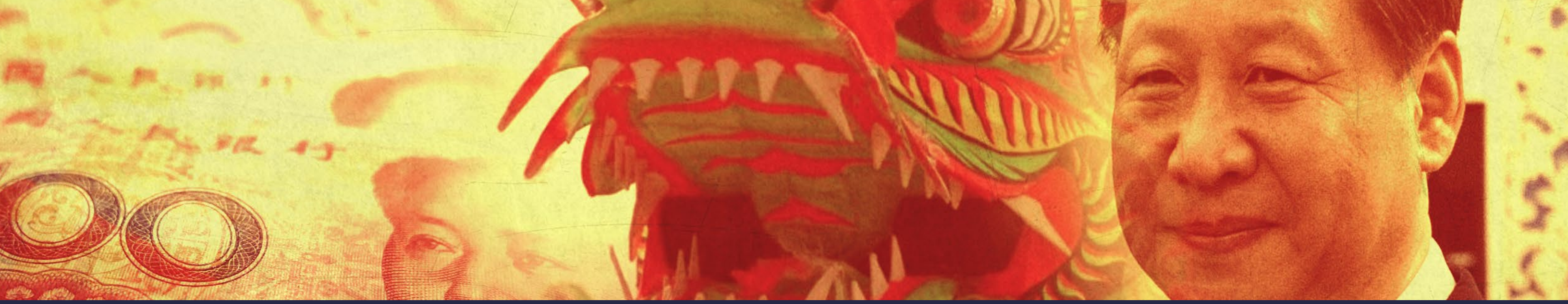
FEEDING THE DRAGON:

How will Beijing Stimulate its Slowing Economy?

A Wikistrat Crowdsourced Simulation

September 2015



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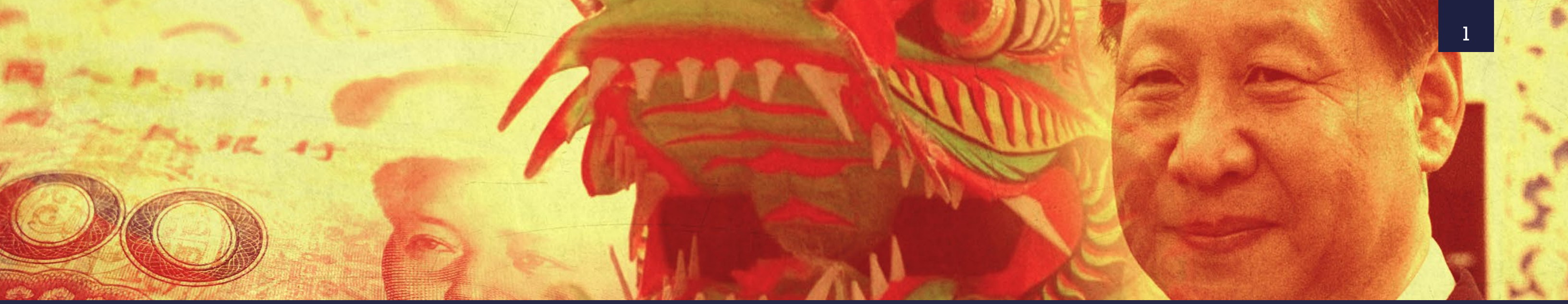


EXECUTIVE SUMMARY

CHINA'S ECONOMY

- **China's 2015 GDP growth will likely fall to around 6.8 percent**, down from 2014's 7.4 percent and below the government's target of 7 percent.
- **China's 2016 GDP growth rate will fall to 6.4 percent**, and continue a downward trajectory in 2017 and 2018.[1]
- **China's most apparent economic issue is its rapidly ballooning debt,** but they have the resources and buffers to manage this and do not appear to be at a tipping point in terms of debt accumulation or debt service.
- **China's biggest vulnerability will come from a substantial and uncontrolled correction in the real estate sector**, which is harder for the government to control and has far reaching political, economic and social implications.
- **China will make progress on structural reforms** in the monetary and financial sectors, improving management of government finances. Less progress will be seen in cleaning up state-owned enterprises (SOEs), making meaningful headway on anti-corruption efforts or reining in the shadow-banking sector.
- **China's ability to deal with its economy is becoming increasingly inefficient and constrained.** This is a substantial longer-term problem.

CHINA'S OPTIONS

- **Expect to see moderately paced devaluation of the yuan until it reaches its 2008 average of $1 = 7.6 yuan by mid-2016.**
- **Expect the People's Bank of China (PBOC) to maintain an expansionary monetary policy to offset inflation.** Expect further reserve requirement ratio (RRR) and interest rate cuts and new, targeted tools to provide liquidity to targeted sectors and smooth volatile capital flows.
- **Expect China to expend 2-3 trillion yuan in fiscal stimulus in the next 12 months,** delivered using targeted measures to avoid repeating the mistakes of the post-2008 stimulus package.

[1] Goldman-Sachs outlook – August 30, 2015.

- **Expect China to increase investments and consumption in the military sector** to promote short-term domestic growth, despite shrinking its active duty military force.

- **Expect President Xi Jinping's anti-corruption campaign to increase in size and scope.**

- **Expect an increase in the minimum wage before the March 2016 National People's Congress.**

- **Expect moves by Beijing and the provinces to manage labor and social unrest at the state and provincial level,** but no dismantling of the *hukou* system.

- **Expect China to expand the number of Free Trade Zones (FTZs) and conclude Bilateral Investment Treaties (BITs) with the United States and the European Union.**

THE BOTTOM LINE

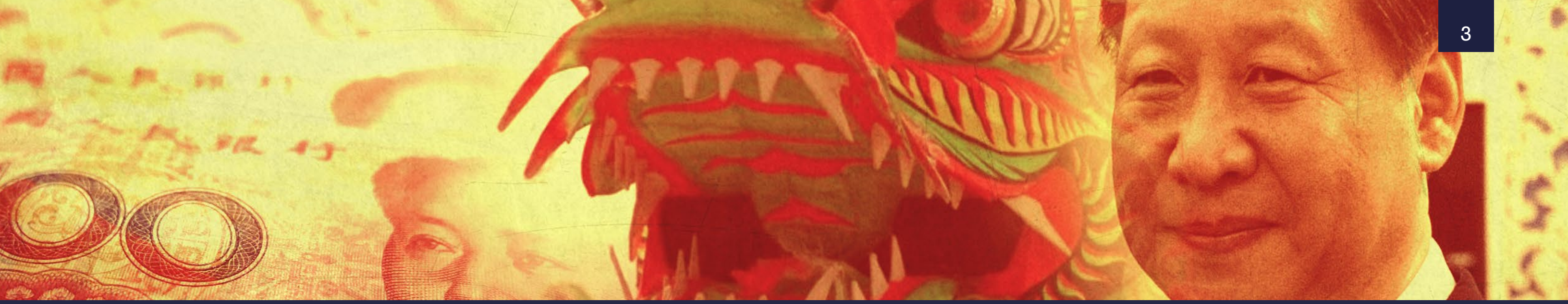
- **China will continue its march toward fundamental economic reform,** managing the complex transition from export-led growth towards domestic consumption. Its economy will decelerate, but radical or catastrophic change is unlikely.

- **Expect volatility and softening prices in key commodities that China imports,** particularly those that support manufacturing, including iron ore, coal, copper and other base metals. This will have ripple effects on major exporters of these commodities, including Australia, Brazil, Chile, Nigeria, Peru, South Africa, Sudan and Zambia, although some price softening will be offset by efforts to decrease supply.

- **A slowing import-export trade will, over time, hit related service industries such as shipping,** but this will be gradual and some of the impact will be offset by China's massive international construction initiatives.

- **Decreasing demand in construction and construction-related industries will impact exporters of heavy machinery, concrete and similar products.**

- **China will remain a robust end market for technology, entertainment and services** to feed healthy domestic demand, with the notable exception of luxury goods which are likely to stay depressed.



INTRODUCTION

After decades during which the Chinese economy grew by an average of ten percent or more per year, it seems the unwritten laws of economic gravity have finally caught up with Asia's "Red Dragon." According to the International Monetary Fund (IMF), China's economy grew by 7.4 percent in 2014. In 2015 and 2016, the IMF is predicting growth rates slowing to 6.8 percent and 6.4 percent, respectively, falling short of China's own expectations.

China's leaders must balance an increasingly complex set of political, economic and social factors to maintain stability in the face of a slowing economy, increasing social tension and international pressure to step up to its role as an economic superpower. In this respect, China may be managing one of the most complex economic maneuvers in modern history.

The global economy has a huge stake in China's successful adjustment, and the slowing economy and growing social tension are increasingly worrisome for investors inside and outside China. This simulation focuses on understanding the challenges facing the Chinese economy and Beijing's options for the immediate future.

SIMULATION DESIGN

In August 2015, more than 50 analysts participated in an analytic effort designed to explore (1) the scope and magnitude of the current economic slowdown in China; (2) what actions the Chinese government is likely to take in order to stimulate its economy; and (3) the impacts these actions are likely to have on business. The simulation focused on mapping the most urgent economic problems China is facing, identifying potential actions by the Chinese government to combat these issues, and exploring the possible implications these actions would have on China's economy and various industries in the coming year.

