

Commentary on the Chinese Macroeconomics

January, 2017

The economy continues the trend of stabilization at the base, but both new and old problems are increasing the risk of economic operation

Steady to improved growth

Even though the December data of 2016 show that there is still downward pressure on the economy, the overall economy continues the trend of “steady to improve” growth.

The main indicators are:

- (i) prices of consumer goods continue to go up moderately, while PPI (Producer Price Index) and PPIRM (Purchasing Price Index for Raw Materials, Fuel & Power) rise much more than expected;
- (ii) although the year-on-year growth of dollar-denominated import and export are declining due to base factors, the performance as compared on a year-on-year basis has improved significantly, with external demand showing signs of marginal improvement;
- (iii) the financial data have exceeded market expectation, mid-to-long term corporate credit demand picked up, M1 and M2 gone further down and capital continued to improve marginally “from real economy to virtual economy”, reflecting the on-going momentum of the real economy is heading to stabilization;
- (iv) business efficiency continues to improve and the microeconomic basis of the macroeconomics shows a positive change;
- (v) there is an obvious fluctuation in the RMB exchange rate recently, this, coupled with the short-term adjustment of the US dollar, reduces the pressure on devaluation of RMB. However, the pressure for RMB to passively devalue still exists though the decline in foreign reserves has been narrowing;

- (vi) the market is expected to improve along with the major economic indicators. Overall, although the high-frequency data show that there is a slight slowdown of industrial production, yet the fourth quarter of 2016 and the annual GDP has ended at 6.7%

New issues and old problems

The last December data show that the Chinese economy continues the trend of “steady to good” growth. While the old problems of economic operations still exists, new issues have appeared, and we believe that in 2017 we still need to pay attention to two new issues as well as the five old problems.

Two new issues

- (i) the first issue is that we need to pay attention to the two new problems in economic operation: the first being the sharp increase in the purchase price of the raw materials and the failure of the price transmission mechanism to run smoothly. This will result in the earnings of the manufacturing industry, especially those downstream in the manufacturing process, to be reduced significantly;
- (ii) the second issue is that the interest rate has been rising, increasing the cost of corporate financing

Five old problems

Next, we need to pay attention to the five old problems in economic operation:

- (i) the first being that under the background of deleveraging, the trend is for state-owned enterprises and private enterprises to move away from each other, decreasing the efficiency of resource allocation;

- (ii) the second problem is that the risk of debt (of non-financial corporations especially), have further risen. The policy of “three decrease, one drop, one subsidy” (三去一降一补)¹ accelerates excess industry credit risk;
- (iii) the third problem is that the property market has cooled down, the regulation imposed on the property market seems overkilling, and we need to prevent the downward risk caused by the possible bursting of the bubble;
- (iv) the fourth problem is the decline in the growth rate of investment capital, and the overall source of funding is uncertain in the future;
- (v) the fifth problem is that if expectation of devaluation of RMB persists, this in turn will cause the outflow of capital out of control, thus, we need to pay close attention to the risk of capital outflow.

Policies in six directions

Although the economy is showing signs of stabilizing at the bottom, there are still numerous conflicts and problems in its operations, especially in terms of the accumulation of financial risks. Based on this as well as the work of the Central Economic Work Conference, we believe that work relating to the economy will focus on six directions:

- (i) economic policy will focus more on risk prevention;
- (ii) deepening the supply side structural reform under the stable and good fundamentals can stimulate economic growth and efficiency.
- (iii) against the backdrop of risk, a prudent monetary policy that is neutral towards the tight end will be adopted;
- (iv) in order to ensure that the fiscal policy is positive and effective, more attention will be paid to structural control functions;
- (v) as the housing market has considerable impact on the economy and people's

¹ “三去一降一补” refers to the five major tasks of cutting excess industrial capacity, destocking, de-leveraging, lowering corporate costs, and improving weak links.

livelihood that control on the housing market must be focused on its “stability” and development in a healthy and stable manner;

(vi) develop a strategy for “risk prevention and keeping the bottom line” to steadily resolve China’s debt risk.

Outlook: bottom hitting in 2017

As a typical “policy market” will prevail in 2017, the real estate industry, under the influence of the purchase limitation policy, industry supply and demand relationship, and inventory factors, will gradually enter a new re-adjustment phase to give downward pressure to the economy. The new control policy will undoubtedly slow down the growth of property development and investment-related industries. At the same time, the global economic recovery continues to be weak, and the probability of substantial improvement in foreign demand is low. Investment in infrastructure is still the main source of stable growth, but under the background of slowing fiscal revenue and high base number, the chance of attaining to a higher level is slim, therefore, the overall domestic demand will be slowed down, the cultivation of new momentum in new industries will take time; the imposition of the policy of “three decrease, one drop, one subsidy” (三去一降一补)² continues to put pressure on the manufacturing industries; and a new political cycle will also bring fluctuations to the economic growth.

