



# China's Economic Outlook and Reform Priorities

Alfred Schipke  
Senior Resident Representative  
April 3, 2014

## Roadmap

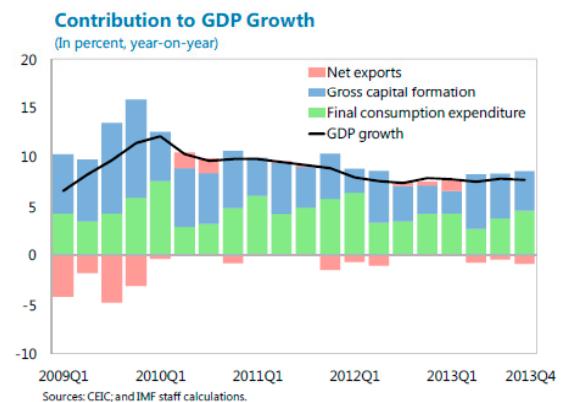
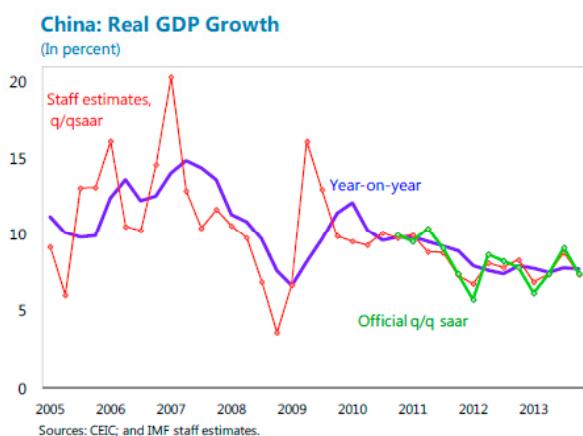
- Short term outlook
- Medium-term challenges
  - Growth model and investment
  - Local government debt
  - Real estate
  - Credit and shadow banking
- Reforms
  - Key objectives
  - Exchange rate band
- RMB Internationalization
- Takeaways

# Short-term outlook and risk

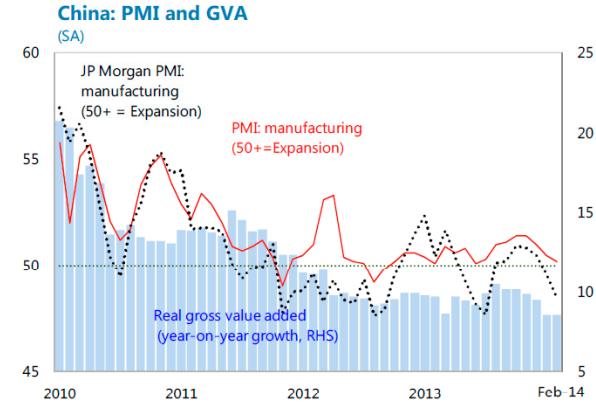
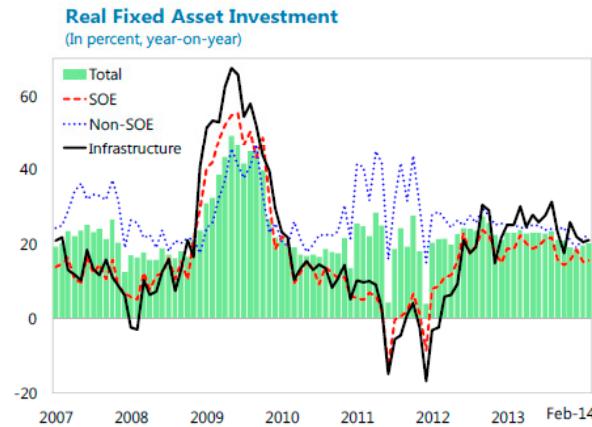
## Strong growth and 2013 outturn as expected

China has enjoyed rapid economic growth and 2013 outturn as expected...