Phase I: Mapping China's Economic Problems

In the first phase, analysts developed 38 scenarios exploring a wide range of structural and other issues facing China and the future political, economic and social implications of these issues.

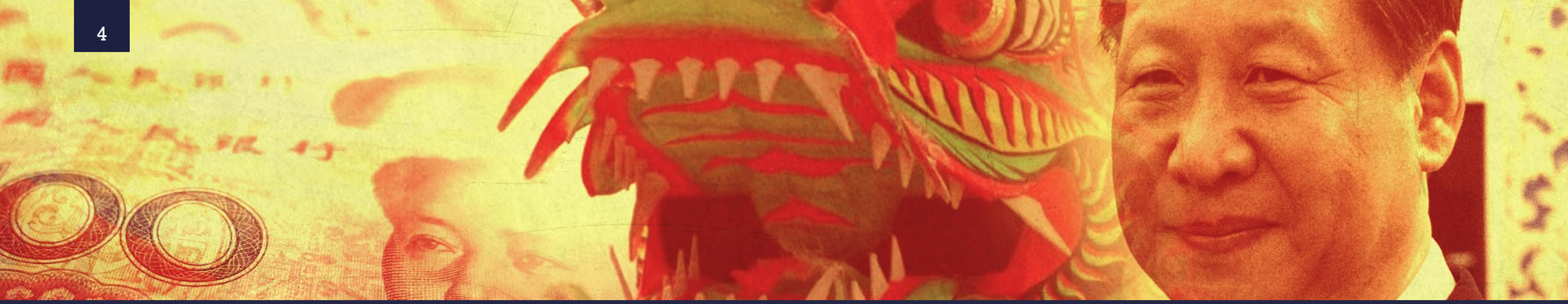
Phase II: Exploring China's Actions

In the second phase, analysts generated 35 scenarios exploring various political, economic and social actions the Chinese government is likely to take in order to stimulate its economy over the next 12 months. In addition to looking at the possible pathways the Chinese government could take to address various issues, analysts were asked to describe the signposts that would indicate this course of action is indeed likely to take place.

During this second phase, analysts were also asked to rank each of the 38 Phase I scenarios on a scale of 1 to 5 (low to high) for (a) the likelihood that the scenario would prompt the Chinese government to take action and (b) the scope and magnitude of the scenario's implications for the Chinese economy.

Phase III: Impacts of China's Actions

In the third phase, analysts were asked to describe the impacts the 35 Phase II scenarios would have on China's economy and international trade and identify the likely winners, resulting in 25 separate impact assessments.



STORM CLOUDS ON THE HORIZON, BUT TOO EARLY TO FORECAST RAIN

In the coming year, China must continue to balance an increasingly complex economic and political situation to maintain stability in the face of a slowing economy, increasing social tension and international pressures to step up to its role as an economic superpower.

- China's GDP growth in 2015 is expected to fall to around 6.8 percent, down from 2014's 7.4 percent and below the government's 2015 target of 7.0 percent. More recent forecasts indicate that China's 2016 GDP growth rate may fall even further to 6.4 percent, and continue the downward trajectory in 2017 and 2018.[2]

- China's most apparent economic issue is its rapidly ballooning debt. However, China has formidable resources and buffers to manage these issues and does not appear to be at a tipping point in terms of debt accumulation or debt service.

- China's biggest vulnerability would come from a substantial and uncontrolled correction in the real estate sector, which is harder for the government to control and has far-reaching political, economic and social implications.

- China will continue to make progress on structural reforms in the monetary and financial sectors and on improving the management of government finances. Less progress will be seen in cleaning up state-owned enterprises (SOEs), making meaningful headway on anti-corruption efforts, or reigning in the shadow-banking sector.

Over the next 12 months, policy uncertainty will increase significantly as the Chinese leadership moves more dynamically to manage the consequences of economic adjustments. This will increase short-term market volatility, particularly in equities. Over a much longer period, China's ability to deal unilaterally with its economic issues will be increasingly **inefficient** and **constrained** as its importance to and connectivity with global markets becomes more and more apparent.

THE DEBT PROBLEM

Since 2008, China's total debt has quadrupled, from $7 trillion in 2007 to $28 trillion by mid-2014.[3] At 282 percent of GDP, China's debt as a share of its overall economy is larger than that of the U.S. or Germany. Nearly half of these debts are linked to China's ballooning real estate markets, more than a third related to shadow banking and a significant portion associated with off-balance sheet local government financing vehicles (LGFVs). Household debt, a significant concern in many developed economies, is relatively low in China.

While China has relatively low levels of public debt (56 percent of GDP, compared to the U.S. at 103 percent of GDP),[4] it has been quickly accumulating debt in both the public and private sectors to stimulate the economy and maintain its arguably unrealistic economic targets.

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[2] Goldman-Sachs outlook – August 30, 2015.

[3] McKinsey Global Institute

[4] http://www.tradingeconomics.com/country-list/government-debt-to-gdp

Credit booms are a significant risk indicator.[5] Nevertheless, **China does not appear to be at a tipping point in terms of debt accumulation or debt service.** Furthermore, credit growth, particularly in the shadow-banking sector, appears to be slowing. However, the medium term debt situation is troubling:

1. Overall credit levels are rising to excessive levels, nonperforming loan levels are increasing, and the economic slowdown is generating more problems with credit quality, particularly in China's large SOE sector, which accounts for the bulk of corporate liabilities;

2. Private and corporate debt is reaching levels where it becomes a drag on the economy;[6]

3. Local governments are finding it impossible to sustain operations without continuing to accumulate additional debt and using it inefficiently; and

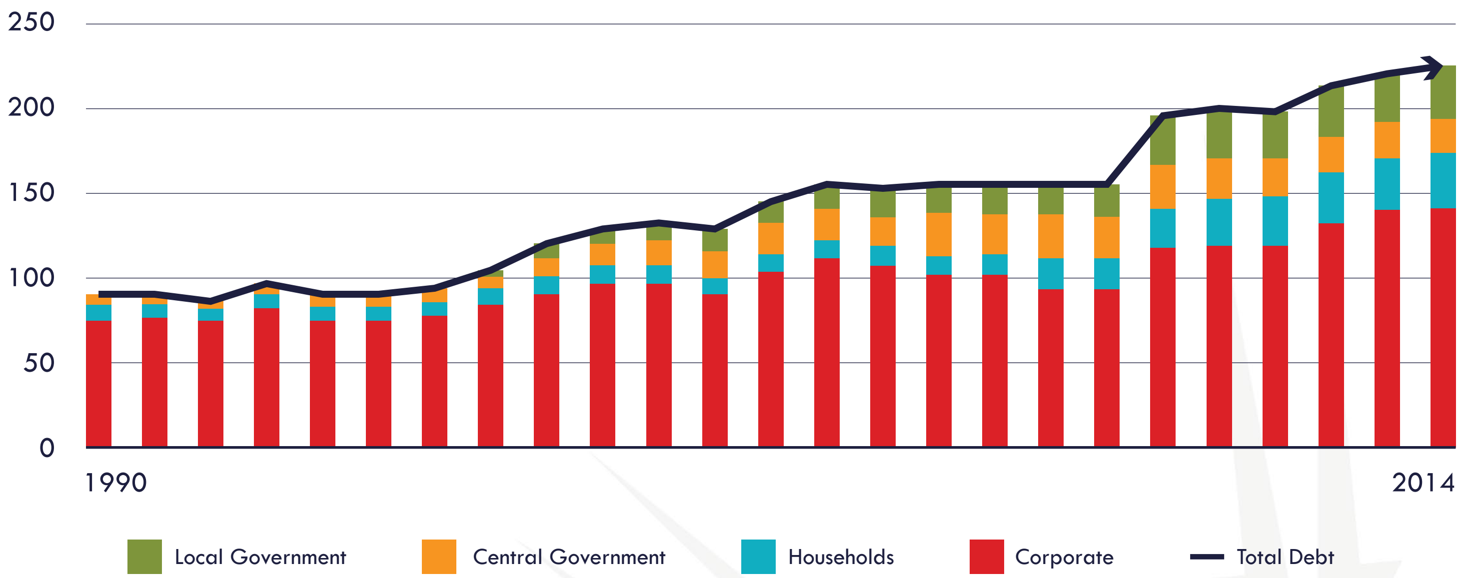
4. Government and shadow-banking information inadequacies are making accurate measurement difficult.

"No issue is more important than managing the debt..."

The analyst crowd clearly believes that there is no issue more likely to be a problem or have greater magnitude than the issue of China's debt. Of 38 urgent economic problems identified during the simulation, managing the debt placed first in a vote by analysts, 13 percent higher than the next highest entry (weakening consumer demand).

TOTAL DEBT AND DEBT BREAKDOWN BY SECTOR

(In percent of GDP)



Source: *www.scmp.com*

[5] In 2014, the IMF looked at credit growth in 43 countries over 50 years and only found four that experienced credit growth comparable to China's recent advance. All four had a banking crisis in the three years following the credit boom. *IMF Country Report No. 14/235 – People's Republic of China*, July 2014.

