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Comments on Dr. Chen Changsheng's Presentation on "New Normal of China's Economy"

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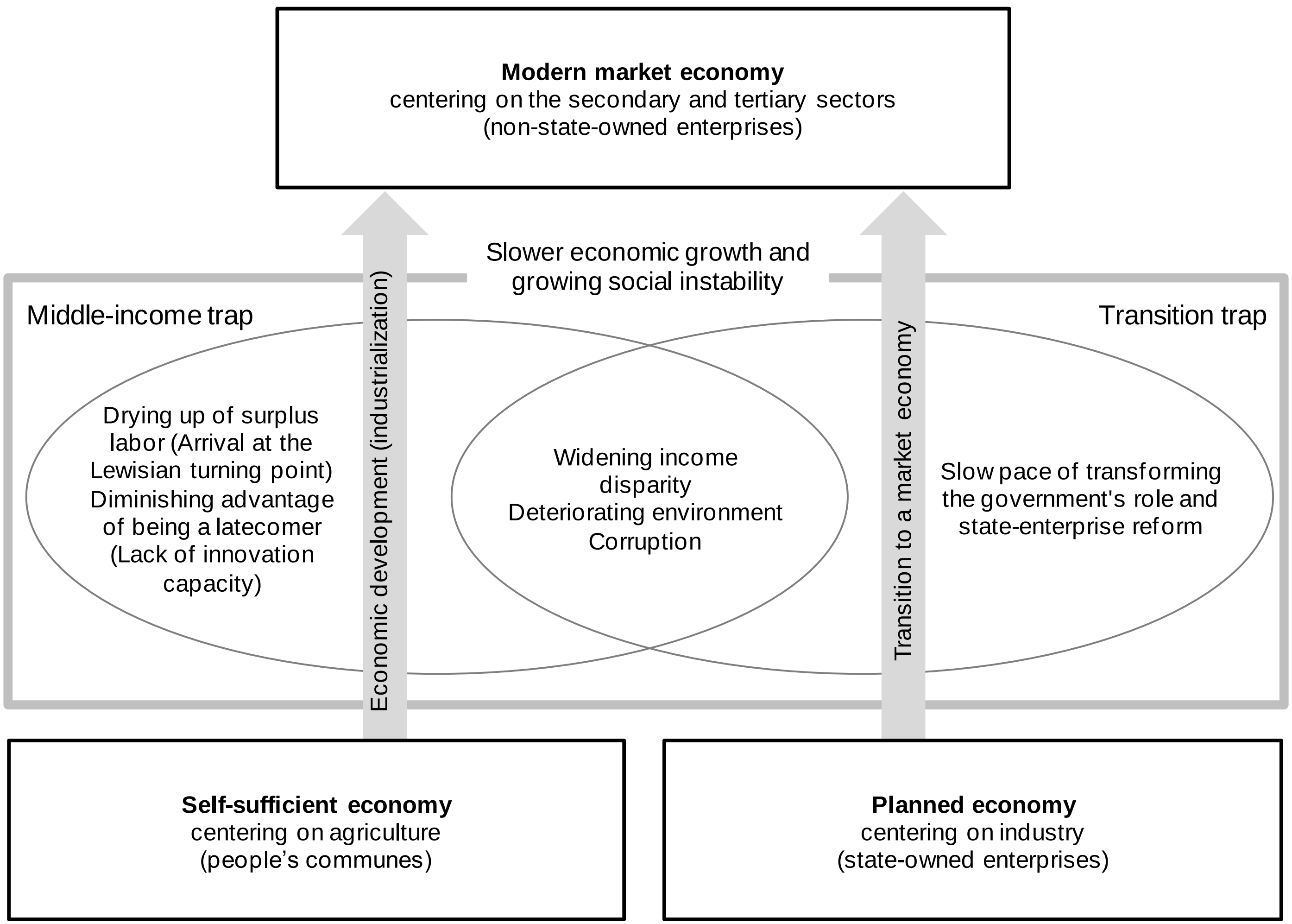
The Two Traps Facing China



Source: Compiled by Nomura Institute of Capital Markets Research.