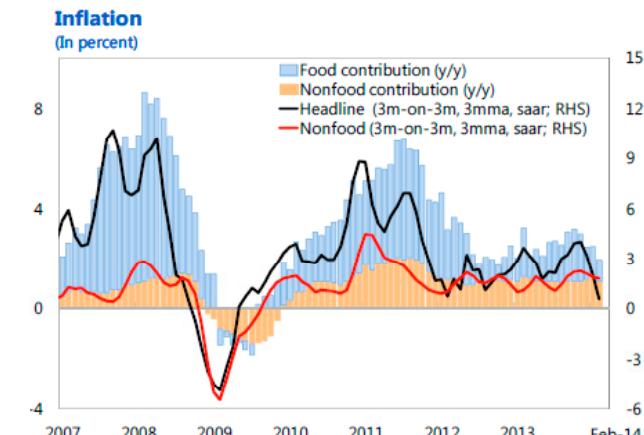
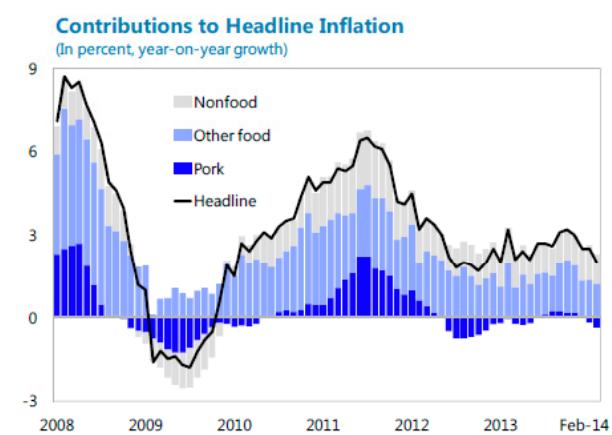
...investment remains a major driver of growth.



