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PRESS RELEASE

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China : Continuous reform in economy, industries, RMB and globalization

The Third Plenary Session of the 18th CPCCC was held between November 9 and 12 in Beijing. Chinese leaders of the Xi-Li regime used the plenary session as the platform to channel their ideology and roadmap of structural reforms. Given the recent signals and evidence from the government, the current regime is likely to successfully take the reform effort forward.

'The Xi-Li regime is open to adapt more market-based policies on various dimensions, such as the lending rate liberalization announced in July and the proposal to reduce utility subsidies for certain sectors in October. These show the government's intention to take a less active role in the administration process and to focus on the rule-setting front.', said Rocky Tung, Economist for Asia Pacific Region of Coface.

As a continuation of the recently-announced proposal to tackle overcapacity issues in industries that involved many state-owned enterprises (SOEs) and privately-owned enterprises, Chinese leaders will continue to step up its effort to provide a level-playing field for private enterprises and SOEs, essentially allowing private firms to enter and compete for business in sectors traditionally led by state-owned companies. It is expected that there will be more competition in areas including certain so-called strategic industries.

Some expected trends:

A. Moderating economic growth

From the announcement of the plenary session, it was signaled that the government is comfortable with the normalization of growth rate. The government's GDP growth target for 2013 stayed at 7.5% (*Coface CRA[1]:A3; GDP forecast: 2013F, 7.5%; 2014F, 7%).* Although it was made quite clearly that no massive stimulus plan is in sight in the short-run, the government should accelerate the launch of investment in infrastructure projects that have already been planned and budgeted, and infrastructure related industries are expected to see near-term boost on the demand side. These industries include, but not limited to, steel and cement. However, due to structural changes including slowing growth and potentially tighter liquidity facilities for these industries, medium-term scenarios for these industries will be bleak.

Inflation is likely to pick up in the rest of 2013. Top-ranked government officials have repeatedly said that prevention of outrun inflation would be a key objective of the government. It is, therefore, believed that the government will be prudent in launching any supportive policies.

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[1] *Our Country Risk Assessment (CRA) is based on Coface's payment experience, and public information including marco and micro indicators*

B. Actively tackling overcapacity issues

In October, the State Council has issued a proposal that focuses on tackling the overcapacity situation in China.[2] Although the officials did not relate the overcapacity situation to many specific aspects directly, the officials are aware of how the current overcapacity situation could lead to systemic financial risks and it is believed that the government will thus tackle the issues more actively than before.

Most notably, there are 5 industries that the government is targeting at – **steel, cement, aluminium, shipbuilding and glassmaking –** and we expect to see relatively quick development in the following areas:

1) ***Speed-up ousting of outdated production capacity***
2) ***Cease of capacity expansion***
3) ***Higher environmental standard and reducing subsidies***

Smaller-scaled industry participants with inefficient production capacities will be facing increasing pressure in the medium-term. Although there are policies discussed in the plenary session that could potentially increase domestic demand, it would take time for such incentive-driven policy to materialize and be sustainable.

C. Establishment of the SHFTZ to engage the global economy

The establishment of the SHFTZ was cited as an important medium to engage the global economy. Such establishment is symbolic that the country leaders are supportive of the China-U.S. Bilateral Investment Treaty (BIT) talks, and there are increasing discussions that the country is planning to participate in Trans-Pacific Partnership (TPP) negotiations. (Appendix 1)

Although there is still a long way to go, we could expect that when the trade agreements come in effect, highly-protected sectors (e.g. financial services, automobiles, food processing) in these member economies will be negatively hurt in the short-run as the relaxation of protective measures come in place; with lower trade restrictions and tariffs, industries and countries will be producing according to their competitive advantages.

If China is determined to participate in the TPP negotiation, it will help accelerate China's reform agenda. In the medium-term, we shall expect acceleration of large-scaled reforms in the entire Chinese market, involving most, if not all, enterprises with different stakeholder structures. With the complexity of cross-cutting trade agreements, smaller firms could be hurt due to the *spaghetti bowl* situation but larger multinational firms and conglomerates are set to benefit from such trade talks.

