

# OBSERVATION

## TD Economics



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## A CHALLENGING YEAR AHEAD FOR CHINA

### Highlights

- Yesterday evening, China lowered its economic growth target for 2015 to “around 7.0%” as it heads for a “new normal” for growth. This is the first time since 2005 that the target falls below 7.5%, and if the target is realized, would mark the slowest pace of growth in China since 1990.
- This was not the only decision taken in China this week, with the People’s Bank of China announcing a cut to its benchmark interest rates last weekend. The cut follows several other monetary policy moves over the past year aimed at supporting the economy as it slowly decelerates.
- Even hitting this lower growth target will be a challenge as China grapples with a declining property market, with knock-on effects on local government finances. Reforming its economy to be less dependant on credit-fuelled investment while ensuring a still lofty pace of growth will be akin to walking a tightrope for central government authorities. All things considered, there are downside risks to Chinese growth for this year, posing another headwind for a number of emerging markets.

At the opening of the National People’s Congress yesterday, China lowered its growth target for 2015 to “around 7.0%” from “around 7.5%” last year. This is the first time since 2005 that the target has fallen below 7.5%, and if the target is realized, would mark the slowest pace of growth in China since 1990.

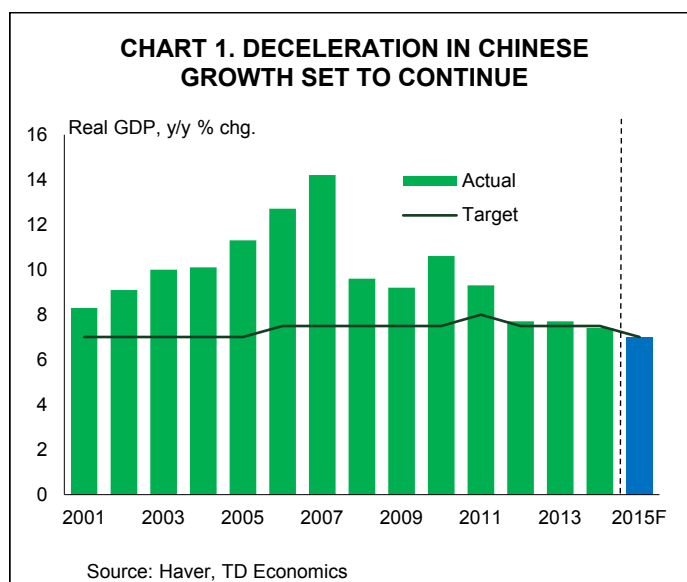
This was not the only decision taken in China this week. Over the weekend, the People’s Bank of China announced a cut to its benchmark interest rates. The cut follows several other monetary policy moves over the past year, and is aimed at supporting the economy as it slowly decelerates.

Overall, China possesses the tools to hit its target, but more policy support measures are likely to be announced in light of the headwinds facing the economy as it navigates its way to a “new normal” for economic growth.

### Interest rates cut as inflation puts upward pressure on real borrowing costs...

On March 2nd, the PBOC lowered the one-year benchmark lending rate and one-year deposit rate by 25 basis points respectively to 5.35% and 2.50%, respectively. This was the second cut in a bit over three months, prior to which the PBOC had kept rates on hold since July 2012. It also follows a suite of other policy moves over the past year, including two cuts to bank reserve requirements in April and February, an easing in mortgage regulations in September, and additional medium-term funding for banks, among other measures.

The easing in monetary conditions is driven by falling inflation, which has driven up the real cost of borrowing. China’s economy has been hit by the same disinflationary forces affecting



**CHART 2. FINANCIAL CONDITIONS IN CHINA HAD BEEN TIGHTENING**



countries around the globe. Consumer price inflation fell to just 0.8% (year-over-year) in January, far from its 2014 target of 3.5%. The target for 2015 has been lowered to 3.0%.

Also contributing to the fall in consumer price inflation is an outright decline in the price producers receive for their goods. Due to the massive run up in investment following the financial crisis, Chinese industry suffers from severe overcapacity across a number of sectors. As a result, producer prices have been declining on a year-over-year basis since early 2012.

