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Connecting Markets East & West

Comments on "Growth Potential and Monetary Policy Orientation in China's Economic Transition Period"

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Summary and Conclusions

- China's potential growth rate
  - China will continue to enjoy the advantage of being a latecomer, although this advantage is diminishing over time as China's income level approaches that of the developed countries.
  - More attention should be paid to the impact of demographic changes.
  - As a result of the escalating trade friction with the U.S., it may become more and more difficult for China to obtain the latest technologies from abroad, with negative impact on productivity growth.

- The role of monetary policy in maintaining macroeconomic stability
  - Although the Chinese economy is slowing down, the government should be cautious when considering whether to pursue a new round of monetary loosening to stimulate economic growth.
  - There are lessons which China can learn from Japan's experience of coping with the asset bubble in the late 1980s.

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China Shifts from Labor Surplus to Labor Shortage

One-child policy implemented since the early 1980s

Declining fertility and aging population

Working-age population ↓ (Demographic bonus→Demographic onus)

Migration from rural to urban areas

Pool of surplus labor in rural areas drying up

Stage of full employment in the process of economic development (Lewisian turning point)

Labor surplus → Labor shortage

Source: Compiled by Nomura Institute of Capital Markets Research.

Changing Age Composition of China's Population
-- Comparison with Japan

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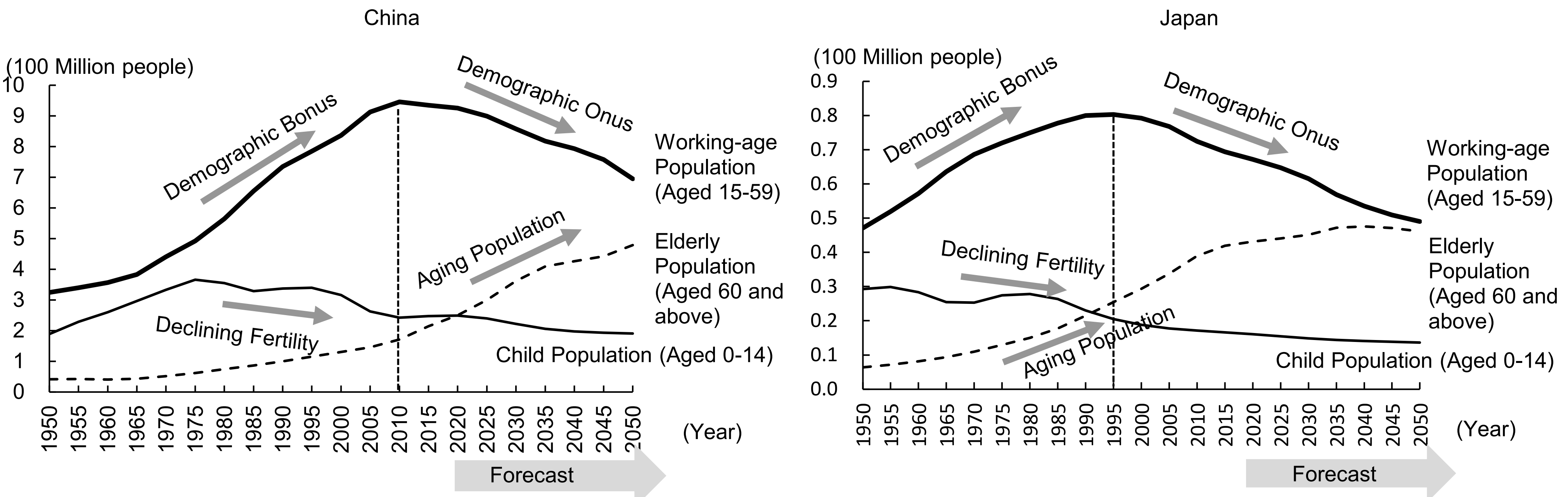

Source: Compiled by Nomura Institute of Capital Markets Research based on United Nations, *World Population prospects: The 2017 Revision*.