[6] http://blogs.wsj.com/economics/

Corporate Debt

China's corporate debt is currently estimated to be $16.1 trillion and is expected to grow 77 percent to $28.8 trillion over the next five years, according to Standard & Poor.[7] In terms of debt load, the IMF estimates that China's corporate debt is expected to grow from 160 to 250 percent of GDP by 2020.[8] Much of China's corporate debt is associated with real estate and related industries.[9]

> **"Zombie" Firms**
>
> As the economy slows, there is increasing concern about high debt burdens turning SOEs and other poorly performing Chinese companies into "zombie companies" needing constant bailouts to continue operation, increasing drag on government resources and the economy.

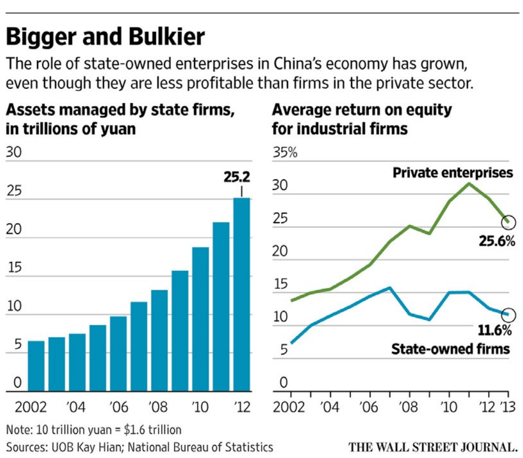
Reliable data on the totality of corporate debt in China is generally not available, but the IMF found that the total debt of listed firms increased by 10 percent of GDP between 2007 and 2014, with about half attributable to real estate and construction. Within this group, **corporate real estate debt appears to be concentrated around a small number of highly leveraged firms** (80 percent of total liabilities in listed real estate and construction firms are held by 60 firms with liabilities more than three times their equity).[10]

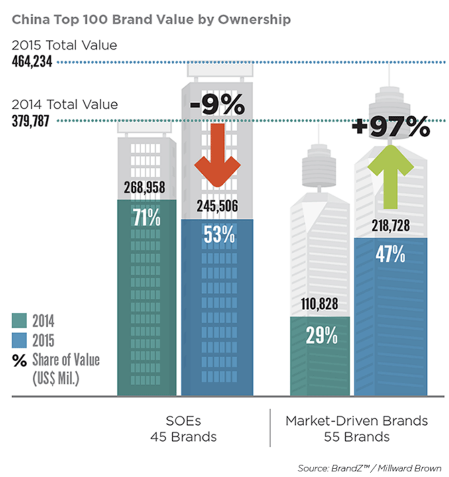
China's corporate debt situation is further complicated by the heavy borrowing of SOEs, who have political clout, are important employers and are widely perceived to enjoy implicit state guarantees. They also underperform the private sector and in many cases may be declining in value.

Over the next 12 months, the Chinese government will continue to work on reforming SOEs, emphasizing:

- No privatization, but requiring higher proportions of private capital;
- Restructuring into holding companies (the Singaporean Temasek-holding is often named as a model); and
- Pressing for mergers between SOEs.

These will only be modestly successful at best.





Source: *www.millwardbrown.com*

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[7] http://ww2.cfo.com/credit/2015/07/china-corporate-debt-growth-seen-high-risk/

[8] http://www.zerohedge.com/news/2015-08-15/chinas-debt-load-hit-250-gdp-5-years-imf-says

[9] *IMF Country Report No. 14/235 – People's Republic of China*, July 2014.

[10] *Ibid.*

Debt, Real Estate and Local Government Finances

Much of China's economic growth and debt in the last decade have been driven by real estate. And much of this debt has been attributable to local governments engaging in a variety of transactions to sell off land and use the proceeds to fund infrastructure development, many of which were notoriously inefficient. As these land deals became an increasingly important source of local revenues (46 percent of local revenues in 2013), local governments began relying on shell companies, LGFVs and shadow banking to keep the revenues flowing.

Overall debt is growing, but the rate of growth is shrinking

The IMF found the pace of Total Social Financing (TSF) growth in China has decelerated considerably, from a peak of 34.4 percent at the end of 2009 to 12.4 percent in May 2015. The flow of credit contracted 19 percent in the first half of 2015.

With the economy cooling and real land sales turning downward, China's regional authorities increased their debt by 34 percent in the past 18 month alone, according to the official record.[11] Beijing, mindful of this problem, is pressing forward with its debt-for-bond swap program as an alternative to LGFVs. On August 27, 2015, Beijing announced it would expand this program to 3.2 trillion yuan (US $499.7 billion) and as of August 29, 2015, announced it would cap local and provincial debt, limiting local governments to 600 billion yuan in additional borrowing in 2015.

The impact of this strategy is unclear. The total volume of these loans is unknown and in the hands of the politically influential shadow banking sector. China's cities and local governments lack a stable method of annual financing. Debt service is closely tied to the maintenance of value in an already overextended property sector vulnerable to losses in other sectors of the economy.

Eventually, China will need a new financial structure, such as annual property taxes yielding predictable revenue streams, to stabilize its local government finances. Development of such a system, which would have major implications for political control in China, may develop – but not for several more years.

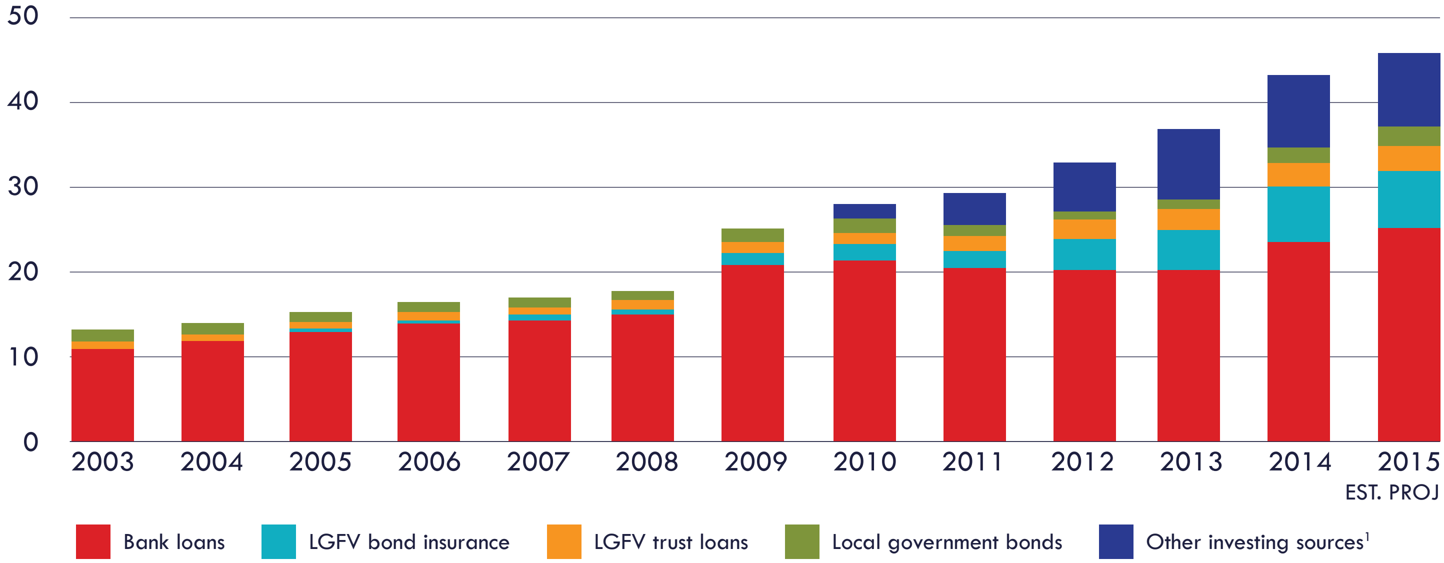
DR. BRUCE GOCKERMAN

Senior Analyst at Wikistrat and a Professor at Sturat School of Business

"China's cities are without a stable method of annual financing. Budgeting in a meaningful way is nonexistent. Much of the real estate bubble in China occurs when the sale of real estate by cities is the only way of raising funds for municipal budgets. This is fueled by the developers of the real estate with bank loans directed from the national government. These loans are non-performing."

[11] http://www.bloomberg.com/apps/news?pid=munievents&sid=aAGKss1D.8rQ

FINANCING SOURCES OF LOCAL GOVERNMENT AND LGFV DEBT
(In percent of GDP)



[1] Other financing sources include Build to Transfer, account receivables and accruals as outlined in NAO report (2013).

Source: *IMF*

Shadow Banking

The widespread practice of shadow banking in China makes it difficult to estimate the extent of Chinese debt and its impact on the economy. A loose market for credit, operating outside fully regulated banking channels, is inherently risky.

Bloomberg estimates the shadow-banking sector in China to exceed $6 trillion, or 69 percent of the economy. Shadow banking loans in China in the first half of 2014 alone totaled as much as $2 trillion, an increase of 24 percent over 2013.[12] These loans typically have higher short-term interest rates, are not guaranteed and are more highly leveraged than traditional bank credit instruments.

Chinese authorities are not totally in control of the shadow-banking sector. When central authorities tried to cool the white-hot property market by requiring banks to impose more stringent conditions on borrowers, funds increasingly flowed outside the official banking system.

Just How Bad is China's Shadow Banking Sector?

