

August 2016

Major economic indicators ^{p1}/Policy updates ^{p5}/Hot topic analysis ^{p6}

China Economic Quarterly



普华永道

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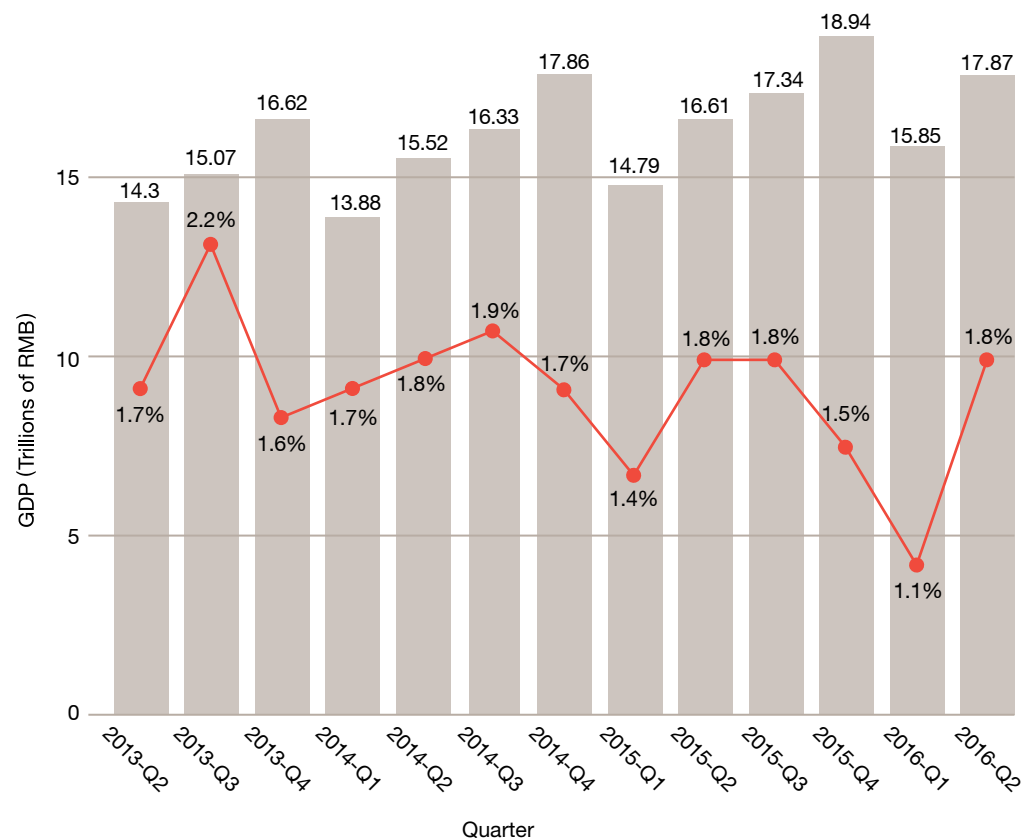
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Major economic indicators