Factors Contributing to the Decline in China's Potential Growth Rate

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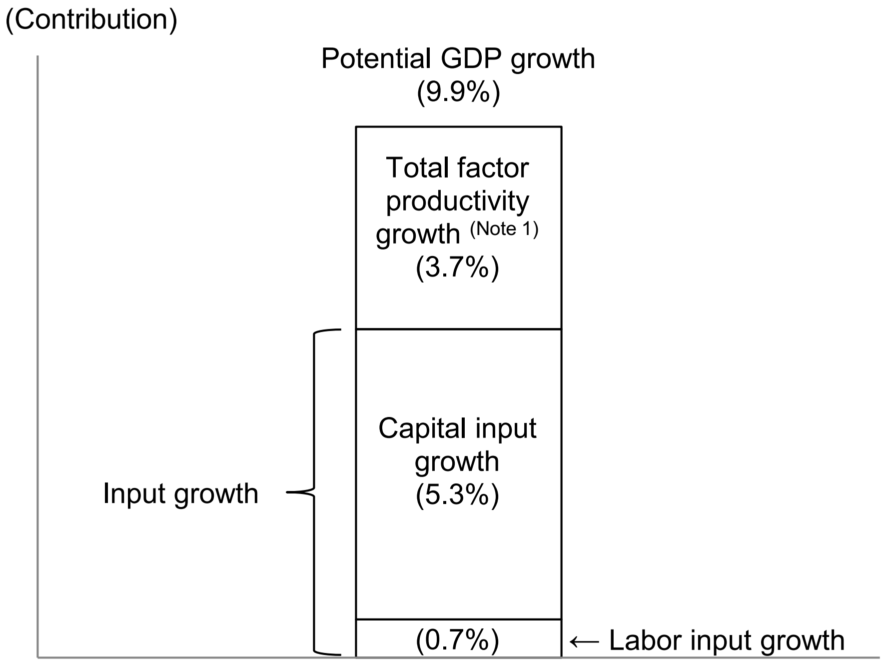
Growth Accounting for China (1995-2011)



Notes: 1) Contribution of total factor productivity growth includes contribution from human capital growth.
2) Components do not add to 9.9% due to rounding.
Source: Compiled by Nomura Institute of Capital Markets Research based on Kuijs, Louis, "China's Economic Growth Pattern and Strategy," Paper prepared for the Nomura Foundation Macro Research Conference on "China's Transition and the Global Economy," November 13, 2012, Tokyo.

- The contribution of labor input is turning negative as working-age population declines and the pool of surplus labor in rural areas dries up.
- The contribution of capital input should be suppressed by a lower savings rate.
- The one-child policy has been relaxed, but the effect is expected to be limited.
- Since the traditional growth pattern based on expanding inputs is no longer sustainable, China needs to shift to a new one based on productivity growth.
- The priority of economic policy has shifted from creating jobs to promoting productivity growth.

Change in China's Economic Growth Rate, Investment (Savings)-to-GDP Ratio and Marginal Capital Coefficient

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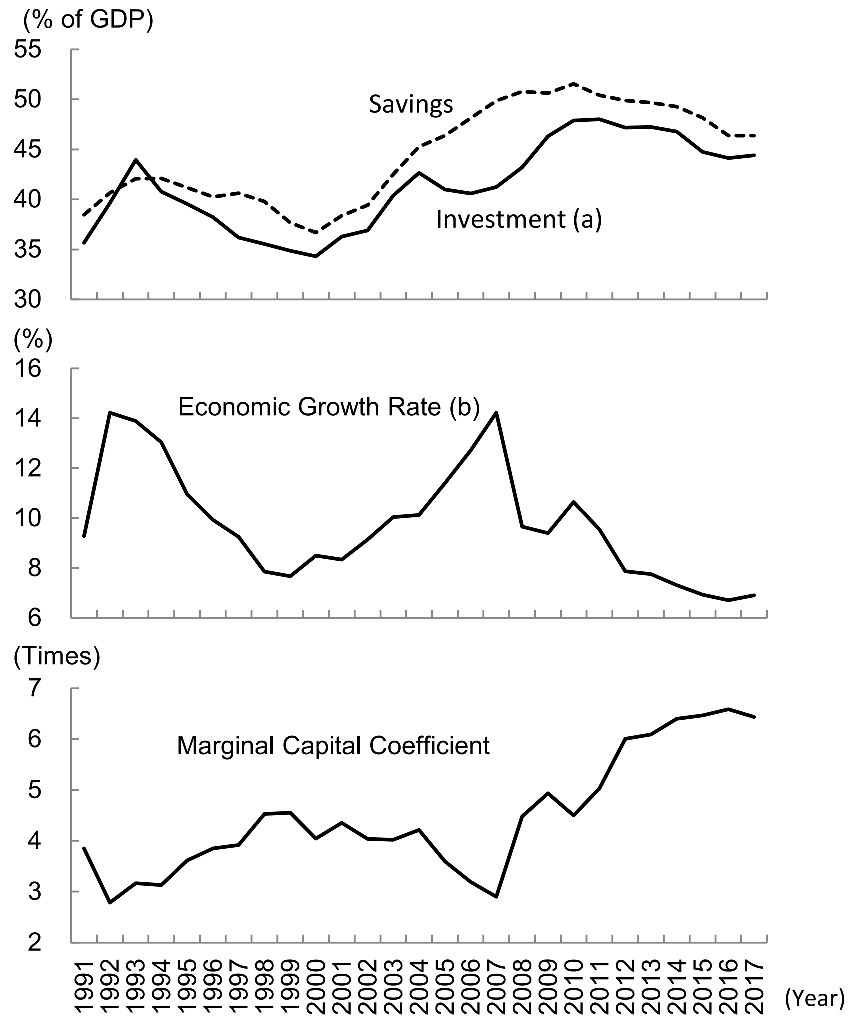