Changes in the Labor Market Suggest that China may have Arrived at the Lewisian Turning Point

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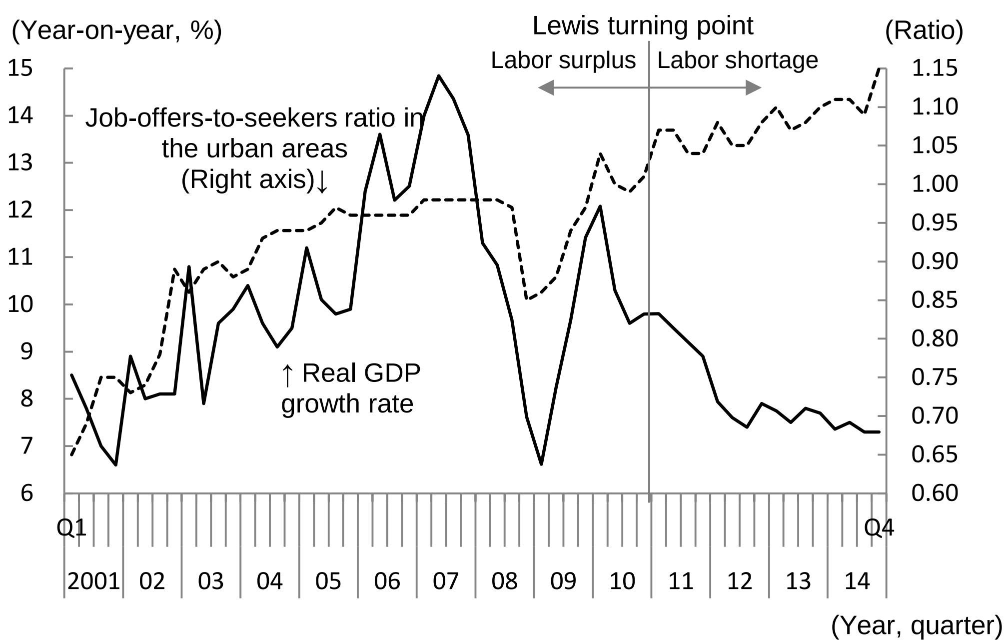
Economic Growth Rate vs. Job-offers-to-seekers Ratio



Note: The job offers-to-seekers ratio shown above is calculated by dividing the number of job offers by that of job seekers registered in public employment services organizations in approximately 100 cities in China.
Source: Compiled by Nomura Institute of Capital Markets Research based on data provided by the National Bureau of Statistics of China and the Ministry of Human Resources and Social Security.

- Despite a sharp fall in the economic growth rate, the labor market has remained tight.
- The job-offers-to-seekers ratio has followed an upward trend since 2009 and stayed at a high level.
- The job-offers-to-seekers ratio has diverged sharply from the economic growth rate, suggesting that the economy may have arrived at the Lewisian turning point.

The Need to Transform Government's Role

- Since the late 1970s when China shifted to reform and a policy of opening up to the world, it has sought to transform itself from a planned to a market economy. With administrative reform lagging behind economic reform, however, the government is still intervening in areas where it should not ("overstretching"), while at the same time, it is not playing a role in areas where it properly should ("negligence").
- Examples of overstretching include the government's continued control of important resources such as land and state-owned enterprises' continued monopolization of key industries. Also, government officials have considerable discretionary authority and frequently intervene directly in the economic activities of companies. In effect, the government, which should be the referee, is at the same time also a player, so the economic game cannot be fair.
- Examples of governmental negligence include China's inadequate provision of public goods and services such as environmental protection, social welfare, medical services, and education. Also, economic regulations have not been put fully in place, and their implementation lacks transparency. Moreover, there is a need to develop the market infrastructure supporting financial and other transactions and to strengthen the government's macro control capability.