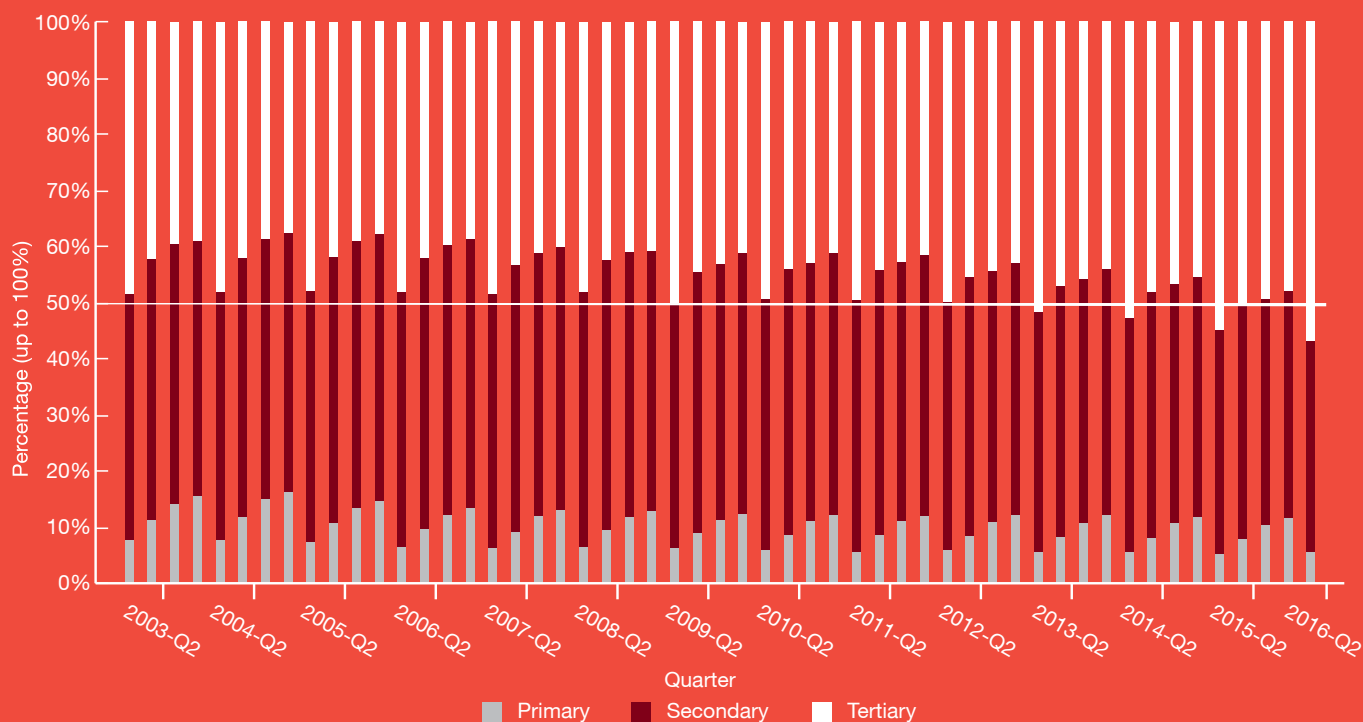
● GDP growth and industry coverage

Graph 1: Quarterly GDP and Seasonally Adjusted GDP Rate



Source: NBS of China

Graph 2: Sector Percentage in Quarterly GDP



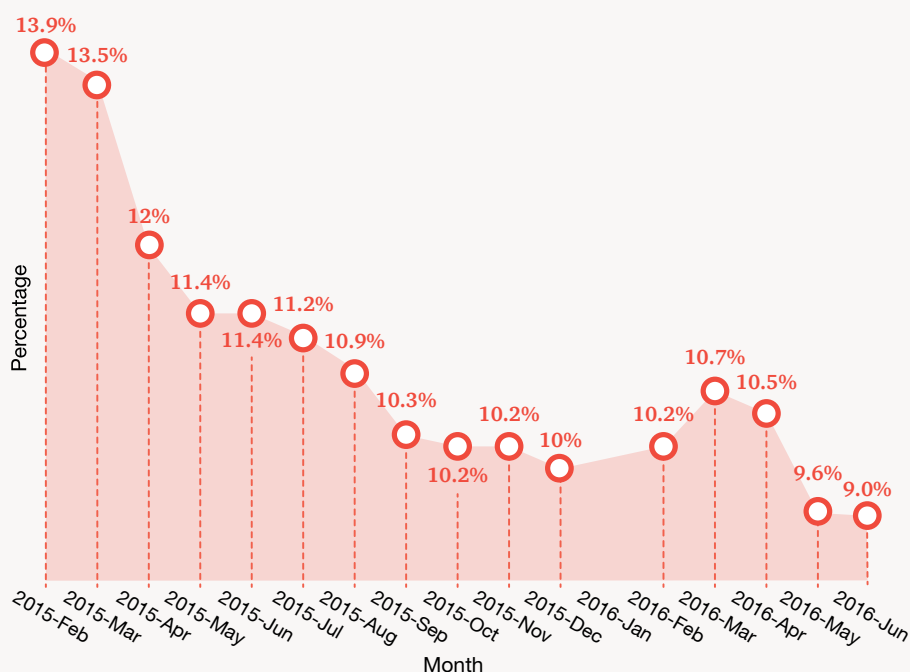
Source: NBS of China

Note: The 'primary sector' is agriculture; the 'secondary sector' is construction and manufacturing; the 'tertiary sector' is services.