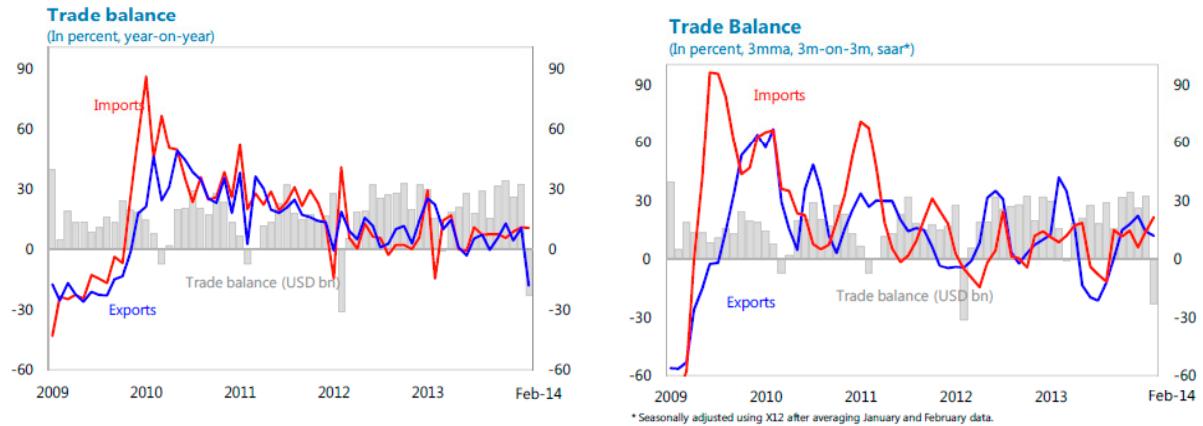
# Signs growth might be slowing



# Inflation bengin

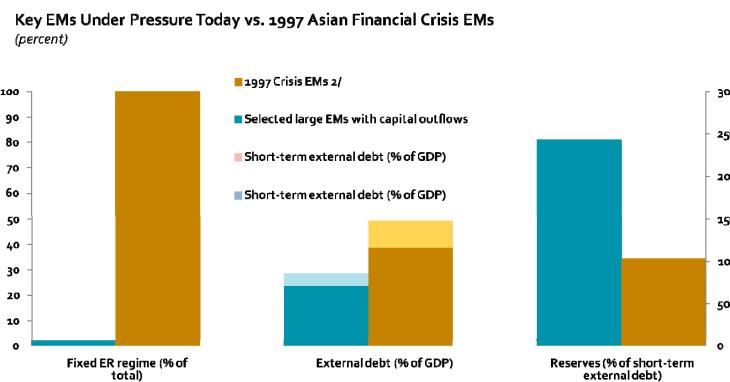


# Recent sharp drop in exports but more benign



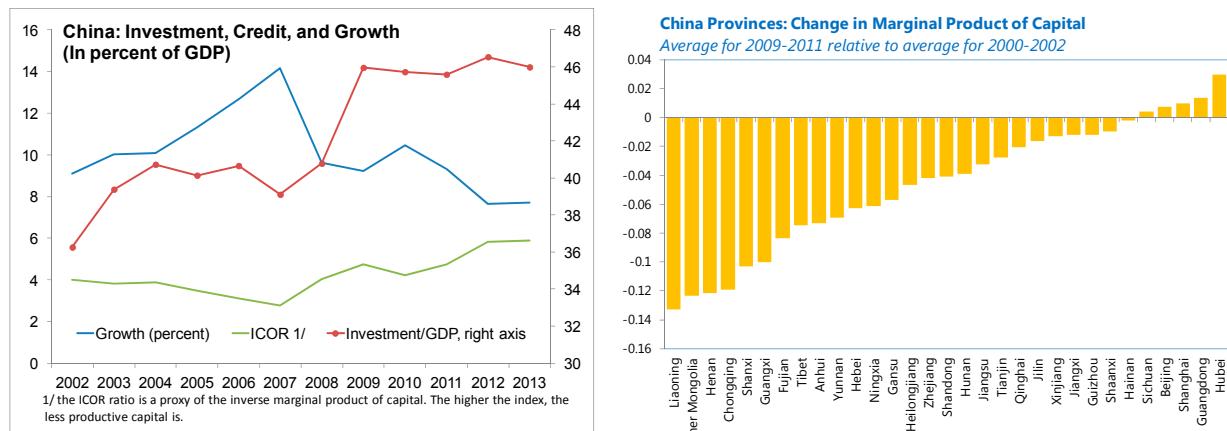
## Short-term risk: impact of tapering limited

- Fed's communication strategy paramount
- Little direct impact as a result of tighter external financial conditions, unless significant funding pressure of vulnerable emerging markets
- EM in better positions than in 1997

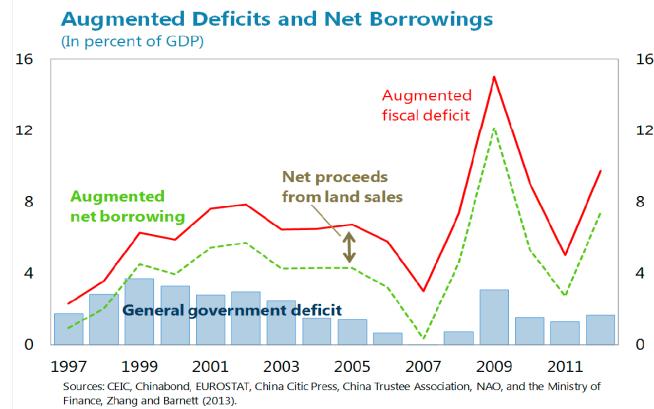
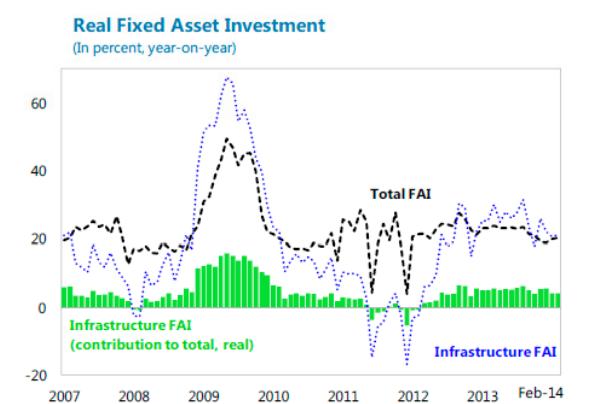