State-owned Enterprises' Declining Share of Industrial Production

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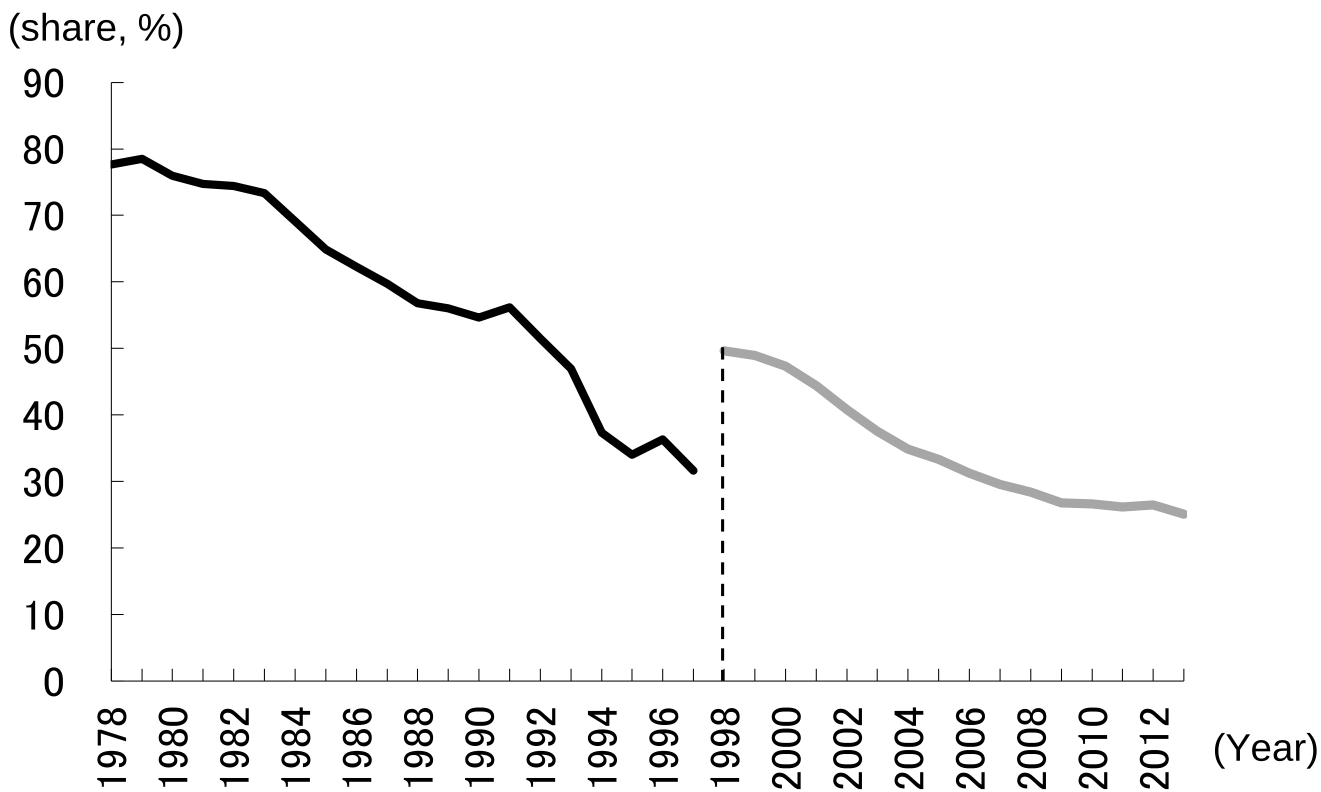

Note: Figures cover all industrial enterprises until 1997, "all state-owned enterprises" and "non-state-owned enterprises with annual revenue from principal business over 5 million yuan" for the period 1998-2006, all enterprises with annual revenue from principal business over 5 million yuan for the period 2007-2010, and all enterprises with annual revenue from principal business over 20 million yuan since 2011.
Source: Compiled by Nomura Institute of Capital Markets Research based on CEIC Database and China Statistical Abstract 2013, 2014.

The Advancement of State-owned Enterprises as a Drag on Economic Growth

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- In order to protect their monopoly position, large state-owned enterprises tend to pressure authorities and increase barriers to market entry. This behavior stymies the introduction of competition and the further opening up of markets for non-state-owned enterprises. A typical example of this situation is the concentration of bank lending in state-owned enterprises which makes it difficult for private businesses to obtain financing.
- The profits of state-owned enterprises, which are mostly retained internally and not paid out, suppress consumption by reducing labor's share of the national income on one hand, and encouraging wasteful investment on the other.
- Because monopolistic enterprises can easily make profits, they have little incentive to improve efficiency. Consequently, state-owned enterprises remain uncompetitive in international markets.

Need to Further Reform State-owned Enterprises through Privatization

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- “Strategic realignment of state-owned sectors of the economy” (Fourth Plenary Session of the Fifteenth Central Committee of the Communist Party)
  - State-owned enterprises, including large ones, should exit sectors where market competition should be the norm, while only 1) industries that are crucial to national security, 2) industries that are natural monopolies and oligopolies 3) industrial that supply public goods and services, and 4) leading companies in key and high-tech industries should remain as state-owned.
- Resistance from vested interest groups, however, has meant that little progress has been made in privatizing large state-owned enterprises.

China Has Fallen into a Transition Trap (Tsinghua University Sociologist Prof. Sun Liping)

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- A transition trap refers to a situation whereby vested interest groups that emerged in the process of shifting from a planned to a market economy, such as state-owned enterprises, hamper further reform and try to maintain the "mixed system" created during the transitional phase. The consequence is distorted economic and social development and worsening associated problems such as income gaps and environmental destruction.
- Strategy for China to break out of the transition trap
  - China must move into the mainstream of global society based on universal values such as a market economy, democracy, and the rule of law. Rejection of the mainstream is the main reason why China fell into this transition trap, as well as the excuse for vested interest groups to maintain the status quo.
  - China must accelerate political reform. The corruption of power is weakening the government's authority and its ability to execute policies. Political reform has to be embarked upon by creating a mechanism to constrain power, such as increasing the transparency of the government.
  - Instead of delegating the power to make decisions on reforms to local governments and ministries as in the past, the decision-making system has to be changed so that reforms are based on a grand design drawn up at the top level of the central government. When promoting these reforms, the government has to listen to the opinions of the people to gain their support and, at the same time, place a basic value on fairness and justice.
- Overcoming the transition trap is the major challenge facing the Xi Jinping Administration.