In 2013, the Brookings Institution estimated China's shadow banking sector at 25 trillion RMB, or about 43 percent of GDP. On the same basis, the U.S. shadow-banking sector stood at 120 percent of GDP. Shadow-banking only accounted for 18 percent of China's TSF flows in 2014 and despite its rapid growth, it appears to remain substantially less important than formal banking as a source of credit in China.

Another strain on the credit markets is China's loosely regulated $2 trillion trust industry, made up of 68 companies selling high-yield investment to wealth customers. Bloomberg claims that about "$853 billion worth of trust products matured [in China] in 2014, 50 percent more than the year before."[13]

[12] http://www.bloombergview.com/quicktake/shadow-banking

[13] Ibid.

The Housing Bubble

China's real estate problems are unlikely to turn around any time soon.

"Pathological" Urbanization

In 1950, only 13 percent of people in China lived in the cities. This had grown to 45 percent in 2010 and it is projected to reach 60 percent by 2030.

After a 15 year bull market in real estate, much of the country's best land has already been sold off and with 75 billion square feet of new property space under construction or ready to be occupied, it is estimated that it will take five years of constant demand to fill this volume of real estate.

The real estate boom is a major Achilles heel for China's economy. Since reforms to local government financing and fiscal policy in 2005-2006, China's almost "pathological" promotion of urbanization has fueled massive over-investment in real estate.

In its attempt to transform from an export-led manufacturing economy to a consumer-based economy, the Chinese government has pursued hundreds of thousands of "broken tail building" projects: neighborhoods in major urban centers where all units are sold at high prices but hardly anyone lives or works there. Scores of "ghost cities" have spread throughout the country.

The more the economy slows, the longer this excess supply will be maintained and the further this will depress real estate sales in volume and value. Local governments are already struggling with declining revenue and there have been allegations that they are illegally using shell corporations to bid up prices and artificially prop up land valuations. Dealing with the problem will largely require local governments to implement austerity programs, which is unlikely to be embraced by local residents, many of whom grew up during an extended period of prosperity.

Failure to manage its way out of the current overheated housing market is the single greatest near-term vulnerability facing China. A true crisis in the real estate sector would drive China into recession, causing significant social dislocation and generating widespread political anger, far outstripping the consequences of the recent stock market slide.

- **More than 65 percent of Chinese household wealth in 2011 was in real estate** (the comparable figure for the U.S. in 2005 was 30 percent). A significant correction in this sector would carry widespread political and social consequences.

- Even China's $3.65 trillion in foreign exchange reserves and sovereign wealth might prove insufficient to bail out a rapid real estate collapse.

- Incremental or unsuccessful bailouts would not only cause severe disruptions, but would undermine global confidence in the Communist Party of China (CPC)'s ability to manage the economy.

- As described above, the linkage between real estate and local government financing could create a scenario where the housing bubble not only bursts, but in doing so it leaves local governments bankrupt and unable to provide services to citizens at a time of deep economic distress. This might require the central government to use its formidable resources to bail out failing municipalities, but the political consequences of such an action would be significant.

Key sectors affected by the irrational run up in real estate values include real estate and construction firms, as well as banking institutions and the shadow-banking sector. Should there be a collapse in property values, firms in the real estate and construction sector would face significant financial distress with their at-risk debt rising sharply. However, since much of this debt appears to be concentrated in a relatively small number of firms, the extent to which this would cause widespread dislocations may be limited.

Other sectors closely related to real estate activity, such as manufacturing and transportation, would still be strongly impacted. In addition, given the extent of household wealth in China represented by real estate, **a collapse in this sector would lead to a slowdown in construction-related industries (e.g., cement, copper and steel) and consumer spending, impacting a wide range of small manufacturing and retail businesses**.

China's Debt Management Options Will Become Limited over Time

China may not be at a tipping point in terms of debt management, but the debt problems of the Chinese corporate sector and the financial challenges faced by local governments, combined with inflated property values, will increasingly constrain China's options over time.

Increasing Inefficiency in Capital Formation

"China's continued reliance on high levels of investment, supported by new credit and directed by political interests at every level of the system, has driven returns on capital formation to world-low benchmarks." – The Long Soft Fall in Chinese Growth, The Conference Board.

The relatively modest devaluation of the yuan will help address some problems of Chinese competitiveness and assist the export sector. However, it is a two-edged sword, particularly in dealing with Chinese corporate debt – part of which is denominated in foreign currencies. It is estimated that the Chinese corporate sector holds more than $1.13 trillion in foreign currency debt (about seven percent of the current corporate debt stock), all of which gets more expensive with each succeeding devaluation.

In terms of stimulus, which is expected to be one of the responses to the current economic slowdown, taking on more public sector debt will not be an issue given China's low public debt to GDP ratios. Nevertheless, there are increasing indications that the "bang for buck" ratio from various Chinese stimulus measures has slipped considerably over the past decade or more. A recent Conference Board study[14] indicates that **China's credit intensity (the amount of yuan credit required to produce one unit of GDP) has more than doubled since 2002.** This puts China in a downward spiral, with more and more credit required to achieve the same level of stimulus.

THE PROBLEMS OF LABOR AND DEMOGRAPHICS

Labor Protests Will Increase

Over the next 12 months, labor militancy will grow in China. Chinese suppression of organized labor means that militancy will be inherently chaotic and will likely turn increasingly to violence, with serious political and economic consequences.

Between January 2011 and January 2015, nearly 2,900 strikes and labor protests occurred nationwide, nearly half of them in 2014 alone.[15] Observers believe that increasing labor unrest is a function of the slowing economy and will accelerate as imported goods climb in price following currency devaluation. The continued failure of Chinese and foreign factory owners to address concerns of safety and working conditions will increase agitation and incidents such as the Tianjin disaster will be quickly publicized throughout China by social media. These trends will lead to more wildcat strikes over the next 12 months.

The Chinese labor market is skewed by the *Hukou* system (a household registration that binds certain people to certain rural or urban locations and control access to different types of welfare benefits). The system creates massive

[14] David Hoffman and Andrew Polk, *The Long Soft Fall in Chinese Growth: Business Realities, Risks and Opportunities,* The Conference Board, 2014.

[15] China Labor Bulletin

imbalances within the Chinese labor market, which – having previously assisted Chinese economic growth – now drag on the economy by creating social unrest and forcing local governments to respond with programs they cannot afford.

The slowing economy, combined with decreasing stocks, commodities and shadow economy loans, means that migrant workers and rural *Hukou* Chinese will be hit harder than their urban counterparts. In addition, many migrant workers who were using the stock market to smooth income and consumption are losing life savings with the stock market crash. These people will have little choice but to reduce spending, slowing the economy even further. Migrant workers facing employment shortages and a lack of state services will protest and riot in manufacturing centers, disrupting production and increasing economic headwinds.

The Hukou System

The *Hukou* system has tied residential status and access to services together since the 1950s, to control internal migration. When restrictions were eased, millions of Chinese moved from rural to urban centers, contributing to China's growth. But access to healthcare, education, pension plans and other urban welfare schemes remain limited.

China plans to reform the system by 2020, but some believe the reforms do not go far enough to stem growing unrest.

The system keeps wages low (migrant workers do not receive the same benefits as urban residents) and helps the government maintain control. As the economy slows, both the cost of reform and the lack of a safety net for millions of Chinese laborers will drag down the economy and increase income inequality.

An Aging Population

The One Child Policy has brought China to the Lewis turning point: when the population of working age starts to shrink, taking the labor force with it. China's working age population peaked in 2010. The population aged 15–64 peaked shortly thereafter in 2013. The end of this demographic dividend would by itself explain the slowdown in China's GDP growth rate from about 10 percent to six or seven percent.

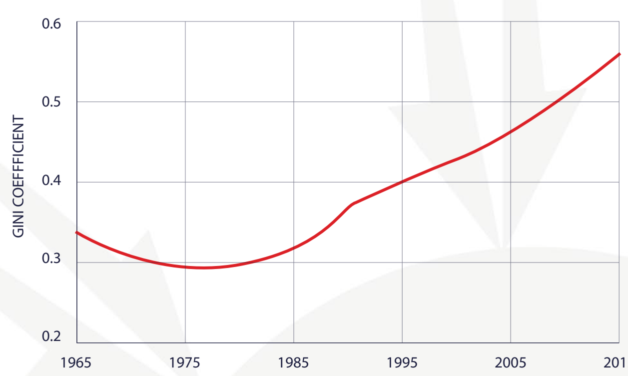
As the population ages China loses an important economic asset – surplus labor – and the consequences will get more intense over time. The old age dependency ratio is projected to rise from the current 13 percent to over 40 percent by 2050, putting considerable pressure on pension and health care systems. Although this is more of a long-term issue for China, the near-term effect will be in the actions of China's economic planning agencies, mindful of the mid and long run requirements for local and national governments, as well as the implications for continued urbanization efforts, since urban areas have lower birth rates.

Income Inequality in China

Income inequality in China is structurally significant and increasingly dangerous.

Income inequality levels in China are among the highest in the world. The wealth gap has important political and social implications, constrains government policy response and impacts China's long-term economic prosperity. As the purchasing power of lower-income groups erodes, the loss of consumer spending will work against China's policy to boost domestic demand. As domestic demand slows, manufacturing decreases and results in less employment for migrants and those from rural areas.