● Drivers of economic growth

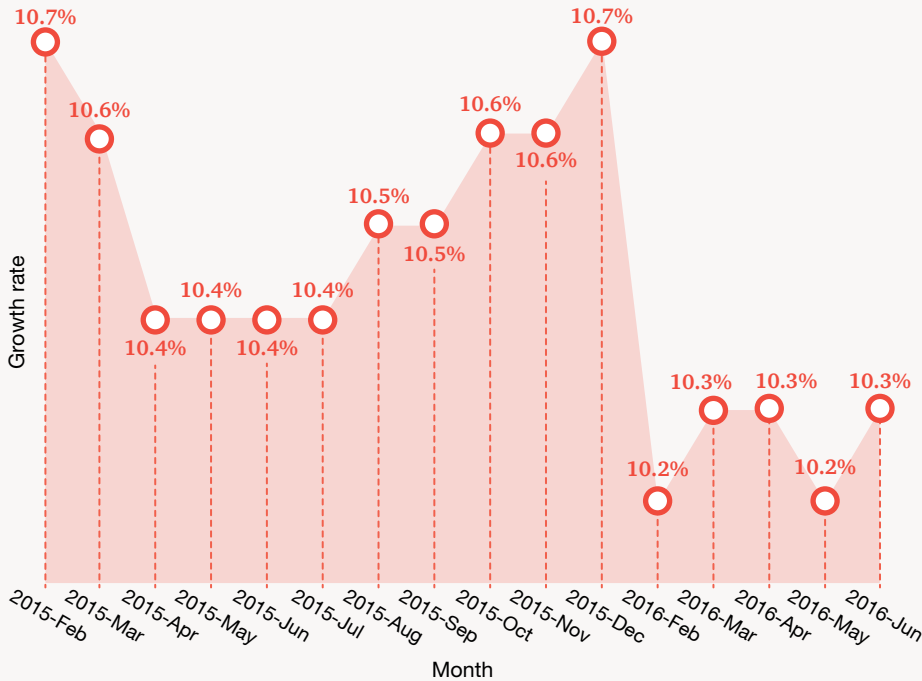
- Thanks to expansionary fiscal and monetary policies, the **GDP growth rate** in Q2 2016 was 6.7%, same as in Q1 and marginally lower than the 2015 rate of 6.9%. Investment in real estate and infrastructure have picked up. This may help boost economic growth in 2016; however, questions remain regarding the long-term sustainability of supportive policies and their potential conflict with much needed supply-side structural reform.
- As **China is in economic transition** from investment and export-led growth to consumption and services, the share of industrial activities and services as a percentage of GDP reached 39% and 54% at the end of June 2016, increasing by 6.1% and 7.5% respectively. Services has become the most significant driver for economic development; consumption contributed 73.4% to GDP growth, 13.2% more than in 2015.