Financial Risks Surfacing

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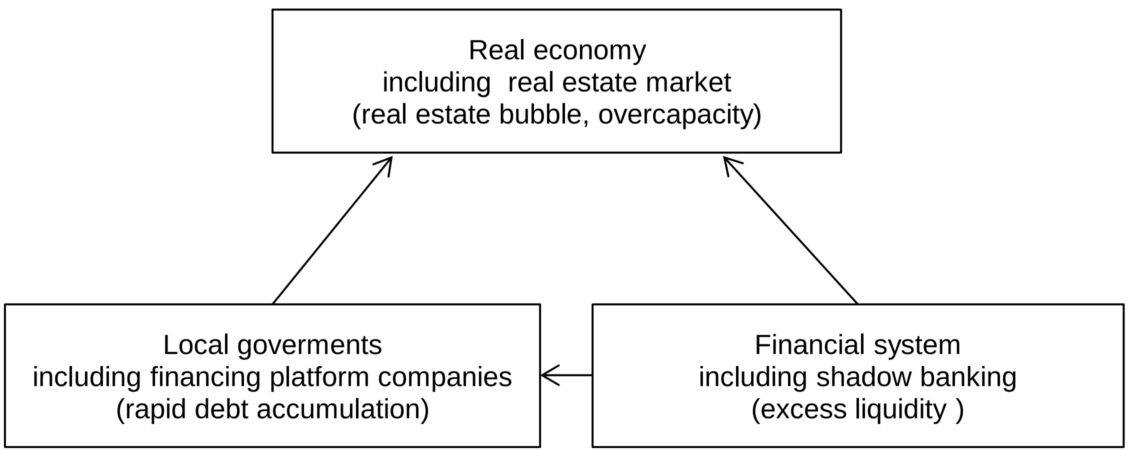
An Overview of “China Risk”



Note: Arrows show the flow of funds.
Source: Created by Nomura Institute of Capital Markets Research.

- With economic growth slowing, risks that remained hidden during the high-growth period come to the surface. In conventional manufacturing industries, many companies face excess capacity and falling profits.

- Since the authorities tightened regulations on shadow banking, many companies are facing funding problems and rising financing costs. In addition, with the real estate market entering a correction phase, the revenues of local governments, which rely heavily on “land finance,” are falling, and their debt-paying ability has become questionable. In this environment, it is uncertain whether the Chinese economy can achieve a soft landing without triggering a financial crisis.

Ratio of House Prices to Average Household Income in Major Chinese Cities (2013)