# Medium-term challenges

## Signs of diminishing returns

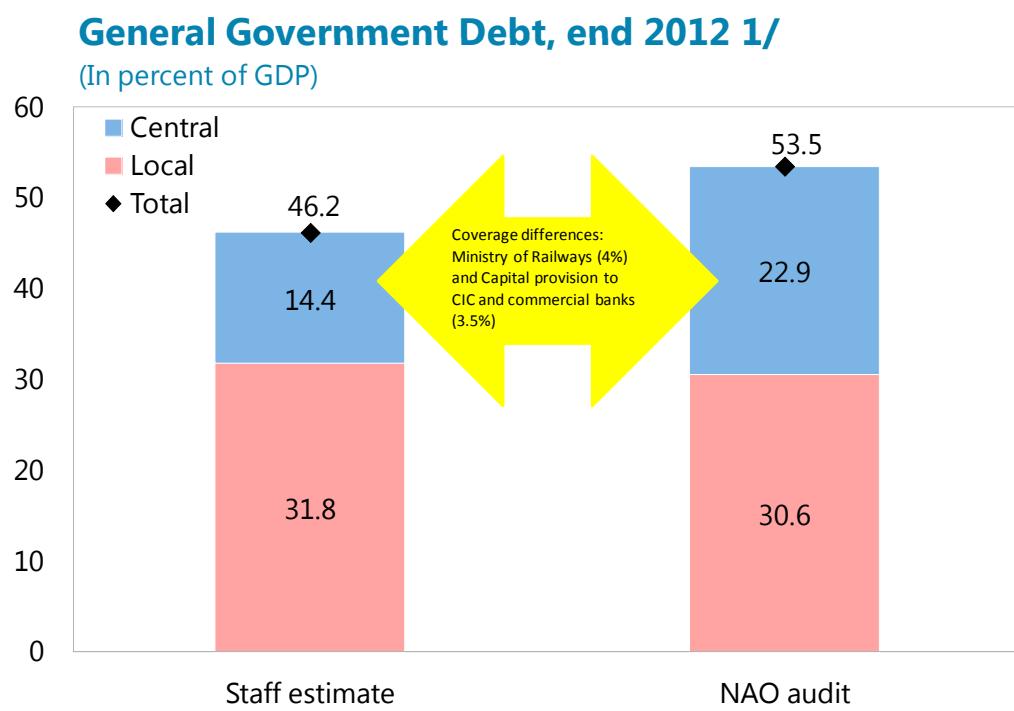


# Investment supports growth...via off budget fiscal spending



# Vulnerability I—Local government debt

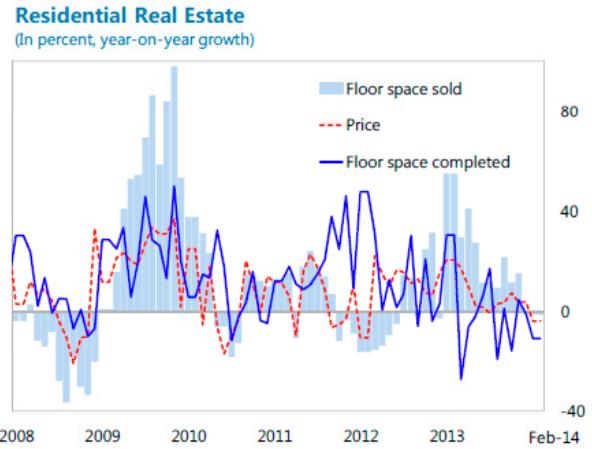
Audit Results basically the same as staff estimate



