tropical storms and the Tianjin disaster held back activity in a number of key manufacturing hubs in July and August. GDP growth forecasts are therefore revised down from those in Asian Development Outlook 2015, to 6.8% for 2015 and 6.7% for 2016.

13. Investment growth will continue to moderate, but less so in 2016 as progress toward structural reform and better financing conditions start to invigorate private investment. The fastest-growing investment segment will continue to be infrastructure, which the government uses as a countercyclical policy tool. Government support will increasingly be provided through policy banks, which have been reformed, recapitalized, and authorized to issue infrastructure bonds. Improvements to the selection and management of infrastructure projects, partly through public–private partnerships, should help to achieve the targeted growth rate with less investment. The already rapid growth of infrastructure investment is unlikely to accelerate, though, as viable projects are hard to find after years of strong investment growth. Real estate investment will remain the weakest segment in light of a large housing inventory surplus, particularly in lower-tier cities. However, the decline in real estate investment may bottom out in 2016 as the surplus tapers. Though further progress toward finance sector reform and the opening up of the PRC economy will improve the investment climate, private investment will continue to moderate because better-performing industries require less capital than do construction and heavy industry, which are slowing more sharply. Consumption is expected to remain more robust than investment, provided that wage growth remains strong. Recovery in the developed economies, expected to unfold in the second half of 2015 and in 2016, should support PRC exports and GDP growth over this period.

14. Fiscal policy will likely stay broadly unchanged. Disappointing consolidated budget revenues may push the deficit above the indicative target of 2.7% of GDP in 2015 if the government sticks to its expenditure targets and lets automatic stabilizers work on the revenue

side. Further widening of the budget deficit is expected in 2016 as more off-budget activities of local governments are brought on budget. Efforts to curb local government spending will likely be rolled out over a longer period, as soft growth in overall investment leads the government to prioritize short-term economic stability. However, despite fine-tuning measures such as allowing banks to continue to lend to local government financing vehicles for the time being, fiscal reform continues to target more efficient, accountable, and sustainable local government finance. Meanwhile, legislative and institutional preparations for a national property tax, including the establishment of a national property registry, are expected to advance over the forecast period.

15. The recent upward movement in money supply growth will support GDP expansion in the coming months. However, monetary policy has to take into account the risks associated with high credit growth, which still substantially outpaces nominal GDP growth. In light of this, additional interest rate cuts are less compelling over the forecast period, particularly as (i) benchmark lending and deposit rates are already close to their historic lows after five rate cuts in 2015; (ii) higher US rates are expected soon; (iii) inflation will likely rise along with commodity prices; and (iv) the PRC leadership has made it clear that it sees structural reform, not monetary or fiscal stimulus, as the guarantor of sustainable growth. Nevertheless, further moves are expected toward full interest rate liberalization, for instance by deemphasizing the importance of benchmark rates. Regulatory reserve requirements—which, despite four cuts in 2015, remain high at 17.5% for larger banks—are likely to be further relaxed, thereby injecting liquidity into the banking system, provided that net foreign capital inflows remain moderate or negative.

16. With an increasingly flexible exchange rate policy, capital flows will become even more a function of progress toward opening the capital account and reforming the domestic finance sector. Over the forecast period, the government is expected to further enhance bond market access and liquidity, improve equity market governance, streamline share issuance procedures, and license more private banks to improve resource mobilization and allocation. In addition, it will launch a pilot for private cross-border capital transfers and reform existing cross-border institutional investor schemes.

17. Headline consumer price inflation should remain low in 2015 as global prices for food and other commodities remain depressed. This provides an opportunity for the government to further accelerate its reform of administered prices. In 2016, inflation will likely rebound as global commodity prices recover, which will also alleviate producer price deflation. Nevertheless, as consumer price inflation in the first half of 2015 was slightly lower than expected in Asian Development Outlook 2015, headline inflation forecasts are revised down to 1.5% for 2015 and 2.2% for 2016.

18. Foreign trade will continue to benefit from accelerating global growth, even with slightly less favorable terms of trade and without real renminbi depreciation. Trade and current account surpluses will nevertheless shrink as global commodity prices recover.

19. The principal risk to this forecast is that investor confidence further suffers through waning trust in the ability or willingness of the government to proceed with market-oriented structural reforms. This risk is, however, mitigated by regular announcements of structural reform measures in an increasing number of policy areas. Discussions about the structural reform agenda of the 13th Five-Year Plan also provide an opportunity to anchor expectations.