D. On-going RMB Internationalization

[2] Ministry of Industry and Information Technology (22 October, 2013)

During the plenary session, the Chinese leaders have again confirmed their direction of taking the RMB internationalization process forward. One of the ultimate goals of RMB internationalization is to make it a reserve currency for central banks. It implies that China will need to liberalize its capital account and promote the usage of the currency externally at the same time.

From now until whenever RMB will become a fully tradable currency, there will be continual effort by external economies to push for RMB appreciation. In fact, the real exchange rate appreciation[3] of RMB against the USD in the last few years is higher than what is reflected in the nominal exchange rate fluctuation. (Appendix 2)

Although the daily fluctuation range for RMB against the USD is now set at 1%, such restriction could be relaxed in the future, potentially in 2014 if not sooner. In the medium-term, wider usage and less restrictive measures on the movement of the currency could lead to higher volatility of the exchange rate.

Foreign businesses that have business relationships with Chinese corporations – especially those who purchase production input from and also sell their products to China – should start invoicing and settling their bills using RMB to hedge against currency fluctuation.

E. Environment-friendly policies on the way

China has experienced a high-growth pattern in the last decade or so, relying on heavy investments in various industries. While such investments have brought the strong economic growth, it also brought along the high social cost to the country, including but not limited to air and water pollution.

Chinese leaders have set out their plans on how to reduce pollution by bringing in higher efficiency to certain industries. The leaders also suggested relocation of certain production capacities in certain cities and provinces to reduce logistics cost and avoid excess production.
Going forward, consumers will be more responsible for costs associated with industrial pollution, which could be reflected that the product price will increase as a result of stricter fuel standards. Potentially, the government will implement it through reducing subsidies on power and energy, resulting in higher fuel prices. Certain players in industries including coal, steel and cement would be negatively impacted, while automobile industries could see mixed impact.

[3] Real exchange rate = (nominal exchange rate * domestic aggregate price level) / (foreign aggregate price level)

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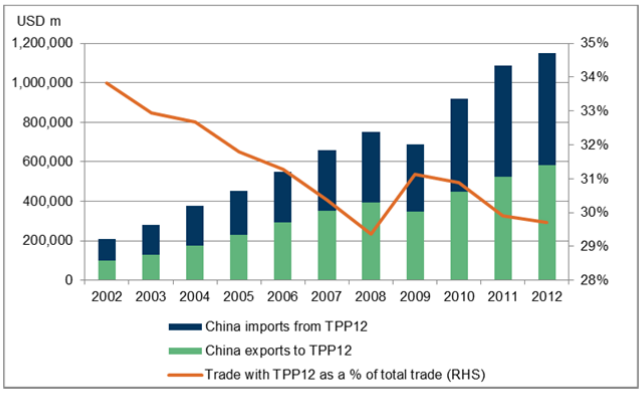
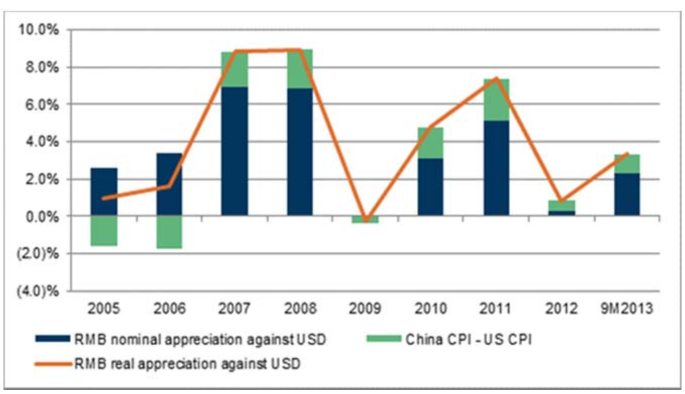
APPENDIX

Appendix 1 : TPP12 is an important trading partner for China



Source: CEIC, Coface

Appendix 2: RMB appreciation against USD



Source: CEIC, Coface