We believe the growth rate of the real GDP will be lowered to 6.5% in 2017, down 0.2 percentage points as compared to 2016. The real GDP growth in the first quarter will be 6.6%, reflecting an annual trend from high to low. In 2017, the growth of fixed investment asset will go down further to 8.2%, the growth of investment in January-February will be around 8.1%, while investment in infrastructure is still the main focus. Consumer demand is slowing down in a stable fashion, with annual growth at around 10.2%, the January consumer growth is at 10.3%. The rate of decline in export has narrowed down, but the overall trend is still continued decline, year on

² Ibid n(1)

year the decline is 2.7%, taking into account the lower baseline, the year on year export growth in January is expected to be positive in the short-term. The price center is moving up, at the same time annual CPI (Consumer Price Index) is up 2.1%, taking into account seasonable factors such as the Chinese New Year in January, and also considering the base number effect and new price factors, it is expected that the CPI will increase by 2.9% in January. In 2017 the year-on-year PPI will show a high to low trend, with an annual increase of 1.9%. Overall, 2017 is a year when the Chinese economy will continue to find the bottom that will take about one year or so. Then, the economy is expected to pick up again in early 2018.

Research department

Contact person:

Zoe Chan, Assistant Vice president

Email: zoe_chan@ccxap.com

Tel.: (852) 2860 7112

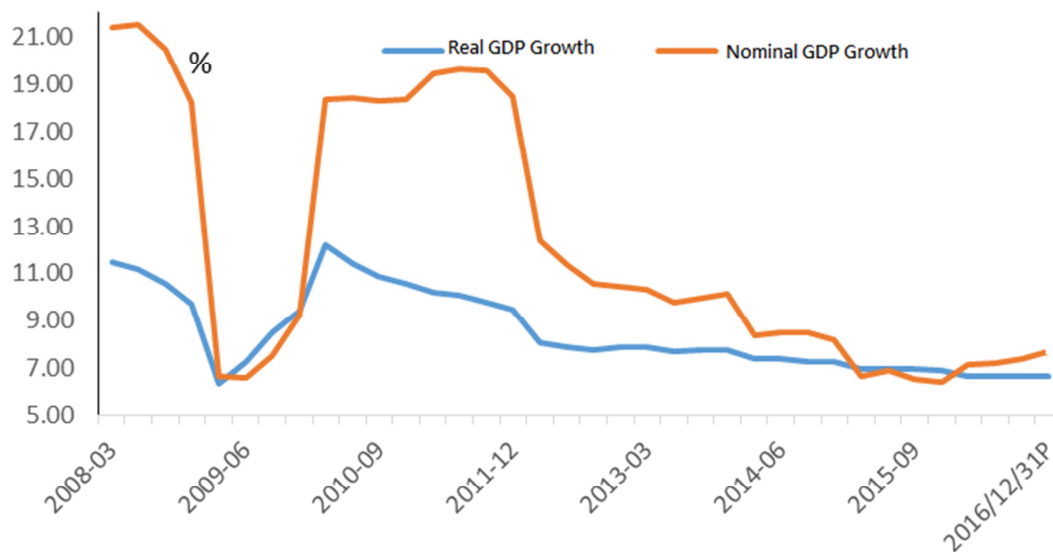


Figure 1: Real GDP growth remains at 6.7% in 2016, and nominal GDP shows a steady increase.