TRENDS IN GINI COEFFCIENT IN CHINA



Source: *"Income inequality in today's China", Proceedings of the National Academy of Sciences, February 20, 2014.*

Since the nationwide protests of 1989, the government's ability to deliver annual economic growth has been a major factor in maintaining China's political stability.[16] However, the growth of household income and savings has never been uniformly distributed. The lack of development in rural and western regions may result in some local and provincial governments becoming less receptive to central government directives. This will create political strains, particularly in places where local officials are living lavish lifestyles in defiance of President Xi Jinping's crackdown on corruption. Tension between local governments and Beijing may generate more social unrest across the country. The widening income gap will eventually test the CPC's grip on power as those living in the western regions seek parity with those in the more prosperous east. Despite development initiatives in western China, regional imbalances persist and have severely affected the potential of western regions, which are still lacking in infrastructure.

With approximately 200,000 reported protests every year,[17] this will become an increasingly urgent problem. According to the United Nations, a country with a Gini coefficient (a widely-used indicator of economic inequality) of more than 0.40 is at increased risk of widespread social unrest. Independent surveys suggest the real Gini coefficient in China now ranges between 0.530 and 0.611.[18] More importantly, the trend is moving sharply upwards.

The Problem of "Green" Investors

In addition, many Chinese offset their lack of access to state services by retail investment. While only 10-12 percent of the Chinese population owns shares, many accounts were opened during the boom – brokers opened four million new accounts in one week of April alone, according to BlackRock.[19] These new accounts tend to be held by green investors who operate with a mob mentality and exaggerate swings in stock prices. Many of these investors trade on margins, leaving them in debt (and losing other people's money) when investments go wrong. Oxford Economics estimates that shares would need to fall 35 percent to return the index to long-term averages, eliminating another trillion dollars of China's wealth.[20]

The next 12 months will see continued volatility in the Chinese stock markets. For those without an urban *Hukou* and access to state services, stock market volatility will cause even more uncertainty. This will exacerbate social tension, both between migratory workers and the government, and between migratory workers and non-migratory workers. This, in turn, will create additional drag on the domestic economy (e.g., protests, possible riots, unemployment and knock-on effects) and discourage foreign direct investment (FDI) if mishandled.

The Long, Slow March from Exports to Domestic Consumption

China will hold its course and move from an export-led economy towards domestic consumption, but implementation will slow.

After two decades of breakneck, export-led growth, China's 12th Five Year Plan (2011-2015) turned to rebalancing the economy, moving the country away from exports towards an increasing the share of private consumption in GDP. This was designed to increase social stability by reducing income disparities. Boosting private

Consumption Gaining

Consumption drove 51 percent of GDP growth in 2014, three percent higher than in 2013 – and services added an additional 1.3 percent.

The Economist, January 20, 2015.

[16] "It was, after all, deteriorating economic conditions that sparked the 1989 riots (annual inflation rates of 30 percent generated panic buying)", from Brendan P. O'Reilly, "The Implications of China's Growth Slowdown", *The Diplomat*, February 26, 2015.

[17] David Shambaugh, *China at the Crossroads: Ten Major Reform Challenges*, The Brookings Institution, October 1, 2014.

[18] Yu Xi and Xiang Zhou, "Income inequality in today's China", *Proceedings of the National Academy of Sciences*, February 20, 2014.

[19] http://money.cnn.com/2015/07/02/investing/china-stock-markets/

[20] Ibid.

consumption would reduce the competitiveness of exports, but increased wages would ultimately put more money in the pockets of consumers. It would also reduce pollution levels by de-emphasizing capital-intensive manufacturing and thus improve quality of life for the average citizen.

There has been progress made towards these objectives. Consumption contributed 0.1 percent more to GDP growth than investment in 2014, and labor income appears to be gaining a larger share in GDP. Growth in the services sector shows that services are becoming increasingly important to the overall GDP.[21]

Nevertheless, China still remains highly dependent on its export sector and the rate of change will be defined, in part, by **whether China's growing services sector can offset economic losses in labor-intensive manufacturing for export – and the government's ability to withstanding the strain resulting from the gap between the two**.

The current leadership is aware of the fragility of the economy and will continue to pursue reforms, making China less vulnerable to exogenous macroeconomics shock and building its domestic economy. The rate of change, however, may slow due to the overall economy and fraying consumer confidence, and leading to a flattening consumption rate. In the meantime, China may need to boost exports, which currently constitute 30 percent of GDP (which the recent currency devaluation will assist) to balance the social problems of slowing growth rates.

Disposable income per capita continues to grow in China, cresting at 28,844 yuan in 2014,[22] and consumption can be influenced by policy, but changes will not manifest overnight and have a cultural component that transcends government policy. China has maintained remarkably high levels of savings despite the fast growth of its economy since 1979. While compression of consumption has been key to underpinning an investment-driven economy, inverting the path appears to be harder than expected. At the same time, there are also structural factors that discourage consumption. These, in principle, can be addressed by policy – but those policies will need to be moderated if social unrest spikes.

In the long run, China will maintain a path towards strengthening consumption, continuing to pursue the majority of reforms currently underway (e.g., stock market reform, better social security and the internationalization of the currency). The improvement of the social security system will decrease the percentage of income saved for retirement, healthcare and education, freeing up resources for consumption – but here again, it will take time for full implementation. While a new urban middle class is perhaps the regime's prime mass constituency and the main beneficiary of reform policies, as discussed above, wealth is increasingly concentrated among a few, further constraining consumer demand and eroding social morale.

[21] IMF Staff Report for the 2015 Article IV Consultation, July 7, 2015.

[22] http://www.tradingeconomics.com/china/disposable-personal-income

CHINA'S OPTIONS

China may be managing one of the most complex economic maneuvers in modern history: shifting a slowing economy away from export-led manufacturing to domestic consumption without shattering a deeply held social compact built on the assumption that the Communist leaders would provide significant year-on-year improvements to the people's quality of life.

It's an extraordinarily complex balancing act and there is no real modern precedent. The Chinese authorities must navigate through an accumulation of economic issues while maintaining forward momentum on the reforms necessary to achieve long-term sustainable growth.

Three things are certain:

1. **Time is not on their side**. Social and economic pressures are accelerating. Demographic changes and public anger at corruption and income inequality are inexorably building.

2. **Change will be evolutionary, not revolutionary.** Economic and social forces ensure that the political landscape will be so complex that there are no silver bullets or single solutions to solve all the problems facing the economy.

3. **China's options will be increasingly constrained**. China's increasing participation in and vulnerability to the global economic system means that its ability to hold itself apart from the rest of the global community and act unilaterally is fading quickly.

The tools in China's economic toolkit are **becoming increasingly inefficient,** and at some point (outside of the timeframe of this analysis) China – like most other countries actively manipulating their economies – will simply run out of options.

- **This will hit monetary policy first, then fiscal.** It now takes almost 4.5 yuan of credit to achieve 1.00 yuan of GDP growth. The returns on capital in China have been falling steadily for decades, and its Total Factor Productivity plateaued after 2012. Without structural reform China's increasingly inefficient credit allocation system will only worsen, making future stimulus efforts an exercise in frustration.

- **China's aging population will become yet another growing drag on the economy**, requiring leaders to divert an increasing portion of the nation's resources to care for the elderly.

- Unrealistic economic targets may have traditionally benefitted Chinese politicians seeking to demonstrate their commitment to economic growth and improved standards of living. The problem, of course, is when governments set unrealistic targets, people start to behave badly: Pressing local governments to meet unrealistic targets simply encourages corruption and financial malfeasance as local officials try to do whatever it takes to meet the demands from above.

MONETARY POLICY

Continuing Devaluation of the Yuan

Expect to see moderately paced devaluation of the yuan, until it reaches its 2008 average of $1 = 7.6 yuan by mid-2016.

With inflation in China under control and the CPC continuing to restrain credit growth, a slower and well-managed devaluation path, *as opposed to rapid devaluation*, would:

- Reinforce investors' confidence in the government's ability to manage China's economy;
- Support China's major foreign policy goal of establishing the yuan as a global currency;
- Limit capital outflows on which China depends to support its ailing economy; and
- Mitigate the risk of competitive currency devaluations by countries that compete with China as a manufacturing center, including the Western economies and Vietnam.

Devaluing the yuan is widely expected to boost the export industry, which suffers from overcapacity and whose productivity gains have been leveling off against headwinds from a real effective exchange rate (REER) that has appreciated 100 percent in the last 20 years and 15 percent since April 2014, when the U.S. dollar began trending up. Even though China's leaders are looking long-term to realign the industry away from export-led growth towards domestic consumption, near-term stabilization of the export sector will help offset the broader political, economic and social consequences of the overall slowdown in the economy, now falling below the official growth target of seven percent.

Devaluation would support export industries, in particular labor-intensive ones like textiles, steel, aluminum and refined fuels, but domestic

The Path to Devaluation

Between August 10 and August 13, 2015, the PBOC allowed the yuan to depreciate three percent against the U.S. dollar to 6.39 yuan, bringing the exchange rate back to its 2011 levels. Although the move was consistent with yuan daily floating bands, it was a marked deviation from the average yuan intraday volatility and was an attempt to stimulate China's economy.