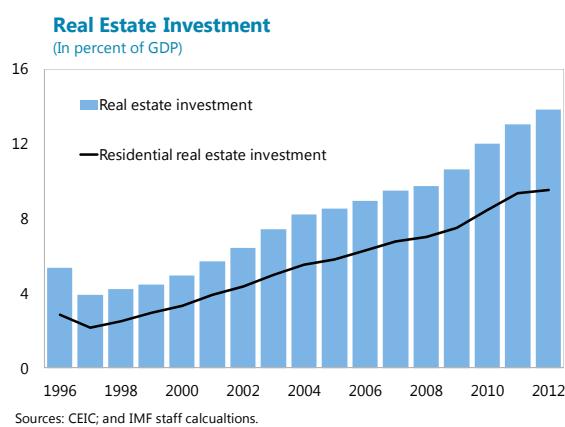
Sources: National Audit Reports; and IMF staff calculations.

1/ Includes both explicit and contingent liabilities.

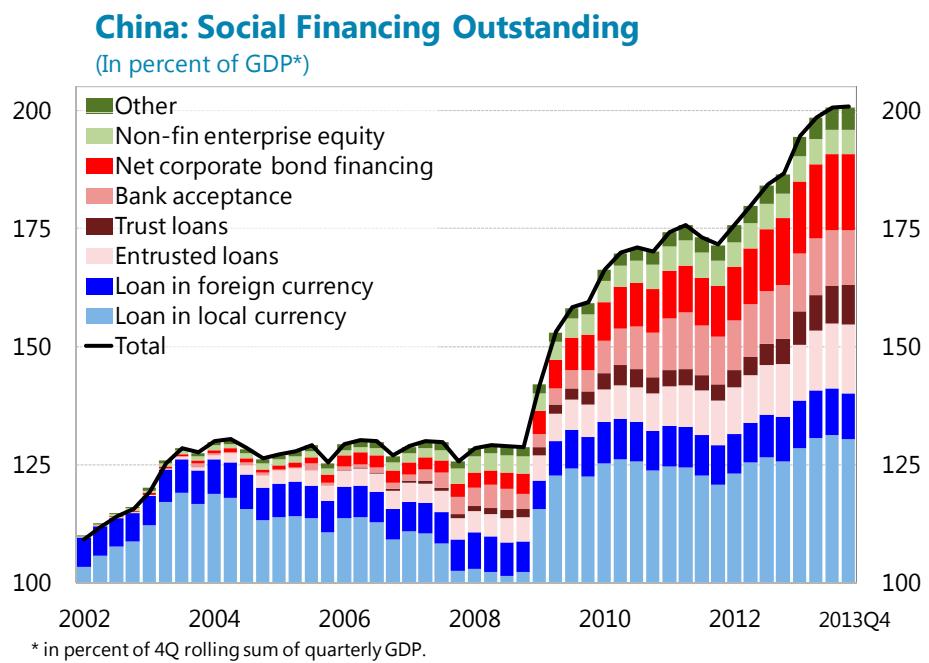
# Vulnerability II: real estate sector



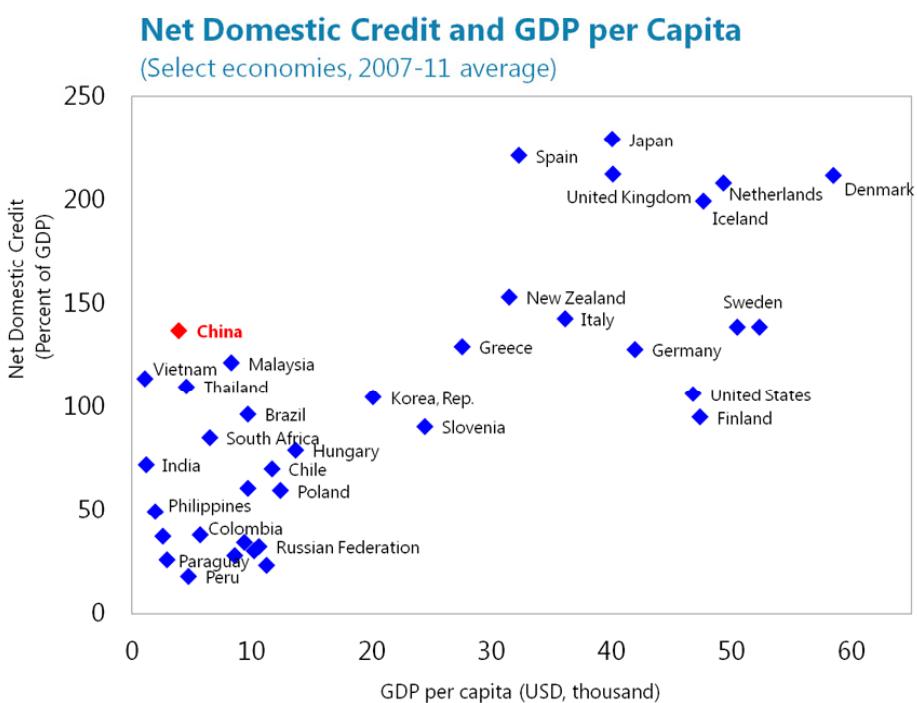
# Vulnerability II: Real estate as growth engine