Note: The larger the marginal capital coefficient, the less efficient the investment.
Source: Compiled by Nomura Institute of Capital Markets Research based on the CEIC Database (Original data from the National Bureau of Statistics of China).

Strengthening of U. S. Restrictions on Chinese Companies' Investment

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- The United States has become strongly vigilant against Chinese companies acquiring cutting-edge technologies through direct investments in the United States, including M&As, and the government is strengthening the national security review system concerning investments by foreign companies centering on the Committee on Foreign Investment in the United States (CFIUS).

Acquisition Plans Abandoned Due to Failure to Obtain Approval under the Trump Administration

Target	Would-be acquirer	Country	When killed	Deal size
Qualcomm	Broadcom	Singapore	Mar-2018	$117 billion
Xcerra	Hubei Xinyan Equity Investment Partnership	China	Feb-2018	$580 million
MoneyGram International	Ant Financial Services Group	China	Jan-2018	$1.2 billion
Cowen	China Energy Company Limited	China	Nov-2017	$100 million
Aleris	Zhongwang USA	China	Nov-2017	$1.1 billion
HERE	NavInfo	China	Sep-2017	$330 million
Lattice Semiconductor	Canyon Bridge Capital Partners	China	Sep-2017	$1.3 billion
Global Eagle Entertainment	HNA Group	China	Jul-2017	$416 million
Novatel Wireless	T.C.L. Industries Holdings (Hong Kong)	China	Jun-2017	$50 million
Cree	Infineon Technologies	Germany	Feb-2017	$850 million

Source: Compiled by Nomura Institute of Capital Markets Research based on David McLaughlin and Kristy Westgard, "All about CFIUS, Trump's Watchdog on China Dealmaking: QuickTake," Bloomberg, April 20, 2018.

The Foreign Investment Risk Review Modernization Act

- To strengthen the power of CFIUS, the Foreign Investment Risk Review Modernization Act was signed into law in August 2018.
- This new law is meant to "close gaps" between the transactions that CFIUS is currently able to review and transactions it currently cannot review despite the fact that they raise similar national security concerns.
- Those "gaps" largely pertain to particular Chinese investment trends, including:
  (1) minority investments that might not be controlling but that nonetheless provide access to sensitive information or technology of the target US business,
  (2) the increasing use of Chinese joint ventures into which US-origin technology is transferred,
  (3) concerns that Chinese deals are being structured to circumvent review by CFIUS.
- From now on, China will find it more and more difficult to realize the advantage of being a latecomer by importing technologies from abroad. This may retard the pace of productivity growth.