The PBOC's action occurred against a backdrop of weakening China foreign currency reserves (down four percent since 2014), a deterioration in the exports sector as showed by Chinese shipment data, and contraction in the contribution that exports are making to total GDP (down from 35.7 percent in 2006 to 22.6 percent in 2014).

DEVALUATION

In August 2015, Beijing devalued its currency 4% – the first devaluation since it was first unpegged from the U.S. dollar in 2005. They can be expected to devalue it again.

IF... **China Continues to Devalues its Currency**

A more gradual devaluation than the three-day burst seen in August is likely, devaluing at a maximum of 7% over a 12 month period

The hemorrhaged capital outflows that would follow a "shock" devaluation would be in part avoided

Chinese exports become comparatively cheaper

OPPORTUNITIES

Chinese exporters: Export will not decline as in the first half of 2015 (-8.3% in July), instead lingering between -4% and +1% on a month-to-month basis for a general trend of steady exporting

Chinese domestic tourism industry: As international travel can be expected to contract by 5-10%, domestic transportation, hotels, and the hospitality industry will all benefit

Commodity importers: China will purchase fewer commodities, driving down the prices for other nations on imports such as oil and iron

THREATS

Chinese consumers/industry and foreign importers: Typically imported goods such as electromechanical products and increasingly coveted electronics will be more expensive for Chinese consumers

Competing exporters: Vietnam, Malaysia, and other countries that compete with China in exports will see their exports become less competitive and face pressure to devalue

International stock markets and capital investment: Chinese devaluation has been demonstrated to increase market instability and deter capital investment

BUT... A less likely but still possible "shock" devaluation would significantly exacerbate capital outflow and intensify the immediate impacts on winners and losers industries (in particular capital-intensive ones and those that require imported commodities and machinery) may struggle to transfer the additional exchange-related costs down the supply-chain and ultimately to consumers. Certain industries, such as consumer electronics that sell heavily in the domestic market, are likely to suffer short-term margin compression, but probably not to the extent that they will be forced into significant layoffs.

China may need to use its foreign exchange reserves to prevent rapid devaluation of the yuan, which could trigger inflation, but its $3.65 trillion in foreign exchange reserves and the administrative capacity to limit capital outflows mitigate this risk.

Expansionary Monetary Policy

The PBOC will maintain an expansionary monetary policy to offset inflation. Expect further reserve requirement ratio (RRR) and interest rate cuts and new, targeted tools to provide liquidity to targeted sectors and smooth volatile capital flows.

Quantitative Policies: RRR and New Targeted Facilities

At the end of August, China cut its RRR by 50 basis points to 18 percent so as to inject liquidity into the economy. This still leaves the PBOC with substantial latitude to control its monetary base. During the Asian Crisis the RRR was cut to six percent and in the 2008 financial crisis to 15.75 percent.

In addition to the RRR cuts, more targeted tools were introduced. **The PBOC is expected to make incremental use of these facilities to provide liquidity as structural reforms are implemented and capital flows become more volatile.**

Although the objective of the new facilities is to provide liquidity, some of them, like the Pledged Supplementary Lending (PSL) facility, are designed to provide liquidity to distressed sectors. **It is likely that these facilities will be used more in the coming months.** The PSL would support the expansion of the market for municipal bonds that has the added advantage of bringing transparency to borrowing by local governments. A wider range of targeted facilities would allow the PBOC to provide controlled liquidity to specific sectors and banks and hence avoid the mistakes of the post-2008 stimulus, when all sectors in the economy were flooded with liquidity.

Interest Rate Policies

August 2015's lending rate cut to 4.6 percent still leaves the PBOC with substantial latitude to conduct additional expansionary monetary policies. Though the base interest rate at 4.6 percent is at a 10-year low, the PBOC is likely to introduce further rate cuts if the output gap continues to widen. Nevertheless, until the transition to a true money-market based financial system is complete, quantitative policies will be the PBOC's preferred monetary transmission mechanism.

- Expect cuts to take place in one to three increments over the next year, interest rates will fall to between 3.85 and 4.35 percent, financing costs will decrease, borrowing will increase and export-competitiveness will improve.

INTEREST RATE

China has cut interest rates five times since November 2014 – how low will they go?

IF... **China continues lowering Central Bank interest rates**

Cuts will take place in one to three increments over the next year

Interest rates will fall to between 3.85 and 4.35 percent

Financing costs will decrease, borrowing will increase, export-competitiveness will improve

OPPORTUNITIES

Chinese manufacturing and exporters will have greater access to credit and lower export costs

Investors and global markets will be reassured that China can manage its economy

Chinese construction and real estate will enjoy lower interest rates

THREATS

Foreign investors will reduce FDI to 1-2 percent

Imports to China will be less affordable

Chinese banks will be less profitable as interest rate yields decline

LIQUIDITY OPERATIONS

Since 2013 the PBOC has developed new tools to control the size of the money aggregates. The new facilities reflect greater need to inject liquidity in the system to offset capital outflows. Some of these new facilities are reserved to sectors that have liquidity issues and thus can also be used as instruments to support liquidity in such markets. The effects of these facilities are the equivalent of changes to the RRR, but are more targeted and thus allow the PBOC to better control the liquidity in the system.

Short-term Liquidity Operation (SLO). Repurchase agreements and reverse repurchase contracts with a maturity of less than seven days are the main tools of the SLOs. The SLOs can be used to borrow short term money from the PBOC. The details of the operations are disclosed one month after the auction.

Standing Lending Facility (SLF). This allows commercial banks to borrow money from the PBOC for one to three months using highly rated bonds as collateral. The SLF is similar to the Fed discount window, but the SLF is more "bank-friendly". Banks rarely tap the Fed discount window because of concerns that the market will negatively react to their being short of liquidity, but Chinese banks do not have this issue as the PBOC publishes the details of the SLF operations no later than the end of the following month.

Pledged Supplementary Landing (PSL). This dates back to April 2014 when the PBOC started using it to channel a trillion yuan ($161 billion) to the China Development Bank for redevelopment of shantytowns. The PBOC intends to use PSL to support loans to sectors with lending issues such as agriculture, small business, etc.

Medium-term Lending Facility (MLF). This allows commercial banks to borrow money from the PBOC for three months using highly rated bonds as collateral. The MLF comes with an option to extend the term and renegotiate the interest rate. Similar to the PSL, the MLF supports loans to sectors with lending issues.

Re-lending with credit-asset collateralization. This targets smaller banks. Contrary to the SLF and MLF that accept highly rated bonds as collateral, re-lending accepts high-quality loans.

¥ MONEY SUPPORT

China must tame growth in provincial, municipal and local debt.

IF... China expands its money support

China may expand its debt-for-bond swap plan from 3.2 trillion yuan to 4 trillion yuan

China will enforce a 2016 debt-limit equal to the $16 trillion allowed for 2015

OPPORTUNITIES

Domestic health and education will receive greater local/municipal/provincial spending

Increased household purchasing power will lead to greater consumer spending

China may build a functioning bond market

THREATS

State debts will increase

Massive debt-swap will trade high-yield loans with low-yield bonds, hitiing the banking sector with a four percent drop in interest income

None of these policies are a silver bullet. In the long run, they do not address fundamental structural issues, have the potential to create asset bubbles, perpetuate cycles of credit-infused GDP growth, discourage FDI, rely mainly on state-owned lenders that are less efficient than private lenders in allocating capital, and channel liquidity through political channels instead of allowing the market to work.

However, in the short term, PBOC monetary policy easing does reduce the cost of capital, support some fair market values and encourage domestic investments. Capital-intensive and/or leveraged industries would benefit the most, as would the real estate sector, which accounts for 15 percent of fixed asset investments and 15 percent of urban employment.[23]

Policy easing may consolidate recovery of the real estate market and prevent negative economic conditions in other sectors from spilling over into the real estate market. Unfortunately, given that China's house inventory is excessively high, the impact of these measures on real estate and construction will be limited. Its impact on stimulating domestic demand for appliances, furnishings and housewares, however, may be greater.

[23] Chivakul M. et al., IMF Working Paper: Understanding Residential Real Estate in China, International Monetary Fund, page 3 (2015)

Debt for Bonds Swaps

China can be expected to expand its debt-for-bond swap plan from 3.2 to 4 trillion yuan and enforce a 2016 debt-limit equal to the $16 trillion allowed for 2015.

- This will provide opportunities for domestic health and education programs to receive more local, municipal and provincial funds. It also increases household purchasing power, leading to increased consumer spending and, possibly, a more capable and robust bond market.
- It will also increase overall State debt and trade high-yield loans for low-yield bonds, hitting the banking sector with a four percent drop in interest income. This will increase demand for bonds, leading to increased interest rates.

FISCAL POLICIES

Expect China to expend two to three trillion yuan in fiscal stimulus in the next 12 months, delivered through targeted measures to avoid repeating the mistakes of the post-2008 stimulus package.

Although there are challenges in managing any stimulus program, China is unlikely to repeat the mistakes of the post-2008 stimulus for the following reasons:

- There is broad recognition that the post-2008 stimulus produced severe asset misallocations and increased system vulnerabilities by increasing local government and bank debt and encouraging off-balance sheet liabilities.
- The value of stimulus measures on GDP growth has diminished sharply.
- Higher levels of total debt to GDP limit the margin for error.
- Long-term GDP growth trajectory depends on structural reforms.
- World economic conditions are more favorable now.