As a result of slower price growth, real (inflation-adjusted) interest rates have been drifting higher (see Chart 2). For Chinese companies looking for financing, falling producer prices have pushed real borrowing costs even higher.

The PBOC rate cut can be viewed as mitigating this inadvertent financial tightening. The easing in lending rates will reduce financing costs for large companies. They appear to need the help. Profits at large industrial companies grew only 3.3% in 2014, but declined a whopping 8.4% year-over-year in December.

**...but boost to economic growth will be modest**

Overall, the rate cut should not be viewed as a profound shift to additional monetary easing. The authorities are trying to provide stimulus to the economy, while also keeping a tight rein on credit growth, as there is a clear understanding that excessive credit growth has contributed to many of the imbalances in the economy.

Monetary policy transmission in China is governed by a host of levers, including interest rates, loan-to-deposit ratios, loan quotas, and reserve requirements, among others. In

order to gauge the level of monetary accommodation in the economy, it is important to look at other indicators, such as total social finance, and M2 money supply. Growth in total social finance over the past three months has averaged 14% year-on-year, while M2 money supply growth has averaged 11.45%, both of which are the weakest these measures have been going back at least ten years. All things considered, these point to a slowing economy.

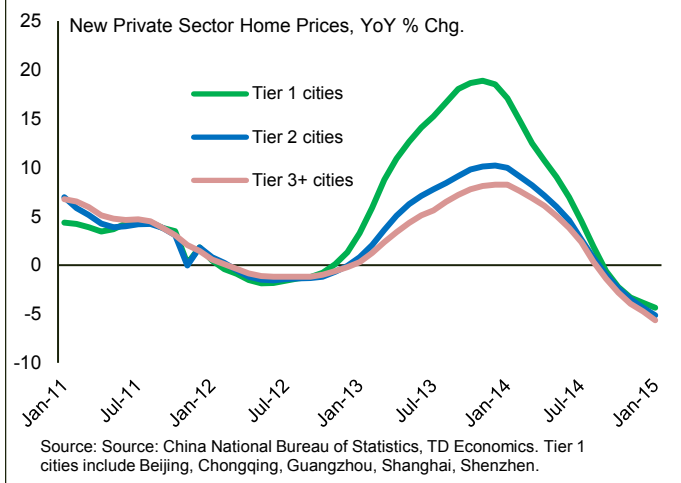
**Overbuilt and overextended**

The move to lower China’s growth target was prudent. It reduces the extent that monetary and fiscal policy need be accommodative. This is all the more important considering the massive rise in Chinese debt since the financial crisis – non-financial public and private sector debt reached roughly 245% of GDP at end of the second quarter of 2014. A lower growth threshold will help facilitate the rotation in the economy away from credit-fuelled investment and towards domestic consumption.

Among other near-term challenges, China’s property market continues to slow. New real estate construction dropped 10.7% in 2014, while real estate sales fell 7.6%. While there are some signs that the easing in mortgage regulations and additional monetary stimulus in the fall may have brought a measure of stability, new home prices fell 5.3% year on year in January, the steepest fall since the data begins in 2010.

Weakness in the property market is also expected to have an impact on local governments, where land sales account for a significant portion of revenues. A deceleration in revenue growth from land sales began in 2014 and is likely

**CHART 3. CHINA PROPERTY MARKET YET TO HIT BOTTOM**



to continue. This is likely to reduce the fiscal support local governments can provide and will place greater pressure on the central government, which has already raised its fiscal deficit target from 2.1% of GDP last year to 2.3% in 2015.

### **The bottom line**

To be clear, not all the risks to China lie on the downside. Recent PMI indicators are pointing towards a mild pickup in economic growth. China is the second largest net oil importer after the U.S., and therefore the fall in energy

prices will provide a fillip to growth (notwithstanding the hit to Chinese oil producers). Due to price controls, some of the benefit of lower gasoline prices will accrue to the state, easing their budget constraint.

Nonetheless, given the challenges facing the Chinese economy, more policy support measures will likely be necessary, even to hit the lower growth target. All things considered, slower growth in China is likely to weigh on growth in other emerging markets for this year, many of which are also facing a number of their own challenges.

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