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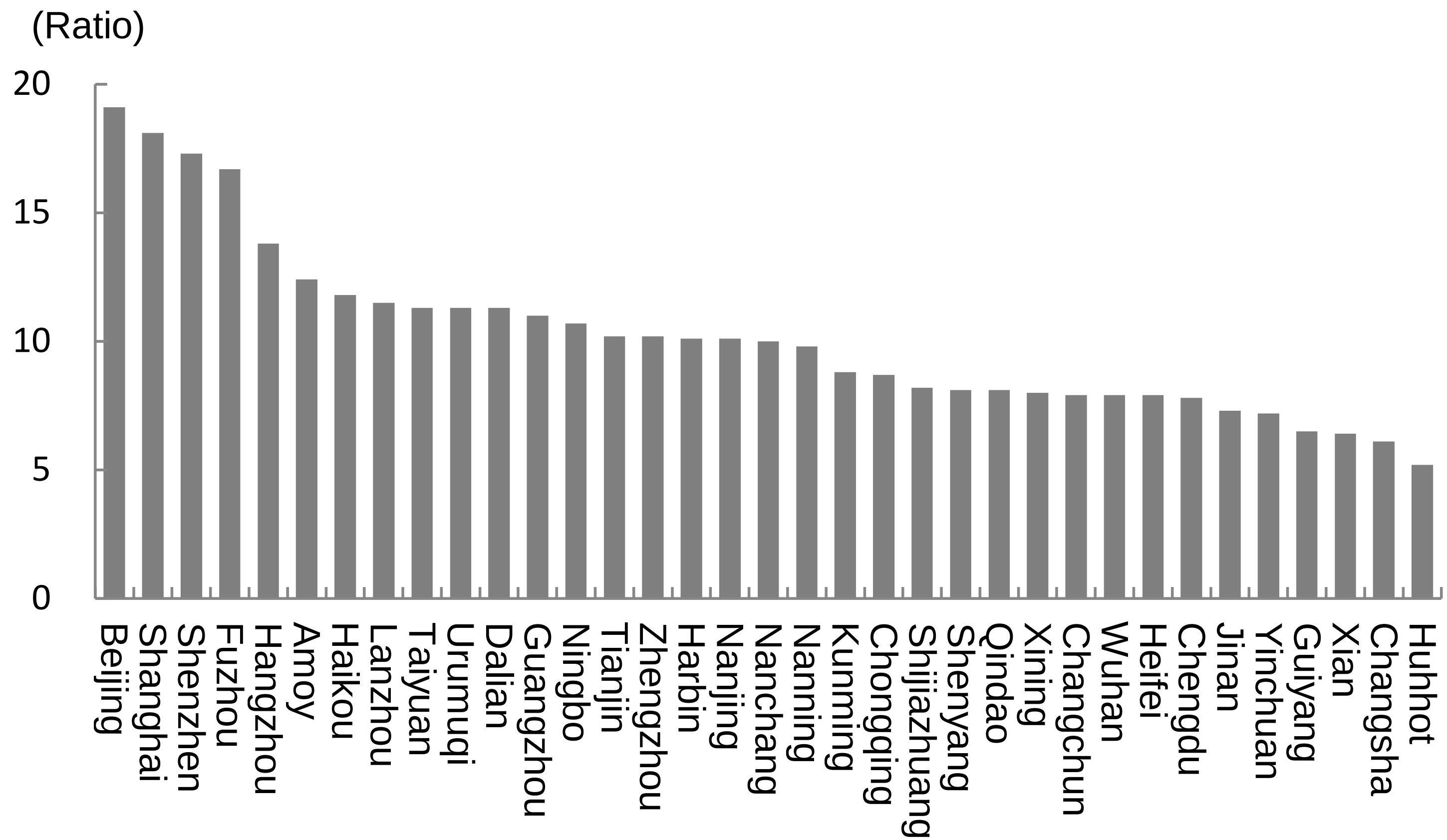

Note: Excluding indemnificatory housing for low-income earners. Average household income is measured on an annual basis.

Source: Compiled by Nomura Institute of Capital Markets Research based on the "Ranking of the House Price-to-Income Ratio in 35 Large and Medium-sized Chinese Cities 2014" of Shanghai E-House China R&D Institute (May 2014)

Rent vs. House Price in Major Chinese Cities (April 2014)

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	(a) Rent (Annualized, Yuan/m^2)	(b) House price (Yuan/m^2)	Rent-to-house price ratio ((a)/(b), %)
Beijing	761.0	37,865	2.0
Shanghai	702.5	29,622	2.4
Shenzhen	631.2	26,494	2.4
Amoy	435.5	21,869	2.0
Sanya	489.4	19,334	2.5
Wenzhou	407.0	19,180	2.1
Guangzhou	494.3	18,400	2.7
Hangzhou	479.2	18,229	2.6
Nanjing	405.2	18,049	2.2
Tianjin	381.5	15,977	2.4

Source: Compiled by Nomura Institute of Capital Markets Research based on date of CityRE data (http://data.cityhouse.cn/).