China Should be Cautious When Considering Whether to Stimulate Economic Growth through Monetary Loosening

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- The job-offers-to-seekers ratio is staying at a historic high level, suggesting that full employment has already been achieved, and there is no need for stimulation.
- Monetary loosening may fuel inflation, which is facing upward pressure resulting from the yuan's recent depreciation and the imposition of additional tariffs on imports from the United States.
- Monetary loosening may put further downward pressure on the yuan and prompt a new round of capital outflow, as happened in 2015-16.
- Monetary loosening may fuel the housing bubble. The ratio of house prices to average household income in major Chinese cities has reached levels higher than that of Tokyo in the late 1980s. At the same time, the annualized rent-to-house price ratio in major cities has fallen to under 2%, much lower than the average mortgage rate, which stands at above 5%.
- Monetary loosening may prompt a further rise in the debt-to-GDP ratio of the private non-financial sector, which has already reached a level that may threaten the stability of the financial system.
- Taken together, the room for monetary loosening is small.

Changes in the Labor Market Suggest a Fall in China's Potential Growth Rate

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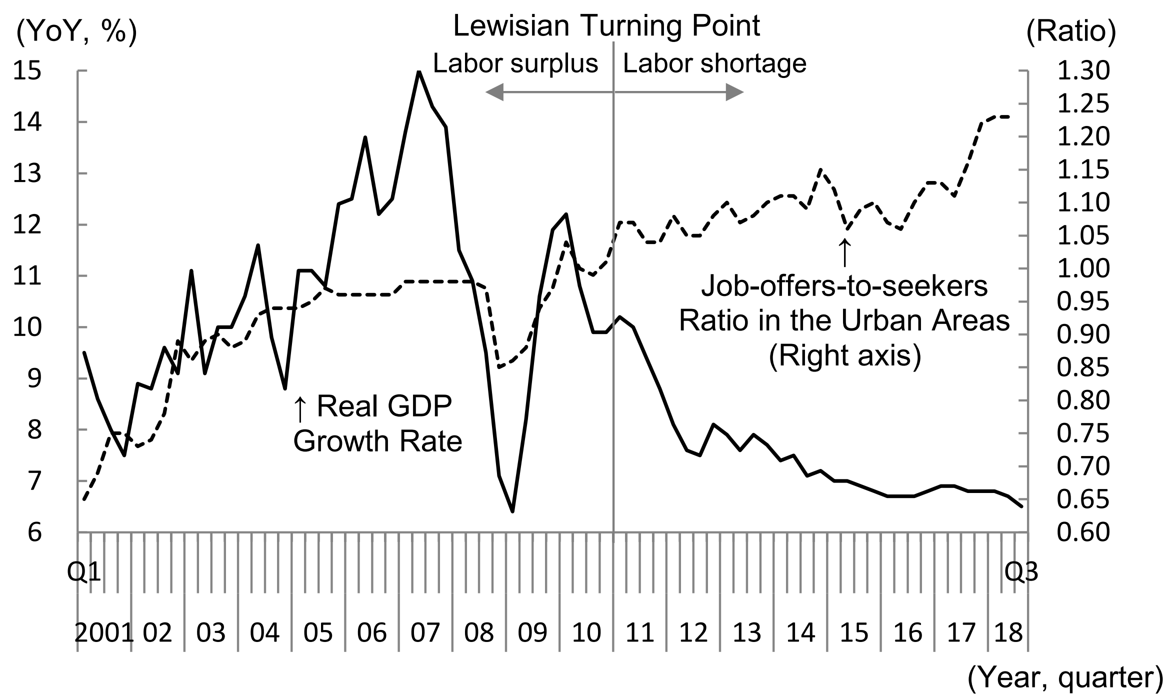
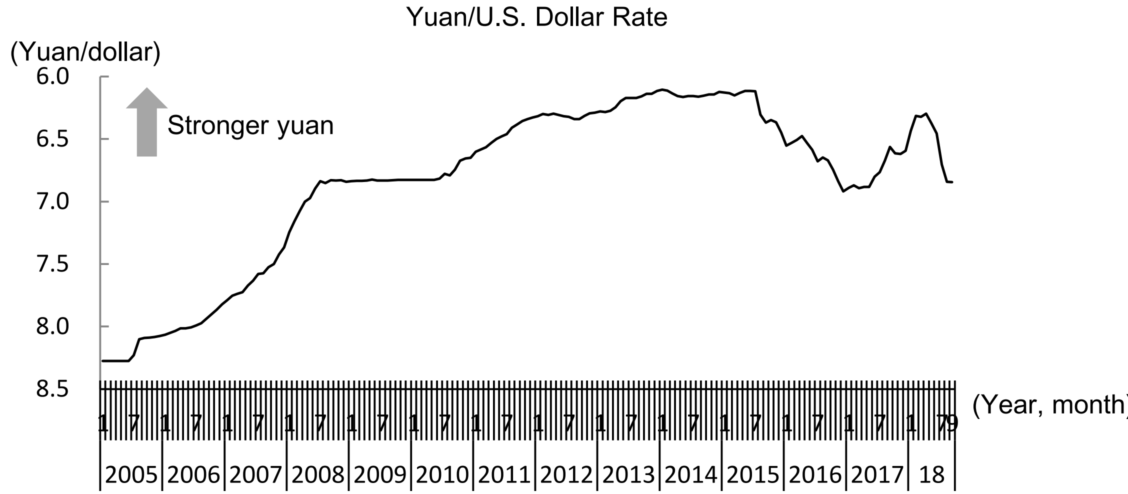
Economic Growth and Job-Offers-to-Seekers Ratio in Urban Areas