## Vulnerability III: Large stock of social financing



# Vulnerability III...and credit relatively high



# Increase in shadow banking can pose risks

- As in other countries, China's non-bank/shadow banking system covers a multiple of products/institutions and instruments, including money market funds, insurance companies, pensions funds, etc.
- More specific to China: wealth management products (WMP), trust companies, and entrusted loans
- Also, more recently a new but rapidly growing sector is emerging that is related to online banking, payment systems, and money market funds that are worthwhile monitoring

# Change in growth model

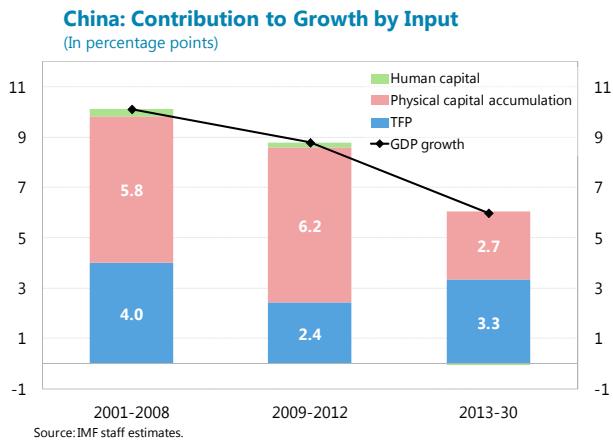
Financial sector      Fiscal      Social safety net      Resource pricing      Service sector



Consumer-based, inclusive, and environment-friendly

# More sustainable growth

Rely less on capital accumulation and more on TFP to generate slower yet...



## Reforms

# Government's key reform objectives

- 3<sup>rd</sup> Party Plenum (Nov. 2013) and National Party Congress (Mar. 2014)
- Comprehensive diagnostic of challenges
- Broad reform objectives:
  - Further economic opening (trade & services)
  - Relaxation of administrative controls and increased reliance on market
  - Improvements in transparency/reduction in waste and corruption
  - Rationalization of SOEs (including exist)
  - Strengthening of the private sector
- Implementation of reforms would facilitate transformation of economy, more efficient allocation of resources, and expansion of services

## NPC and economic targets for 2014

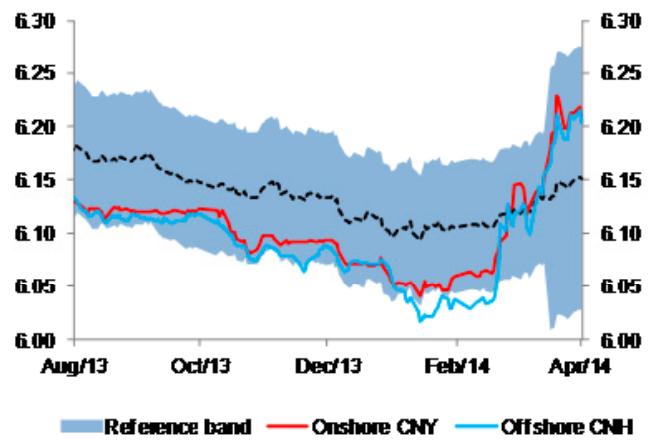
- Growth around 7.5 percent
- Deposit insurance and bank resolution frameworks (2014)
- Interest rate liberalization (1-2 years)
- Establishment of private banks (2014)—first banks in Shanghai, Tianjin, Guangdong, Zhejiang

