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MEET THE NEW REFORMS, SAME AS THE OLD REFORMS? CHINA'S LATEST "DECISION TO COMPREHENSIVELY DEEPEN REFORMS" AND THE OUTLOOK FOR 2014

SUMMARY

- China's President Xi Jinping and Premier Li Keqiang, who assumed their current roles in mid-2013, have used recent high-level Communist party meetings to set expectations for economic policy during their administration, which will likely run through 2020.
- On its face, their agenda of pro-market economic reforms could be transformational if implemented to the letter.
- But since their agenda is in many ways the same one the Communist Party has ostensibly been advancing since before Xi and Li assumed power, reality seems likely to fall short of promises, as is typical in Chinese (or, as in all) politics.
- The most concrete economic consequences of the Xi-Li agenda so far have been higher interest rates, combined with a push to cut bureaucratic red tape and encourage private investment. This policy mix could slow investment by state-controlled companies and encourage faster investment by private companies in 2014.
- Over the next ten years, the Chinese economy will likely change as substantially as it did in the past ten. But external economic and popular pressures will likely influence the scope and pace of reform as much as official state plans do.

A new team leading the Chinese government and Communist Party is adding new uncertainties to the economic and political outlook for the year ahead. President Xi Jinping and Prime Minister Li Keqiang, inaugurated last March, used the "Third Plenary" meeting in mid-November to announce a sweeping platform of policy goals to be achieved by 2020, roughly coinciding with the likely end of their administration. The annual Central Economic Working Group meeting underway in mid-December is expected to clarify which of the Plenum's proposed reforms will take effect in 2014. The Plenum's decisions, announced in a sprawling, 30-page document, likely overstate how much China's government expects the country to change: they promise "comprehensive" reforms to allow a "decisive" role for the market in the economy – and come from a government that has rarely followed through entirely on past promises to reform. On balance, though, China now seems to be cautiously moving toward a more open and market-oriented economy after the post-crisis years, in which maintaining growth was a higher priority than economic reform.

President Xi and Premier Li's policy platform as described in the Plenum policy paper stakes out positions on everything from economic and fiscal policy to government officials' performance targets to education to national defense. In the area of economic policy, they commit to complete by 2020 many of the long-term goals that the Chinese government has ostensibly been working toward for many years: a market-determined exchange rate, permitting more privately-owned banks, a deposit insurance program, removal of bureaucratic obstacles to investments by Chinese companies, opening a variety of service sector industries to foreign investment, and so on. Chinese state media emphasized that the Plenum affirmed the "decisive" role of market forces in allocating the economy's resources, meaning the market should play a larger role than the government in allocating capital, land, energy, and labor; the market used to play a "basic" role.

Rhetoric aside, some incremental economic reforms are already visible after the November Plenum. The interest rate on the benchmark 10 year government bond rose from an average of 4.0 percent in August to above 4.5 percent, the first time at that level since August 2008, following Premier Li Keqiang's widely publicized plenum speech on economic policy. Premier Li's speech advocated boosting growth by cutting bureaucratic red tape and allowing privately-owned businesses a freer role in the economy, instead of by using fiscal or monetary stimulus to goose growth. The Plenum also loosened



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China's One-Child policy, encouraging modestly higher birthrates in coming years, although changing the immediate economic outlook little. And, negatively for nearterm growth prospects, the plenum seems to have given the Chinese military a green light to more aggressively contest China's claims to the Senkaku/Diaoyu islands, which are also claimed by Japan and Taiwan, potentially chilling trade relations with China's Northeast Asian neighbors.

A more detailed version of the Xi-Li administration's plans for China in 2014 will likely be released following the mid-December annual Central Economic Work Conference, which sets priorities like the annual real GDP growth target. Most likely, they will signal more gradual, cautious steps to shift Chinese economic growth to focus more on domestic consumers and private investment, and less on exports or government-directed investment. When thinking about the magnitude of change likely from China's government, consider that its new leaders are (obviously) members of the same Communist party as the leaders they replaced they share similar goals and views, which is why they were chosen to lead the country in the first place. Their pledge to reform likely holds a double-meaning: "Reform" in China can mean that policy should change, or it can be an endorsement of business as usual in a country where the official economic policy is called "reform and opening." And even if Xi and Li would like to transform the economy, substantive policy change in China usually waits until a political administration is firmly established – and past Chinese leadership transitions have usually been followed by a year or two in which the new administration consolidates control. In short, there seems little reason to expect the Xi-Li government to push a "big bang" economic transformation.

If more fundamental reform is possible, it would be so because an external shock could convince the more conservative members of the Chinese leadership that inaction is becoming riskier than action. The largest transformations of China's economy, politics, and institutions since the country began a transition to a market economy in 1978 have typically been triggered by such a confluence of leadership, opportunity and crisis. The momentous economic reforms of the late 1990s and early 2000s, for example – when state-owned enterprises and the real estate industry were privatized, lifetime employment ended, and China joined the World Trade Organization – were the Chinese leadership's attempt to prevent the Asian Financial Crisis from spreading to China and undermining their regime as it had undermined, for example, the

authoritarian government of Indonesia. China's leadership today could be ready to capitalize on a potential crisis to accelerate reform. Current Premier Li Keqiang, with his arguments for a more entrepreneurial, more privately-oriented economy, seems to be emulating the style of ex-Premier Zhu Rongji, who ushered through the pro-market economic reforms of the late 1990s and early 2000s.

If China's leadership is looking for an outside crisis to justify reform, the next few years could offer ample opportunity. Historically, the crises triggering fundamental economic reforms in China have been linked to bad loans, chronically unprofitable companies or sectors, or foreign economic turmoil. The next few years could see all three. Chinese state-owned banks are expected to recognize more nonperforming loans originated during the 2009-2011 credit boom as interest rates rise. The official news agency Xinhua reports that industrial capacity utilization among manufacturers of steel, cement, aluminum, plate glass, and shipbuilders is quite low, as is, presumably, profitability. And rising long-term U.S. interest rates in 2014 and 2015 could trigger sudden capital outflows from emerging markets like China, echoing past periods when rising U.S. risk-free interest rates triggered financial turbulence in emerging markets.

In addition, China's increasingly pervasive social media have made popular sentiment an unpredictable catalyst for reforms, including of economic policy. The announcement of the Plenum's decisions ironically demonstrates public opinion's growing influence on the Chinese government's day to day conduct. The government mouthpiece Xinhua only released the full 30-page Plenum "Decision" after a barrage of scorn from Chinese online commentators, who panned the news agency's initial public communiqué as a vague mash-up of Communist boiler-plate. In the years ahead, the scope and pace of reforms in China will likely be determined similarly – as much by external economic crisis and internal popular pressure as by the state's plans and priorities.

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