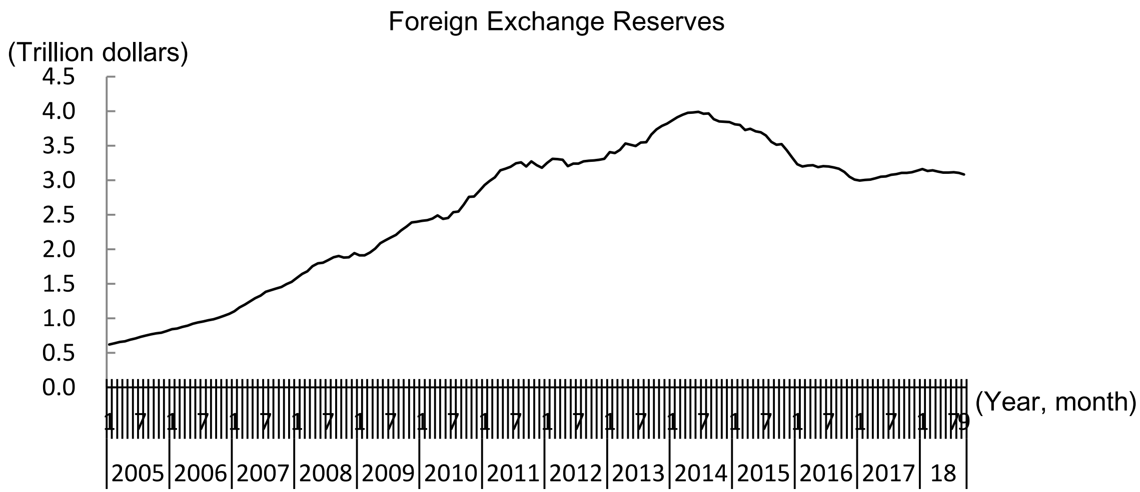


Note: The job offers-to-seekers ratio shown above is calculated by dividing the number of job offers by that of job seekers registered in public employment services organizations in approximately 100 cities in China.
Source: Compiled by Nomura Institute of Capital Markets Research based on data provided 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 since 2011, suggesting that the economy may have arrived at the Lewisian turning point where surplus labor in the rural area has dried up.
- Coupled with the decline in working-age population, the potential growth rate has fallen sharply.