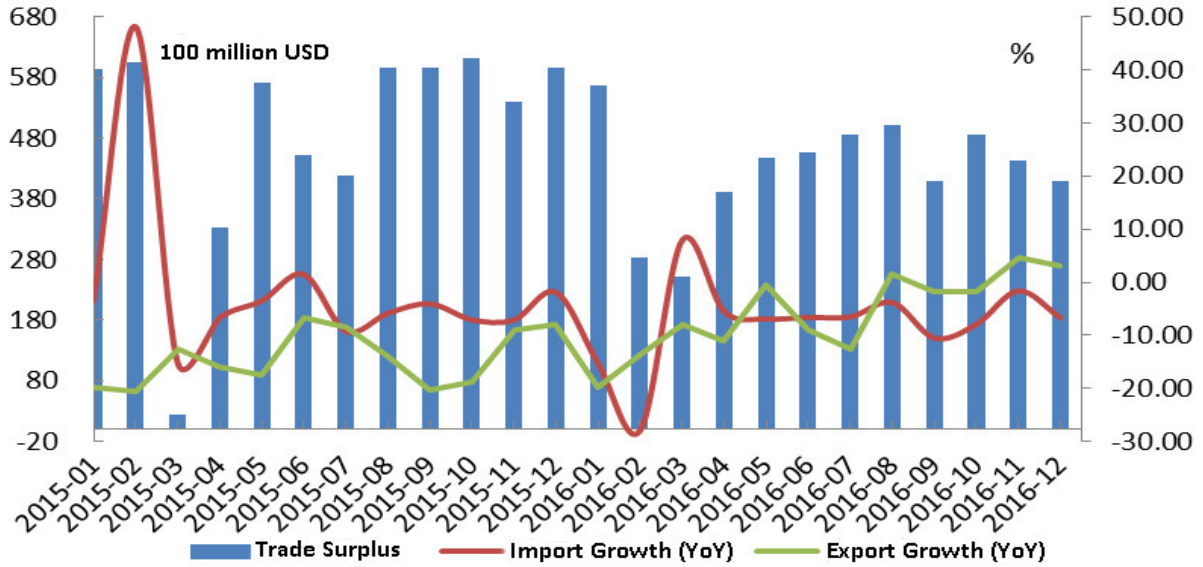


Figure 2: Export continues to decline and import growth slows down.

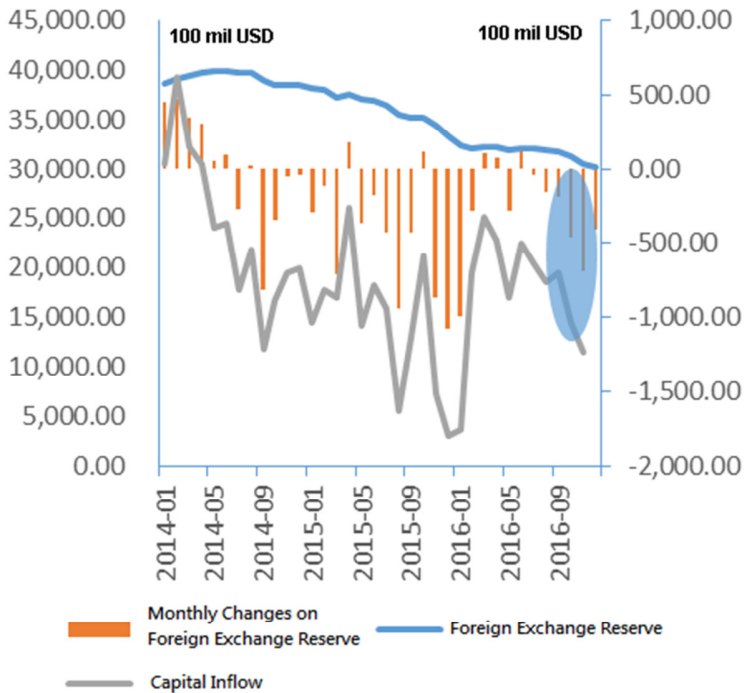


Figure 3: The decline of foreign exchange reserves and capital flows continues.