A New Stimulus Package

The extent of China's fiscal stimulus program partly depends on China's leaders doing what they think is necessary to reassure the nation that slower, more sustainable growth is a good thing (e.g., lower pollution, better resource allocation, improved income distribution). The implications of this approach are not in the economics, but in the political choices.

FUEL INFRASTRUCTURE

China will filter money into new infrastructure projects to bolster consumption.

IF... **China expands infrastructure development**

Beijing will accelerate its $230 billion stimulus by releasing $115 billion between Summer and Fall 2015 instead of the originally planned $48 billion

China will increase the overall stimulus package to $300-330 billion

OPPORTUNITIES

Chinese construction, energy and mining firms will benefit from increased funding

Local and municipal governments will avoid financial overburden as Beijing assumes financial burden

The CPC will benefit in the short-term by raising GDP more than 0.3 percent

THREATS

Confidence in CPC will be at risk as GDP growth slows and stimulus becomes increasingly inefficient

DR. DRAGAN PAVLICEVIC

Senior Analyst at Wikistrat and a Researcher at the Chinese Academy of Social Sciences

"Apart from reserves, a stimulus could be financed by regular government tax revenues as well as higher fiscal deficit, so there should be plenty of space for the Chinese government to launch one."

Any faction within the CPC advocating this course of action must be able to expend resources to offset the inevitable economic pain and prevail in the inevitable intra-party debate. In other words, acknowledging lower economic growth and retreating from promises of dramatic and ongoing economic improvement would in itself be an outward expression of an even larger change within the party.

Implementation requires Beijing to be careful. Measures that support the transition to a more domestic economy will be balanced against the costs to export industries. Local governments and state-owned banks will need to be restrained from ineffective and highly leveraged programs when implementing stimulus measures, but at the same time must publicly demonstrate the steps being taken to improve local economic conditions. Anti-corruption measures and legal reforms will need to balance the excesses of increased government spending.

State-owned banks could be used to leverage and deliver the stimulus measures, though their ability to efficiently allocate resources is doubtful. Bank capitalization is adequate, but the recent market correction, increasing numbers of bad loans and overall economic weakness may limit the sector's involvement. This is positive news as it prevents a repeat of the post-2008 bank loan bonanza.

Assuming an efficient transmission mechanism and a revision in the GDP growth trajectory, China will need two to three trillion yuan in fiscal stimulus in the next 12 months to achieve one to two percent of additional GDP growth. This could be used to stimulate internal and external demand.

STIMULATING INTERNAL DEMAND	STIMULATING EXTERNAL DEMAND
• Transitioning from coal-fed to gas-fed heating and electricity-generating infrastructure. • New high-speed and regular railway projects across China. • Western and Southwestern China infrastructure project funding. • Subsidies for first-time and low-income property buyers. • Temporary reduction of taxes on luxury/consumer goods. • Greater income tax deductions for individuals and corporations. • Incentives on R&D spending. • Increased military spending.	• Speeding up *One Belt, One Road* (OBOR) and *New Silk Road* (NSR) disbursements to keep Chinese SOEs and the construction industry fully engaged. • Ensuring that projects financed through the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB) are awarded to Chinese firms. • Lobbing for projects financed by multilateral institutions and funds to go to Chinese firms. • Improve rail and road linkages to neighboring countries.

CHINA'S BIG PROJECTS

China's "One Belt, One Road" (OBOR) project is a massive infrastructure development effort designed to simultaneously support China's domestic industries while expanding the country's economic influence around the world and generate long run competitive advantages in energy resources, foreign exchange reserves, scalable industries, and more.

China is likely to speed up funding for the China-Pakistan Economic Corridor, already projected to use $46 billion of OBOR funding over the next 10 years. Additional construction projects, particularly in energy and transportation, are likely. High-speed rail is an especially attractive investment for China in view of the amount of capital it consumes and the demand it would create for specialized Chinese labor and capital-intensive industries.

Beijing is likely to invest heavily in road, rail, sea and air connections with neighboring Asian countries, including India, Nepal, Myanmar, Laos and Vietnam. Using the OBOR initiative to improve logistical connections with the rest of Asia would also help lift China's flagging exports.

Expect increased investments in infrastructure that will enhance China's access to both natural resources and markets around the world. This will the Nicaragua Canal, improvements in the rail network in Brazil, pipeline projects linking Central Asian and Russian hydrocarbon resources to Chinese markets, improvements in the trans-Russian rail transport network to enhance land-based access to the European markets for Chinese products, and enhancement in rail and highway transport infrastructure in various African nations of interest to China due to their natural resources.

Military Keynesianism

Expect China to increase investments and consumption in the military sector to promote short-term domestic growth, despite shrinking its active duty military force.

President Xi Jinping

As a military power with a slowing economy, Beijing will use military procurement to support its domestic industries and increase arms exports for their economic return. This will increase competition in the global market for military goods. China can be expected to increase its investments and purchases of military goods and services on the order of an additional $170 billion over the next 12 months.

The multiplier for changing in military spending is between 0.6 in the short term (6-24 months) and 1.2 in the medium term (2-3 years). The Stockholm International Peace Research Institute has estimated 2014 Chinese military expenditures at about $216 billion (PPP basis), or 2.1 percent of GDP. A $170 billion increase in military spending should therefore support an incremental 0.5 percent GDP growth in 2015 and one percent in each of the two following years.

China's naval forces are the most likely beneficiaries of such an initiative, but overall, increased military spending would include procurements of weaponry and other equipment (i.e., uniforms, vehicles, safety gear, etc.). The overall effect of these procurements would be quite positive for a wide variety of domestic industries. Supporting employment, particularly for low-skilled and migrant laborers, would have a positive political impact.

From a geopolitical standpoint, a ramp-up in military spending would raise tensions with China's neighbors and the U.S. However, this is unlikely to spill over into foreign action, as would be done to discourage foreign investment and trade.

POLITICAL, LEGAL AND REGULATORY REFORMS

To the extent that the present legal regime in China supports the CPC's ability to maintain control of the nation, the central challenge to China's political leaders will be maintaining a balance between actions in response to public demand for continuing economic gains and social reforms, and the specter of social discord and economic losses associated with the need to slow the economy for a long-term, sustainable growth path.

A key element of this will be President Xi Jinping's anti-corruption campaign.

The Anti-Corruption Campaign

In the coming year, President Xi Jinping will continue his highly publicized anti-corruption campaign. This effort will target corrupt individuals and government institutions, largely avoiding the kind of policies and legal reforms that would address the root causes of corruption.

China's anti-corruption effort will continue to focus on purging corrupt CPC officials. Since President Xi took office in late 2012, the campaign has resulted in the 414,000 CPC officials disciplined for corruption, with about half of those prosecuted in court.[24] In 2014 alone, China officially carried out anti-corruption cases against 68 high-level officials, with more than 70,000 officials also punished for violating the eight-point anti-graft rules.[25]

Given the emerging economic problems facing China's economy, President Xi will continue to hold steady on the low-

[24] http://www.theatlantic.com/international/archive/2015/04/

[25] http://www.abc.net.au/news/2015-01-14/chinas-tigers-downfall-timeline/6016714

level "flies" that carry out corruption in the bottom ranks of the CPC, while also mounting a greater effort at publicly taking down high-level "tigers." This will see China's anti-corruption figures for the next 12 months remain at about the same levels as the previous year as high-level prosecutions rocket into the 100-300 range.

ENDEMIC CORRUPTION	TIGERS AND FLIES
The scale of official corruption in China is staggering. Bank of America estimates that China's GDP fell 1.5 percent last year as cadres ceased purchasing luxury goods and real estate for fear of being targeted for investigation. ***Source:*** *www.abc.net.au*	"We must uphold the fighting of tigers and flies at the same time, resolutely investigating law-breaking cases of leading officials, and also earnestly resolving the unhealthy tendencies and corruption problems which happen all around people." *- Chinese president Xi Jinping in 2013*

The anti-corruption campaign is both an exercise in control and a pressure relief valve. Close scrutiny and enforcement actions by the powerful Central Commission for Discipline Inspection (CCDI) will have a chilling effect on the financial abuses of China's elites. By some estimates, as much as one to four trillion dollars in assets have left the country since 2000.[26] At the same time, this activity aims to reassure the Chinese population that the government – particularly President Xi – is capable of safely guiding the economy back to stability and demonstrating that China's economic "rebirth" will be bolstered by giving individuals and businesses a level playing field.

SOCIAL AND LABOR POLICY

Raising the Minimum Wage

Expect an increase in the minimum wage before March 2016.

Since 2013, China has been working to raise its minimum wage to offset social instability. As the global economic uncertainties continue, the government is likely to roll out this initiative by the end of the year or March 2016 at the latest, before the next National People's Congress (NPC) and Chinese People's Political Consultative Conference (CPPCC) meetings.

The policy is to increase minimum wage to 40 percent of average urban salaries by the end of 2015 to reduce poverty and enlarge the middle class. It will mainly focus on income growth, although some will argue that income redistribution should be the main priority. Over a longer period, more consideration of programs that shift income distribution should be expected, though this will be a complicated task requiring balanced reallocation of resources.