Graph 3: Fixed Asset Investment: Accumulated Growth Rate



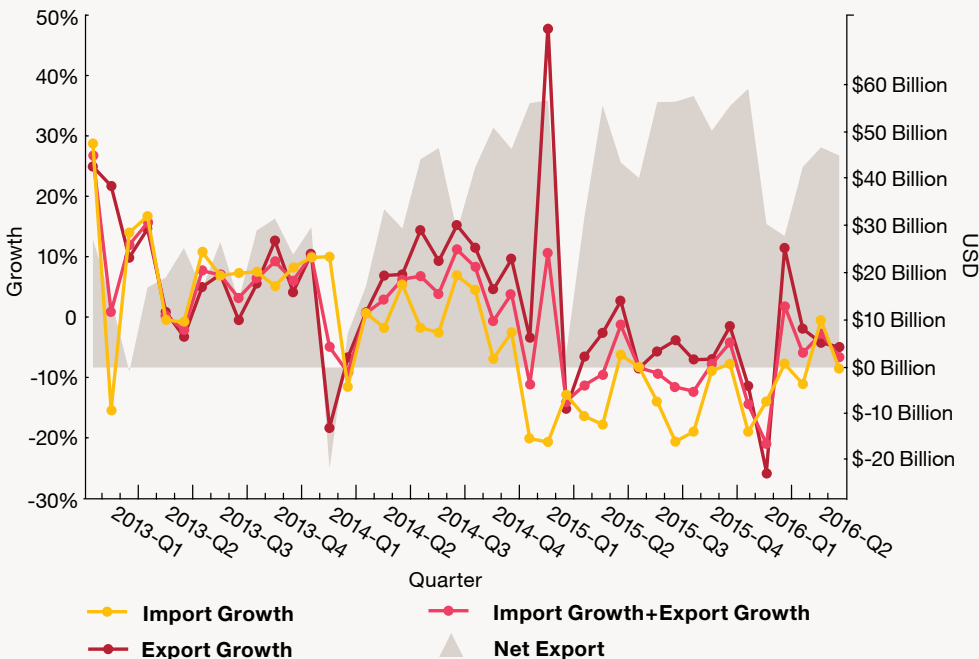
Source: NBS of China

Graph 4: Retail Sales of Consumer Goods: Accumulated Growth Rate



Source: NBS of China

Graph 5: Quarterly Balance of Trade

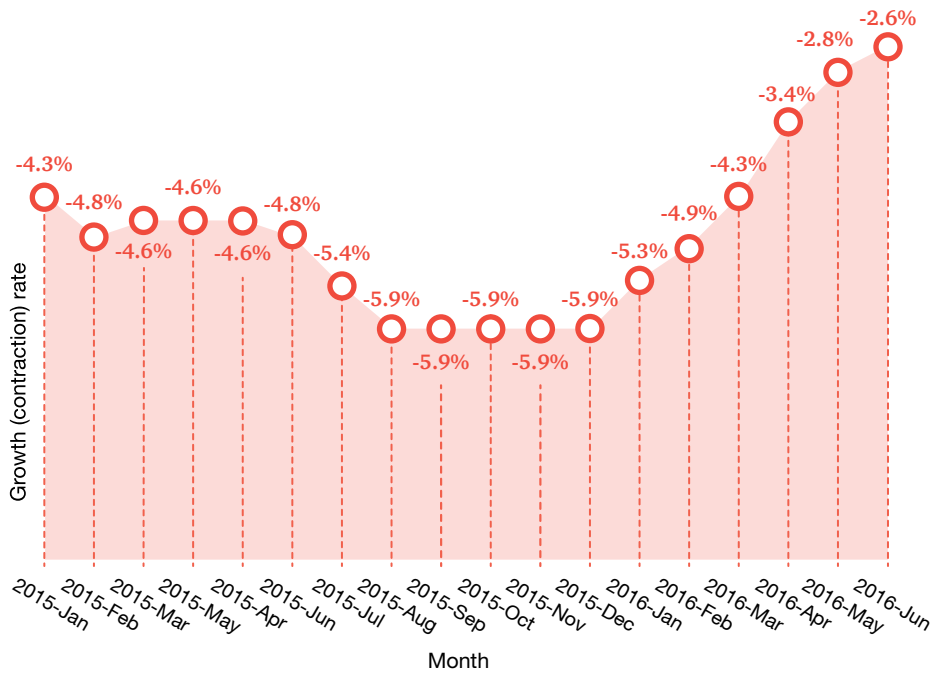


Source: NBS of China

- In the first half of 2016, **fixed asset investment** totaled 25.8 tn yuan, a 9.0% year-on-year increase (11.0% real growth after deducting pricing factors). Infrastructure investment, driven by government spending, grew by 20.9% over the same period, reaching 4.9 tn yuan; services investment increased by 11.7%. For the first half year of 2016, however, private investment grew only by 2.8%, while state holding investment increased by 23%. The subdued growth in private investment reflects the lack of confidence over future economic prospects. SOE investment rose notably over the same time period, and is expected to remain high to meet government goals.
- In the first half of 2016, **total retail sales** reached 15.6 tn yuan, growing by 10.3% year-on-year. Online sales of goods and services continued to deliver strong growth: total sales stood at 2.24 tn yuan, a 28.2% increase year-on-year.
- The total value of **imports and exports** reached 11.1 tn yuan in the first half of 2016, falling by 3.3% year-on-year, though improving from a decline of 5.9% in the first quarter. China's trade surplus equaled 1.67 tn yuan or about 15% of total trading volume. As global imports and exports have declined 14.7% and 16.1% respectively in 2015, China's prospect of stronger growth in international trade for the rest of 2016 looks dim.