Prices of Newly Constructed Residential Buildings（year-on-year change）

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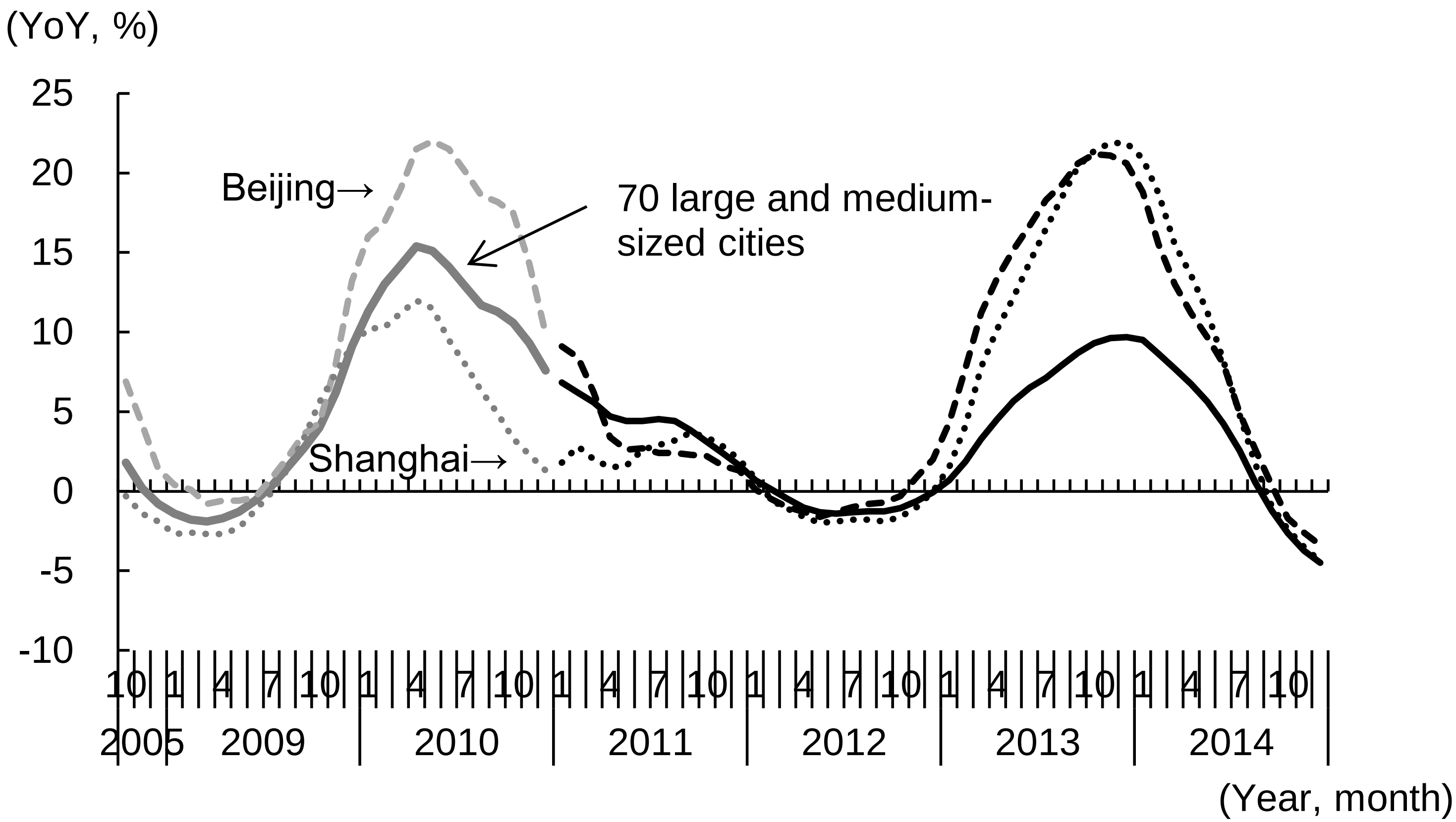

Note: Price Indices of Newly Constructed Residential Buildings until December 2010, and Price Indices of Newly Constructed Commercial Residential Buildings from January 2011. Series labeled 70 large and medium-sized cities is the simple average of the cities concerned.

Source: Compiled by Nomura Institute of Capital Markets Research based on the CEIC Database (Original data from the National Bureau of Statistics of China).

Floor Space Sold of Residential Buildings as a Leading Indicator of Residential Building Prices