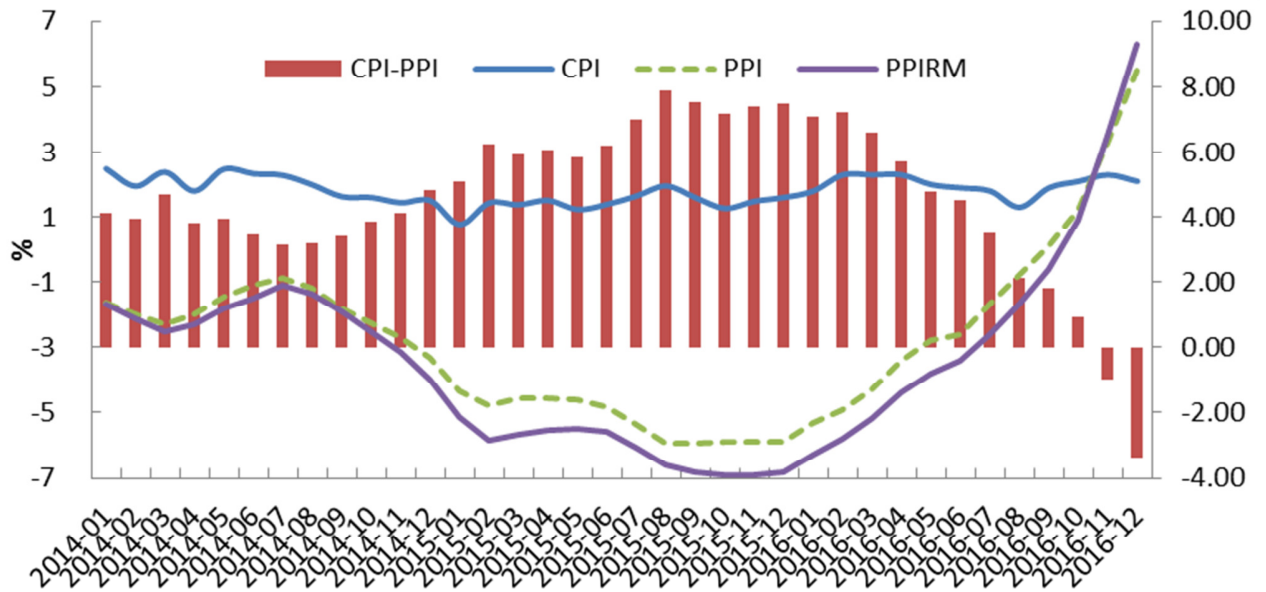


Figure 4: PPI and PPIRM sharply increase, but price transmission mechanism is less effective (as reflected by the difference between CPI and PPI).

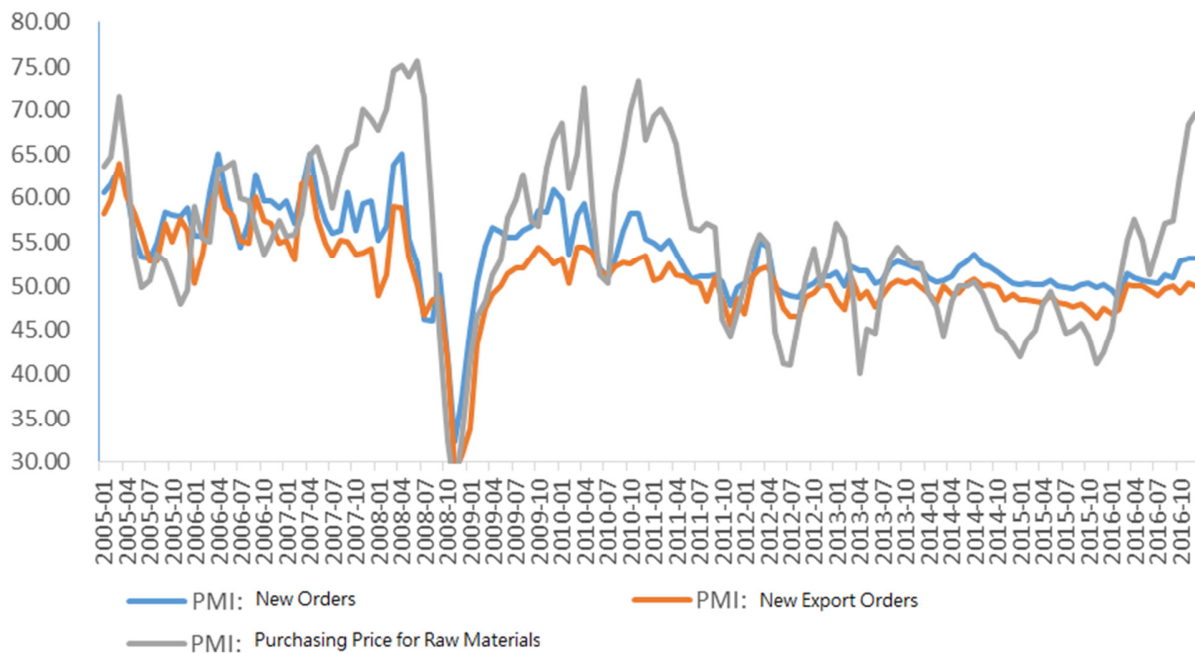


Figure 5: Demand of corporations has not shown obvious increment; purchasing price of raw materials sharply increases.