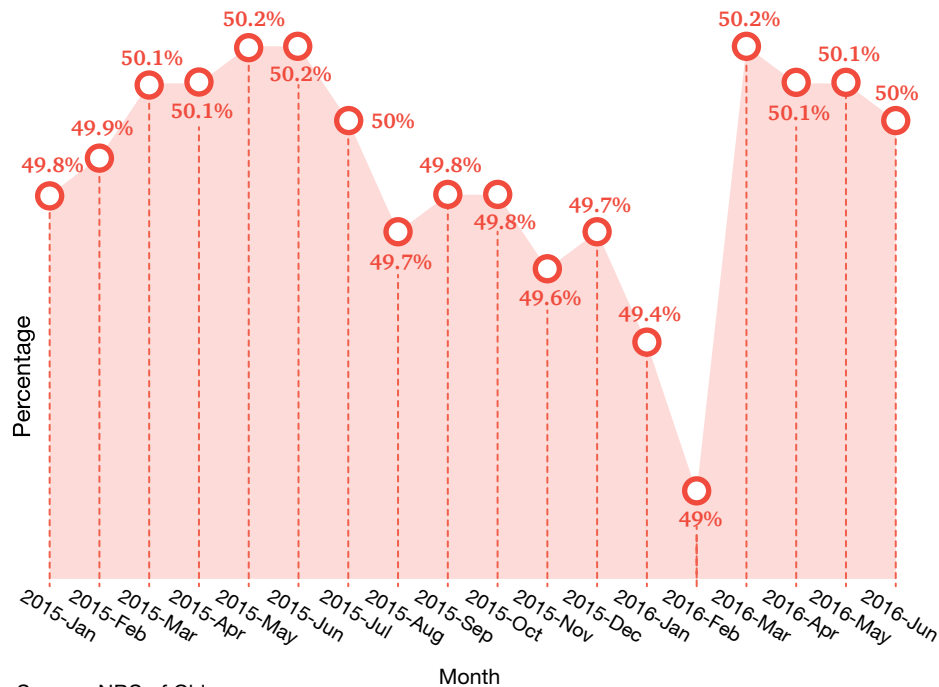
● Manufacturing and pricing

Graph 6: Producer Price Index



Source: NBS of China

Graph 7: Purchasing Managers' Index



Source: NBS of China

- **Consumer Price Index (CPI)** grew by 2.1% year-on-year in the first half of the year. As a result, concerns over deflationary pressure have eased. Meanwhile, **Producer Price Index (PPI)** has gradually recovered since the beginning of the year.
- **Purchasing Managers' Index (PMI)** registered 50% in June, on the threshold between expansion and contraction, after staying above 50% for four consecutive months. While the PMI for large state-owned manufacturing companies was at 51%, it was at 49.1% for medium-sized companies and only at 47.4% for small companies. Non-manufacturing PMI in June stayed at 53.7%, indicating a healthier outlook for service companies.

Policy update

- **President Xi stressed supply-side structural reform** at the Communist Party’s Politburo meeting on 26 July when discussing economic policy priorities for the second half of 2016. Xi indicated that “the key to reducing redundant capacity and deleveraging was deepening reforms of SOEs and financial institutions,” and “reducing oversupply in the property sector would proceed in line with urbanisation needs, while the asset bubble should also be reined in and the tax burden cut.”

Thus far, progress on supply-side reforms has been slow due to structural barriers and concerns of local governments over social stability and loss of tax revenues. And it remains to be seen what specific measures the government will take to curb the housing bubble.

- **Premier Li emphasised room for fiscal and monetary stimulus** at the Summer Davos Forum in Tianjin. Li stated that the Chinese government’s national total debt ratio was at a low level of about

40% of GDP and only 16% for the central government. Coupled with a high savings rate (50% of GDP), China has sufficient policy tools to maintain stable economic growth and the required capacity to manage systemic risks.

It is largely believed, however, that China’s government and corporate debt levels are much higher than official statistics suggest and still rising. The debt issue is a major threat to sustainable growth of the economy.

We believe the Chinese government may consider reinforcing its fiscal and monetary measures in order to meet the official economic growth target.