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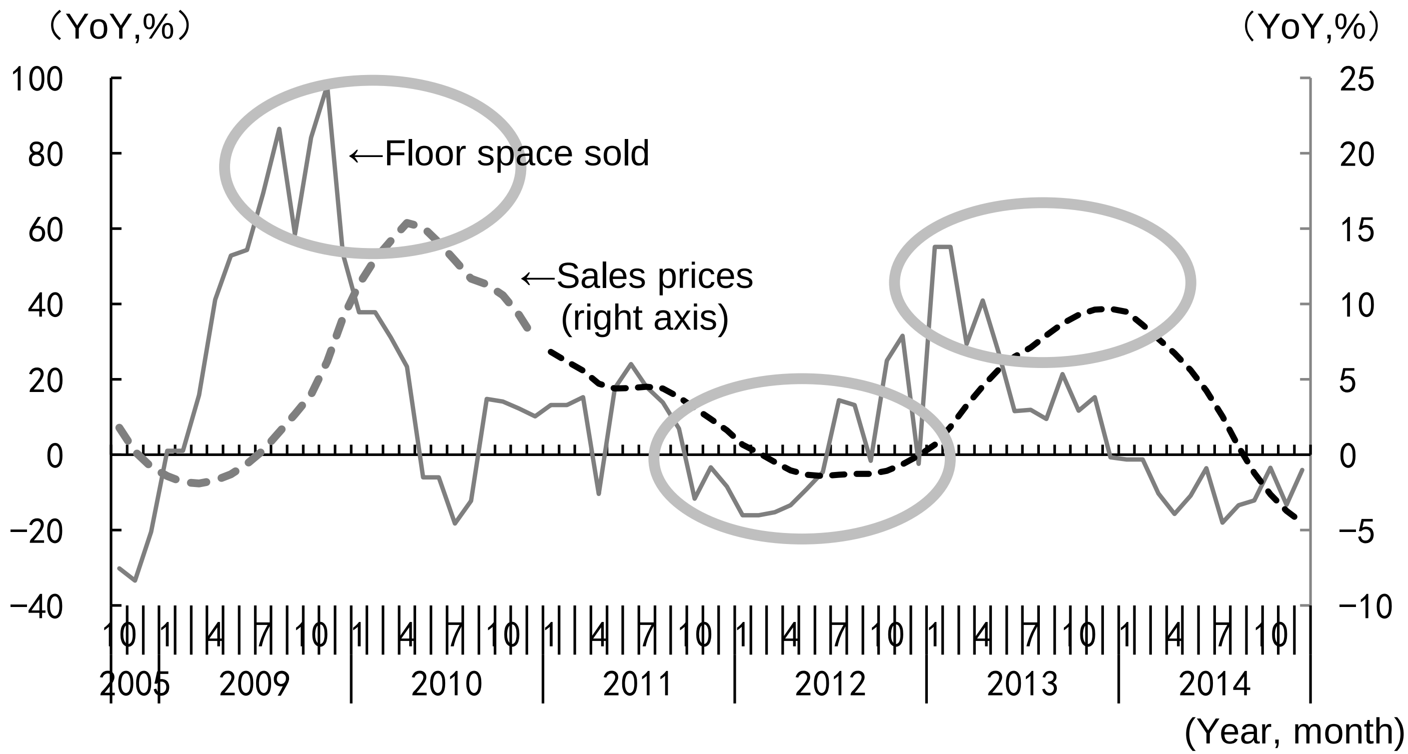

Note: Sales prices are the simple average of 70 large and medium-sized cities, using the Sales Price Indices of Newly Constructed Residential Buildings up to December 2010 and Sales Price Indices of Newly Constructed Commercial Residential Buildings from January 2011. Floor space sold is that of newly constructed commercial residential buildings. As these data are published in aggregate for January and February, the chart shows the same figure for both months.

Source: Compiled by Nomura Institute of Capital Markets Research based on the CEIC Database (Original data from the National Bureau of Statistics of China)

Size of the Real Estate Industry in China (2013)

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	Amount (billion yuan)	Ratio to GDP (%)
Real estate development investment	8,601.3	15.1
Housing	5,895.1	10.4
Real estate sales volume	8,142.9	14.3
Housing	6,769.5	11.9
Real estate loans by financial institutions	14,610.0	25.7
Housing loans to individuals	9,800.0	17.2
Transfers of land	4,125.0	7.3
Tax revenues related to real estate	Approx. 2,000.0	Approx. 3.5
Reference		
GDP	56,884.5	–
Total loans by financial institutions	71,900.0	126.4
Total fiscal revenue (including revenues of government-managed funds)	18,138.2	31.9

Source: Compiled by Nomura Institute of Capital Markets Research based on data from the National Bureau of Statistics of China, the Ministry of Finance, and the People's Bank of China.

