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Flash Notes

China: CEWC Outlines Policy Plans For 2017

Key Messages from the Annual Economic Conference
Amid a year of "black swan" events globally and domestic economic challenges in the ongoing reform and restructuring as growth continued to slow in the "new normal" environment, China held its annual Central Economic Work Conference (CEWC) over 14 to 16 Dec in Beijing, led by President Xi Jinping.

The CEWC reviewed developments in 2016 and set the tone for economic and financial policy for 2017 while noting a series of risks and opportunities ahead both domestically and globally. These meeting's outcomes are expected to show up in the various economic targets and policy steps to be unveiled in the National People's Congress (NPC) sessions in Mar 2017.

Domestically, 2017 is an important year at least in two respects: 1) The 13th 5 year plan (2016-2020) will be moving into further implementation phase, and 2) the China Communist Party is scheduled to hold its 19th National Congress in the autumn of 2017 that is expected to usher in a slate of leaders just as the Xi Jinping-Li Keqiang administration begins its second, and final, 5-year term.

Broadly, some of the messages out from the CEWC:
1. stability as the main tone for 2017 while pushing for supply-side reform
2. proactive fiscal and prudent monetary policies in 2017
3. RMB basically stable, while improving the flexibility of exchange rates
4. deepening supply-side reform, via cutting excess industrial capacity, destocking, deleveraging, lowering corporate costs and improving weak links
5. curbing asset bubbles given the risks to financial stability

Stepping Up Reforms in 2017
While the CEWC looks to deepen supply-side reforms in 2017, growth stability remains the main backdrop. **As such, we expect China's growth rate to decelerate to around 6.6% in 2017, from about 6.7% in 2016.** The CEWC did not announce any target figures, which are left to the NPC sessions in Mar 2017. **We note that there is scope for the growth target to be trimmed from the current 6.5-7.0% range**, to say, 6-7%, to further shape expectations of the "new normal" environment and provide more impetus to reduce leverage.

The tone for prudent monetary policy and ongoing focus on debt and leverage is consistent with our view that likelihood of interest rate cut or reserve requirement ratio (RRR) cut has receded significantly. **We continue to expect PBoC to maintain its current benchmark interest rates unchanged at 4.35% (1Y lending) and 1.50% (1Y depo), as well as the RRR intact at 17.0% for now.** Furthermore, at the NPC in 2017, key targets such as loans growth and M2 money supply growth could be set lower than those for 2016., and PBoC would continue to rely on "targeted" measures to manage liquidity.

Supply side reforms look to be having some impact, e.g. producer price index (PPI) turned positive for the third straight month in Nov, after 54 months of negative readings, and rise in industrial profits. **Further reduction in excess industrial capacity is likely to see PPI moving higher, and this is likely to feed through to consumer prices as well.**

High leverage was noted in the CEWC especially the in the corporate sector. Corporate debt is estimated at about RMB100tn, and even with 4% interest rate, debt servicing is RMB4tn a year, which is equivalent to the increase in China's GDP in 2015. This pace is clearly unsustainable and could lead to the hollowing out of the real economy. **For 2017, there are likely to be more active steps taken in the debt to equity swap space, deepening of equity raising, and caps/restrictions on corporate leverage.**

While the CEWC intends to keep the RMB "basically stable" at reasonable level in 2017, the task is made difficult by the strength in US dollar, upshift in US Fed expectations and US President-elect Trump's domestic economic policy, as demonstrated in the market volatility in 4Q2016. Just as the CEWC concluded, USD/CNY has reached our target of 6.95 set for end-1Q17. **While it remains unclear how long the dollar bull could run, the USD/CNY could breach 7.00 level earlier than our mid-2017 estimation. Our**

end-2017 for USD/CNY is at 7.16. One key event to note is the 20 Jan inauguration of US President-elect Donald Trump, who has vowed to declare China a "currency manipulator" on his day in office.

Speculation in property market and resulting price bubbles were also of great concern in the CEWC, given the potential of causing systemic risks, and also the worrying trend towards "financialization" and hollowing out of the Chinese economy. **The CEWC noted that, roughly, "property is for residing and not for speculating" ("**房子是用来住的、不是用来炒的**").** Steps such as increased land supply in certain cities, raising standards of services in education and medical fields in third/fourth tier cities, and tightened leverage are among the proposed policy direction. This should point to further public investments in those sectors and more restrictions on borrowing for property purchases especially for speculators.