- **China’s “Mid-to Long-term Rail Development Plan”** was released by the National Development and Reform Commission on 20 July. By 2020, high-speed rail will reach 30,000 km, covering over 80% of large urban areas in the country. The national rail network is expected to extend to 200,000 km in the long term, among which 45,000 km will be high-speed rail, featuring eight vertical lines and eight horizontal lines, supplemented by regional connections.

It is expected that rail investment during the 13th Five-Year Plan (2016-2020) will exceed 2.8 tn yuan (excluding investment from local regions), adding new stimulus to sustain China’s economic growth while providing new business opportunities.



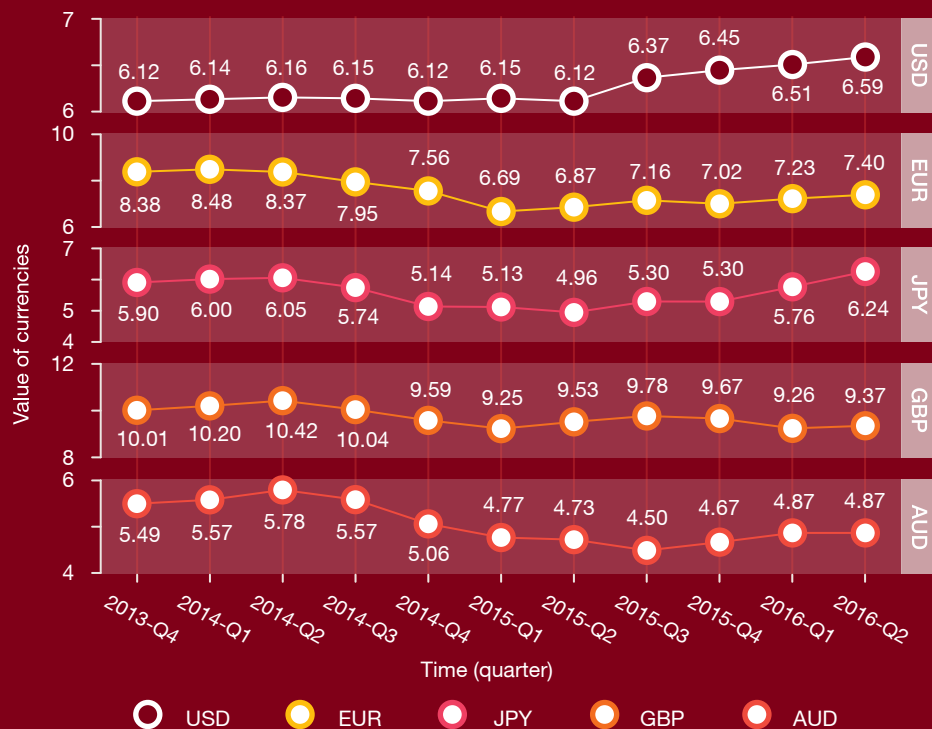


Hot topic analysis

● Will the RMB depreciate further?

The trajectory of China's renminbi (RMB) has become a key issue after recent fluctuations. The RMB hit a multi-year low against the US dollar in July as it depreciated from around 6.20 to 6.68 per dollar since last year, falling by 8%. It also has depreciated against other major currencies, such as the Japanese yen, due to the yen's dramatic appreciation. The movement has not all been in one direction, however: the Chinese currency is relatively strong against the weaker Euro and appreciated against the Sterling after the UK voted to leave the EU.

Graph 8: RMB Exchange Rate



Source: China Foreign Exchange Trade System (CFETS)



Several factors are driving the RMB's devaluation. First, the US dollar is forecast to strengthen on the back of a relatively strong economic recovery in the US.

Second, China's economic recalibration isn't likely to change over the short-term. This factor, coupled with market expectations of US interest rate hikes in 2017, will tend towards further capital outflows, especially from wealthy residents and private companies. On the other hand, the Chinese government has insisted there is no fundamental reason for the RMB to continue falling, as further depreciation would lead to further capital outflows.

The RMB is currently in an early stage of market-oriented reform. During this critical period, the Chinese government has been very sensitive to exchange rate fluctuations and their impact on the real economy. It has reaffirmed its position of sticking to the principles of being autonomous, progressive and controllable when implementing reforms of the exchange rate.