The Need to Reduce Jobs, Investment and Debt

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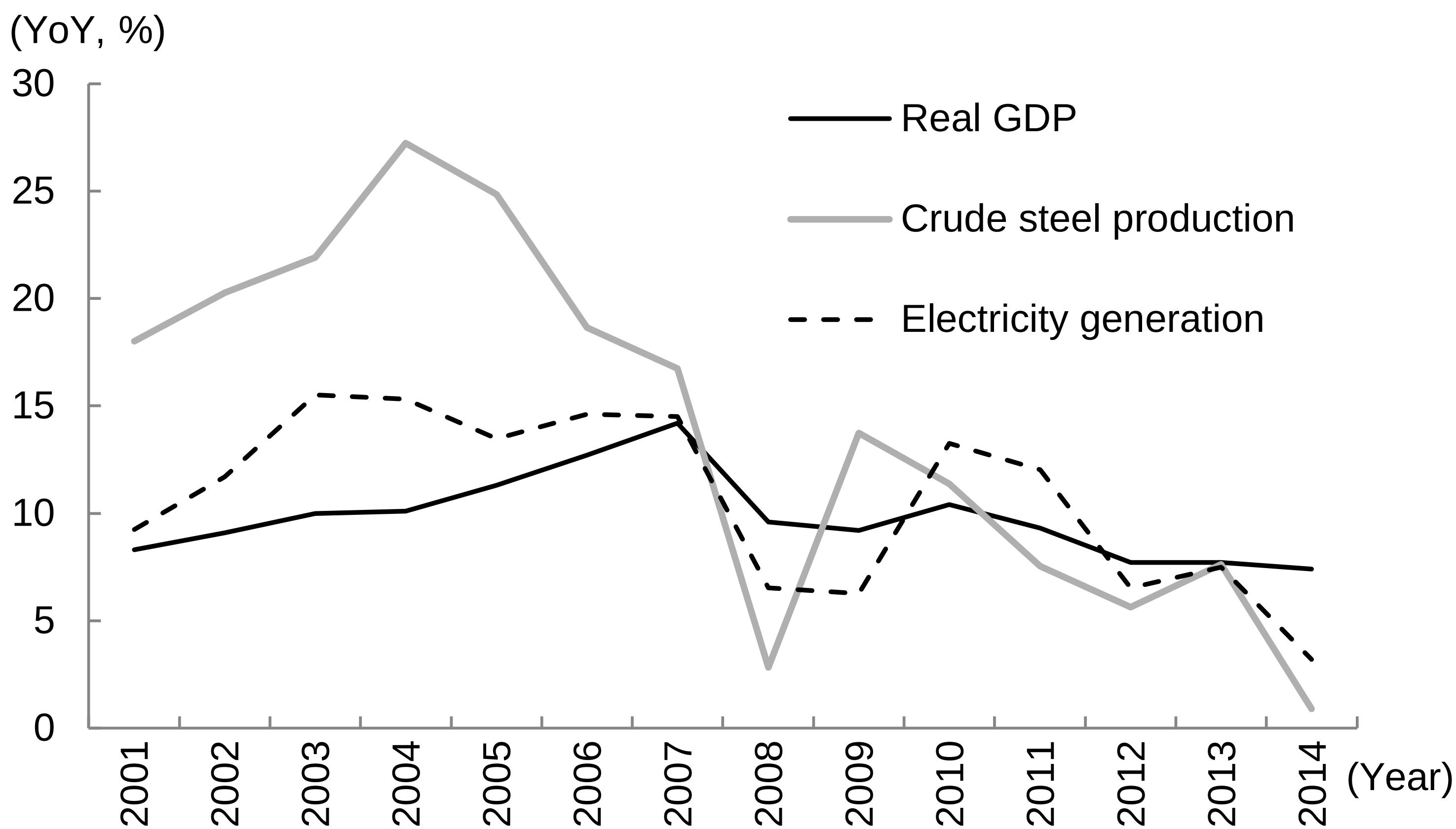
- Reducing jobs
  - The unemployment rate may increase, with negative effect on social stability.

- Reducing investment
  - Plant and equipment investment from the bubble period may become redundant.
  - Excess capacity is already apparent in certain industries, including steel and cement.
  - Should China export its way out of excess capacity, trade fiction may arise.

- Reducing debts
  - To repay debt accumulated during the bubble period, companies may have to reduce new investment.
  - Non-performing loans of banks may increase, leading to credit crunch.

Changes in Real GDP, Crude Steel Production, and Electricity Generation in China



Source: Compiled by Nomura Institute of Capital Markets Research based on data from the National Bureau of Statistics of China.

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Books in English	*Economic Interdependence in the Asia-Pacific Region: Towards a Yen Bloc*, London: Routledge, 1994 *Yen Bloc - Toward Economic Integration in Asia*, Washington: Brookings Institution Press, 2001.
Books in Japanese	*China Facing Two Traps*, Nikkei Publishing Inc., 2013. *China as Number 1*, Toyo-keizai Shimposha, 2009. *Economists Who Changed China*, Toyo-keizai Shimposha, 2007. *Japan-China Relations - A Win-win Game*, Toyo-keizai Shimposha, 2005. *China's Economic Reform - The Last Lap*, Nihon-keizai Shimbunsha, 2005. *Dilemma Facing the Chinese Economy*, Chikuma Shobo, 2005.
Japanese Government Committee Memberships	1996 - 97: Economic Council (Advisory Council to the Prime Minister) 1997 - 99 and 2003 -2010 : Foreign Exchange Committee (MOF) 2004 - 05: Working Group on Globalization, Council on Economic and Fiscal Policy (Cabinet Office)
Homepage	“China in Transition” (since January 2002) http://www.rieti.go.jp/en/china/index.html

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