Table 1. Key Economic Targets (2013-4)

	2014 Target	2013 Target	Actual
(annual percent change, unless otherwise indicated)			
Growth	7.5	7.5	7.7
Fixed asset investment	17.5	18.0	19.3
Retail sales	14.5	14.5	13.1
Inflation	3.5	3.5	2.6
M2	13.0	13.0	13.6
Budget deficit ( in trillions of RMB)	1.4	1.2	1.2
Trade	7.5	8.0	7.6
Urban unemployment rate (in percent)	<4.6	<4.6	4.1
New urban jobs (in millions)	10.0	9.0	13.1

# NPC and exchange rate band

- In line with NPC announcement, exchange rate band was widened on March 17 (from 1 to 2 percent)
- Further increase in flexibility, reflects China's commitment to rebalance its economy and allow market forces to play a larger role in determining the exchange rate



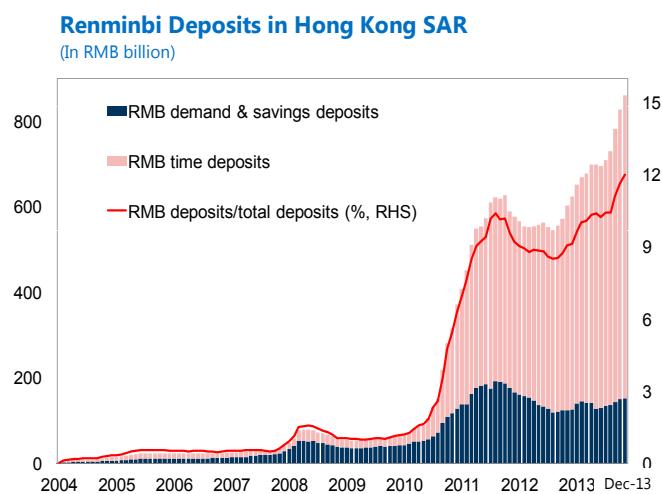
## RMB Internationalization

# Different dimensions of RMB internationalization

- Medium of exchange
  - Foreign exchange transactions associated with cross-border trade in goods, services, and financial instruments (currency, bonds, equity, etc.)
    - Official foreign exchange intervention
- Store of value
  - Savings/investments vehicles used by private companies and households (banks and capital markets)
  - Reserve currency
- Unit of account
  - Global pricing
  - **SDR (IMF)**
  - Pegging of currencies

## Uneven RMB internationalization

- By end-2013, the RMB has become the second most used trade settlement currency after the US dollar
- Recent MOU's with European Central Banks for clearing banks in Frankfurt (BuBank) and London (BOE)
- Hong Kong deposits have surged, but still only 1 percent of mainland deposits
- 25 swap lines (most recent ECB, 2013)



# Takeaways

- Implementation of reform agenda paramount
- 2014 growth outlook a bit weaker than in 2013, but consistent with reforms
- Short-term risks manageable, given China's buffers (solvency and liquidity)
- Risk of a further buildup of imbalances in the medium, if:
  - Reforms are delayed or too much investment to arrest slowdown
  - Continued strong credit growth
  - Further buildup of public sector debt (especially at the local level)
  - A significant slowdown/decline in real estate prices could pose risks
- Financial sector challenges:
  - Distortions in the financial system (deposit rate ceiling, loan-to-deposit ratios, credit rationing) foster "shadow banking" and unregulated financial innovations and call for financial sector liberalization
  - Most recent example internet banking
  - Lack of hard budget constraints and default risk combined with high official growth fosters strong credit demand and shadow banking
  - Financial sector liberalization needs to go hand-in-hand with a constant upgrading of regulation and supervision