[26] http://www.icij.org/offshore/leaked-records-reveal-offshore-holdings-chinas-elite

THE ANTI-CORRUPTION CAMPAIGN

Corruption has long been a problem for China and President Xi Jinping wants to stop it. Since taking office in 2012, the President's anti-corruption campaign has resulted in some 414,000 CPC officials being disciplined. President Xi can be expected to continue this campaign in the coming year.

IF... **China continues its anti-corruption campaign**

Roughly 70,000 more officials will likely be disciplined in the coming months

Bribery will be reduced and some money in overseas "tax havens" will be returned to China

Anti-corruption campaigns will allow Beijing to avoid the high cost of true political reform

WINNERS

Less bribery will allow China's general population to purchase more consumer goods, allowing consumer spending to maintain last year's levels

Manufacturers of foreign consumer goods operating in China

LOSERS

Chinese luxury goods and services are likely to contract by two to five percent, following last year's one percent drop

Chinese importers of consumer goods will suffer as domestic brands increase market share, rising from 70 percent to between 71 and 72 percent

FONS TUINSTRA

Senior Analyst at Wikistrat and the President of the China Speakers Bureau

"Minimum wages have gone up (different from province to province) since 2004, with the exception of 2009. There's no reason why that development will stop, and the official line is to increase consumption as a key element of the economy. That can only happen when wages go up."

Raising the minimum wage will be balanced against China's need to ensure that its labor markets remain competitive against nearby countries such as Myanmar, Cambodia or Vietnam. A steep increase will impact FDIs, since some companies will shift investments to lower labor rate markets. Apart from the impact on manufacturing, raising minimum wage is expected to boost domestic consumption and thus have a positive impact on China's gradual shift away from export industries.

Labor Policy

China will pursue a mixture of carrots and sticks to manage labor and social unrest over the coming year.

In anticipation of large worker protests the CPC will move to tighten control over traditional and social media, making preemptive arrests of suspected "troublemakers". Despite these measures, protests will grow, though with only limited and localized impact.

There will be mixed signals on the future of the *hukou* system. China may increase travel restrictions to keep social unrest from spreading, and offset the political impact by improving rural healthcare and other social services. For this to work, China will need to improve services to migrant workers holding rural *hukou* but now living in small to medium cities. At the same time, expect the government to maintain strict control over the large cities.

The economic implications will be difficult to manage. On the one hand, the government need to provide increased services to the volatile migrant community. On the other hand, local governments may not have the resources to handle swelling urban populations without increasing their debt load. In the end, it is unlikely that there will be significant reformation of the *hukou* system in the coming year.

Source: *China Labour Bulletin*

ENCOURAGING FOREIGN INVESTMENT

China will take steps to open its economy, expand the number of Free Trade Zones (FTZs), conclude Bilateral Investment Treaties (BITs) with the U.S. and the European Union and, over time, liberalize its FDI regime.

More Free Trade Zones

Following the success of the pilot Shanghai Free Trade Zone, China will open additional FTZs beyond the three already announced for Tianjin, Guangdong and Fujian. Since companies in FTZs generally enjoy substantial benefits, expect a quick start for these new areas in the coming months and the announcement of one or two new zones after the Chinese New Year (March 2016).

Among the provisions incorporated into the FTZs will be favorable tax and customs treatments, special Intellectual Property Right (IPR) courts and protection of said IPRs, and fair arbitration procedures for foreign investors. These projects will continue to be considered "experimental" and "provisional" as both central and local officials gain more experience with implementation of the zones. Some measures may be expanded in new zones while others may be rolled back in a calibrated process of careful liberalization under controlled circumstances.

New Bilateral Investment Treaties

In the face of declining FDI levels and increased outward Chinese investment, China will take various measures to reinvigorate the inward flow of foreign investment. The most significant move Beijing can take in the next 12 months is to agree with the U.S. on the final text of the BIT that has been under negotiation for a number of years. The visit of Xi Jinping to the U.S. in September provides the necessary impetus and occasion to announce a breakthrough.

- A successful conclusion of the BIT with the U.S. will send the signal that China is serious about economic reform. It will also reassure foreign investors considering exits from China that Beijing will be more inclined to protect their interests.

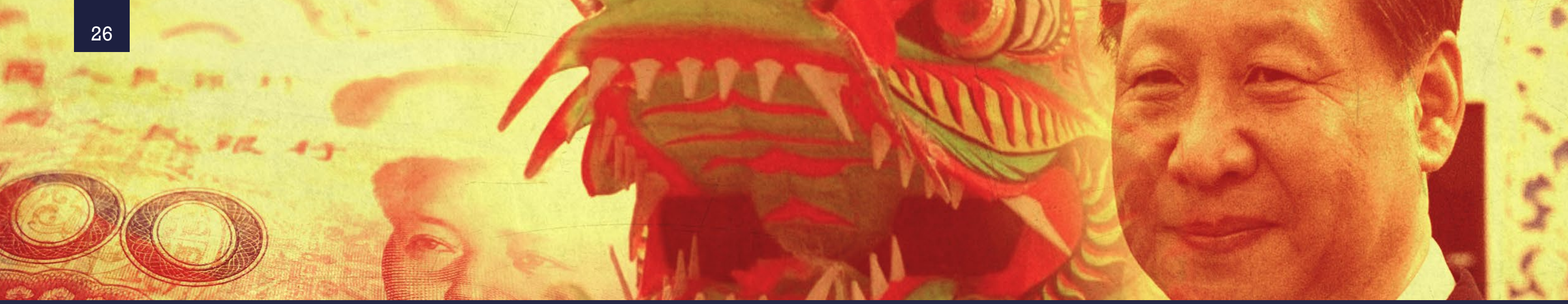
- A new BIT, opening more sectors to American investors, will represent a victory for Chinese reformers who seek to ensure progressive opening of the Chinese economy. In addition, the BIT will allow neutral third-party dispute settlement (the Investor-State Dispute Settlement, or ISDS), to assure foreign investors access to a more neutral if not predictable investment environment.

Similarly, Beijing may get serious about a new BIT with the European Union. EU-China trade reached over €568 billion in 2014, but China accounts for only about two to three percent of foreign direct investment by EU member-states. A BIT would be particularly important for China's relationship with Germany, its largest trading partner in the EU and an important exporter of technology to China. The BIT would provide a strong legal framework for investors on both sides, importantly including an ISDS mechanism ensuring enhanced protection for investors.

Opening the Economy

Foreign investors face various restrictions when investing in China, ranging from industries that are restricted or prohibited from accepting foreign investments to a host of requirements and limitations (e.g., minority-stake joint-ventures, requirements for minimum investment levels, technology transfer agreements, and limitations on hiring foreign staff).
China will take incremental steps to remove some industries from the restricted list, allow lower minimum investment thresholds, make joint-venture regulations more elastic to allow foreign partners bigger shares in companies they invest in and soften the technology transfer rules.

Sensitive to domestic pressures on criminal and civil law predictability, as well as foreign pressures on civil law and litigation, China needs substantial legal reform, including reformation of criminal codes to protect the rights of the accused, tort reform, improvement in contract law enforcement, corporate governance and moderation in areas such as freedom of speech and assembly. Judicial independence (or more accurately the lack thereof), strengthening property rights, and strengthening the regulatory regime for financial services would all encourage a climate of economic and social development.



CONCLUSION

China will continue its march toward fundamental economic reform, managing the complex transition from export-led growth towards domestic consumption. Nevertheless, changing the course of the Chinese economy is akin to turning an aircraft carrier – it begins slowly and only gradually builds momentum. History shows that once reforms start, vested interests move to slow change. In China, central directives take time to become concrete action, and local officials are not always incentivized to put current policy objectives into action. Discipline and "propaganda" (media blitzes to pass the message and mobilize the population) have to be organized. In some cases, personnel must be replaced to ensure the CPC's directions will be followed.

It is inevitable that there will be periods of volatility resulting from policy shifts, unexpected events, external shocks and policy errors. This will cause periodic turmoil in equities and commodity markets, as well as to businesses and industries that rely on Chinese import demand. Nevertheless, as long as China maintains a degree of political balance and substantial economic reserves to act as a buffer, the long-term trend is positive.

There will be continuing volatility and softening of commodity prices, particularly in imports that traditionally support the manufacturing and construction sectors, such iron ore, coal, copper and other base metals. This will have impacts on a number of foreign markets, primarily Australia, Brazil, Chile, Nigeria, Peru, South Africa, Sudan, Zambia and other countries which export a substantial volume of minerals to China each year. This will be offset somewhat in the near term by Chinese stimulus efforts and reductions in output designed to stabilize prices. Nevertheless, the long term implications are for a gradual trend downward.

The slowing import-export trade will also, over time, hit service industries such as shipping, that have traditionally relied on China's massive imports of machinery and commodities and subsequent export of finished goods. While there will be short term shocks primarily following a currency devaluation, the overall trend will be gradual and some of the impact will be offset by China's massive international construction initiatives.

The slowing and shifting economy will reduce demand for imports of heavy machinery and products that support the construction industry. This will impact exporters of heavy machinery, concrete and other inputs to the housing industry. On the other hand, China should remain a robust end market for technology, entertainment and other services that feed growing domestic consumption, with the likely exception of luxury goods, which carry significant political and social implications for the shifting economy.

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