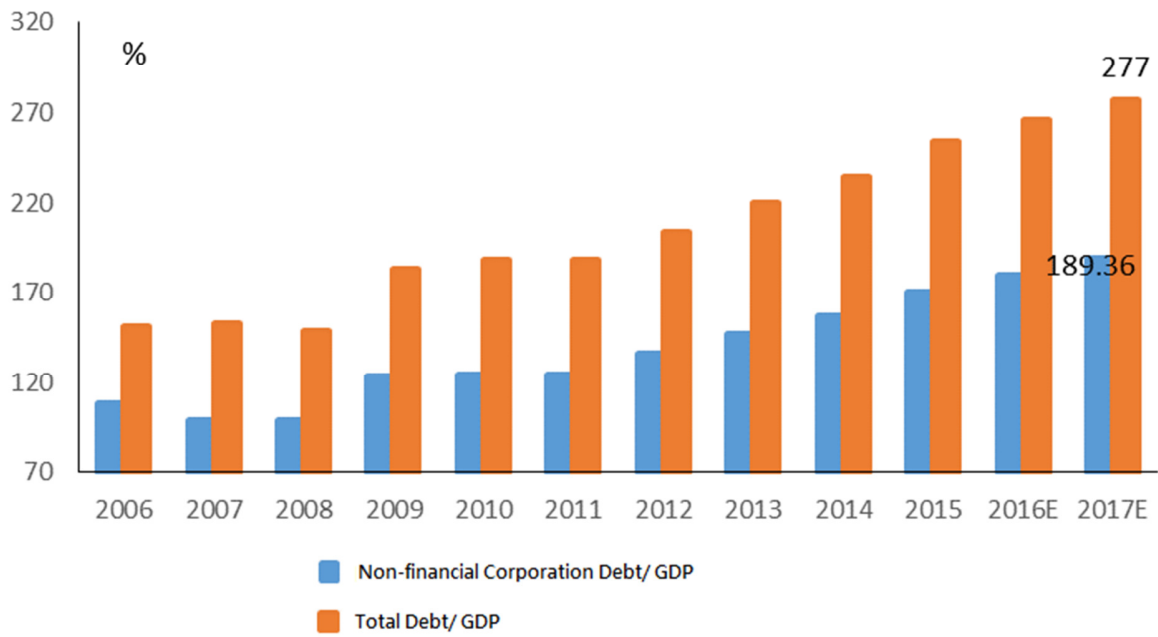


Figure 6: Debt/ GDP of non-financial corporations continue to rise.

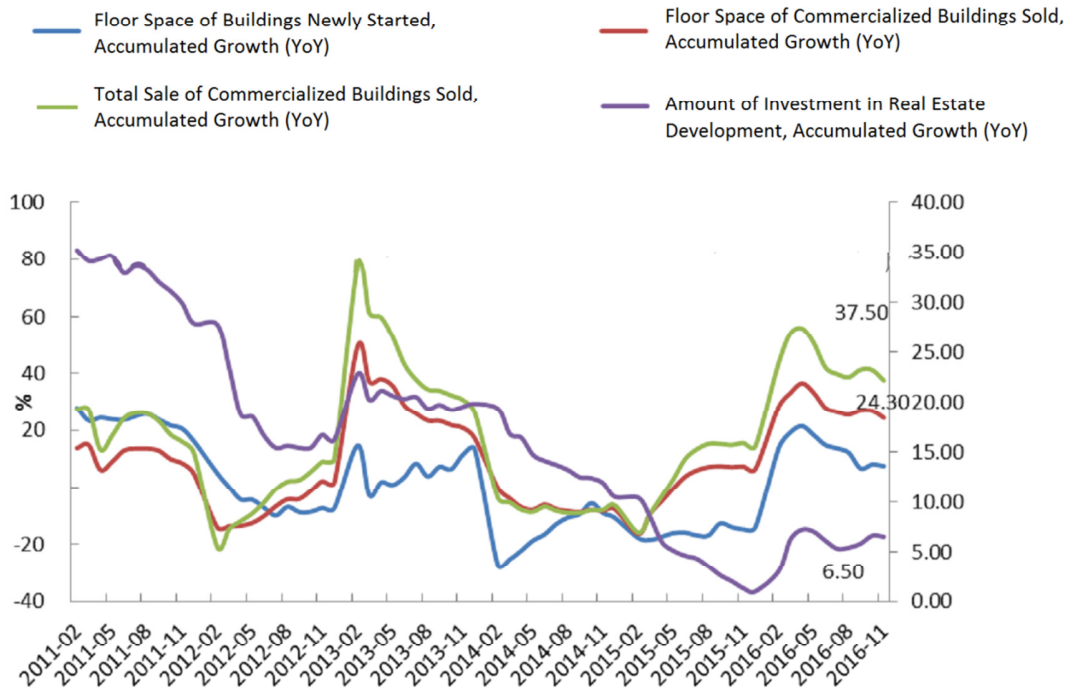


Figure 7: The new control policy will slow down the growth of the real estate development.