The marketisation of the RMB's exchange rate mechanism gives different stakeholders a chance to influence the Chinese currency. Some investors may leverage this reform to place opportunistic bets against the currency. To maintain market stability, the People's Bank of China (PBoC) has to make frequent interventions in the Hong Kong market to ensure a smooth transition.

However, the reform process does not mean that the RMB exchange rate will become fully market determined overnight. This is well reflected in the PBoC's market interventions that aim to iron out excessive arbitrage and market volatility. To some extent, economic and social stability, rather than reform, is more important for the Chinese government.

Overall, the RMB's value can only be determined by the market over the long-term. Before that, predicting the RMB's future trajectory will be difficult, especially when a basket of currencies is involved. We believe that the yuan will stay comparatively stable against the major currencies for the rest of 2016, with the caveat that it may marginally depreciate against a resurgent US dollar. This forecast is based on the assumption that China's economy continues to grow, even at a slower speed, along with China's relatively high interest rates and stringent capital controls. We expect the Chinese government to speed up marketisation of the RMB's exchange rate mechanism once market expectations for RMB depreciation weaken. The trend of the US dollar/ RMB exchange rate will have a significant impact on the pace of these reforms.

● **Brexit: Implications for Chinese investors**

The UK's vote to leave the EU has sent shockwaves across the world. Business investment and consumer confidence in the UK declined, with the pound depreciating by 10% in the first three weeks. Due to increased political and economic uncertainty following the 'Brexit' vote, UK's economic growth, according to the latest PwC analysis, is expected to slow from 2% in 2015 to around 1.6% in 2016 and 0.6% in 2017.

Chinese investors are also affected. As the second largest country in the EU for Chinese investment, the UK has been a favoured investment destination, accounting for a quarter of stock of Chinese investment into the EU, thanks to its stable political system and role as an international financial services hub and of a gateway to the broader single market of the EU. But now all has changed.

The UK's attractiveness as the investment centre for Europe has weakened; R&D companies/projects and education programmes, in particular, will be adversely affected. As a result, the market valuation of existing projects will have to be re-evaluated, while some ongoing projects have been put on hold given the huge uncertainties ahead. Some companies, especially those who have their regional head offices in the UK, using the UK as a gateway to the single market, are contemplating moving their business, or part of it, to continental Europe. Some have done it already.

From a legal and regulatory point of view, nothing will change in the next 2.5 years as UK's new Prime Minister Theresa May has made it clear that she would not invoke Article 50 – the mechanism for leaving the EU – till the end of the year. Allowing time for a 2-3 year negotiation and then an implementation period, the UK is unlikely to formally leave the EU until the early 2020s, and during the process, it will continue to act as an EU member and enjoy all its benefits. Whatever the outcome of the EU/UK negotiations, it is in the interest of both sides to maintain a close economic relationship based on open market access. However, there are likely to be more difficult discussions surrounding the movement of people and immigration controls. In the short-run, there will be turmoil in UK's financial markets, with the pound facing greater pressure for depreciation. Chinese companies are advised to draft their contingency plans to cope with the changed situation.

In the long term, the UK's economic fundamentals such as a sound legal system, vibrant financial markets, diverse talent pool, ease of doing business, competitive tax rate, leading universities and lively entrepreneurship and innovation ecosystems remain intact. These are powerful drivers to lead the UK back onto a sustainable track of growth. Visionary Chinese investors such as China International Marine Containers (Group) Co., Ltd., Wanda Group and Leyou Technologies Holding Limited are already cashing in on the favourable exchange rate: they recently announced their latest investment deals in the UK. The pound has fallen from over 15 Yuan before the referendum to 8.5-9 Yuan now. So this gives Chinese investors a good chance to rethink about their UK investment strategies.

Authors:

Allan Zhang

Chief Economist

PwC China

+86 10 6533 7280

allan.zhang@cn.pwc.com

G. Bin Zhao

Senior Economist

PwC China

+86 21 2323 3681

bin.gb.zhao@cn.pwc.com

Marketing and Communications:

Cynara Tan

Head of Marketing and Communications

Asia Pacific

+852 2289 8715

cynara.sl.tan@hk.pwc.com

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