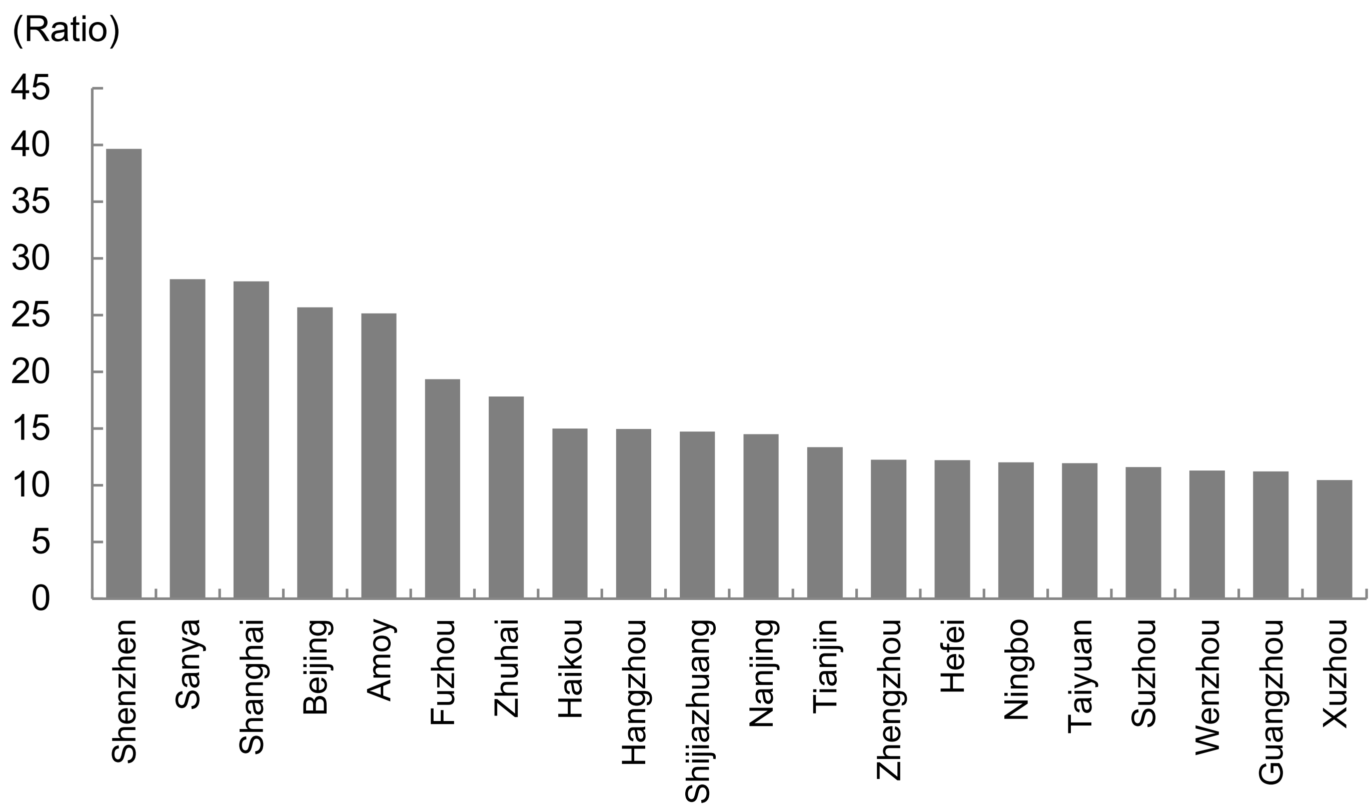
Changes in the Yuan-dollar Rate and China's Foreign Exchange Reserves





Source: Compiled by Nomura Institute of Capital Markets Research based on the CEIC Database (Original data from the State Administration of Foreign Exchange and the People's Bank of China).

Ratio of House Prices to Average Household Income in Major Chinese Cities (2017)



Source: Compiled by Nomura Institute of Capital Markets Research based on Zhongfang Zhiku (China Real Estate Think Tank) “House Price-to-Income Ratio in 35 Major Cities” *from Zhongguo Fangdichan Bao (China Real Estate News)*, March 11, 2018.

Rent vs. House Price in Major Chinese Cities (August 2018)

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	(a) Rent (Annualized, Yuan/m^2)	(b) House Price (Yuan/m^2)	Rent-to-house Price Ratio ((a)/(b), %)
Beijing	1138.4	63,441	1.8
Guangzhou	631.2	33,551	1.9
Shanghai	904.1	53,848	1.7
Shenzhen	959.4	58,575	1.6
Hangzhou	673.7	31,883	2.1
Nanjing	553.4	29,234	1.9
Tianjin	424.4	25,104	1.7

Source: Compiled by Nomura Institute of Capital Markets Research based on data of China Real Estate Industry Association (http://www.creprice.cn/).

Debt-to-GDP Ratio of China's Private Non-financial Sector and Deviation from its Trend Line - Comparison with Japan, Thailand, and Spain -

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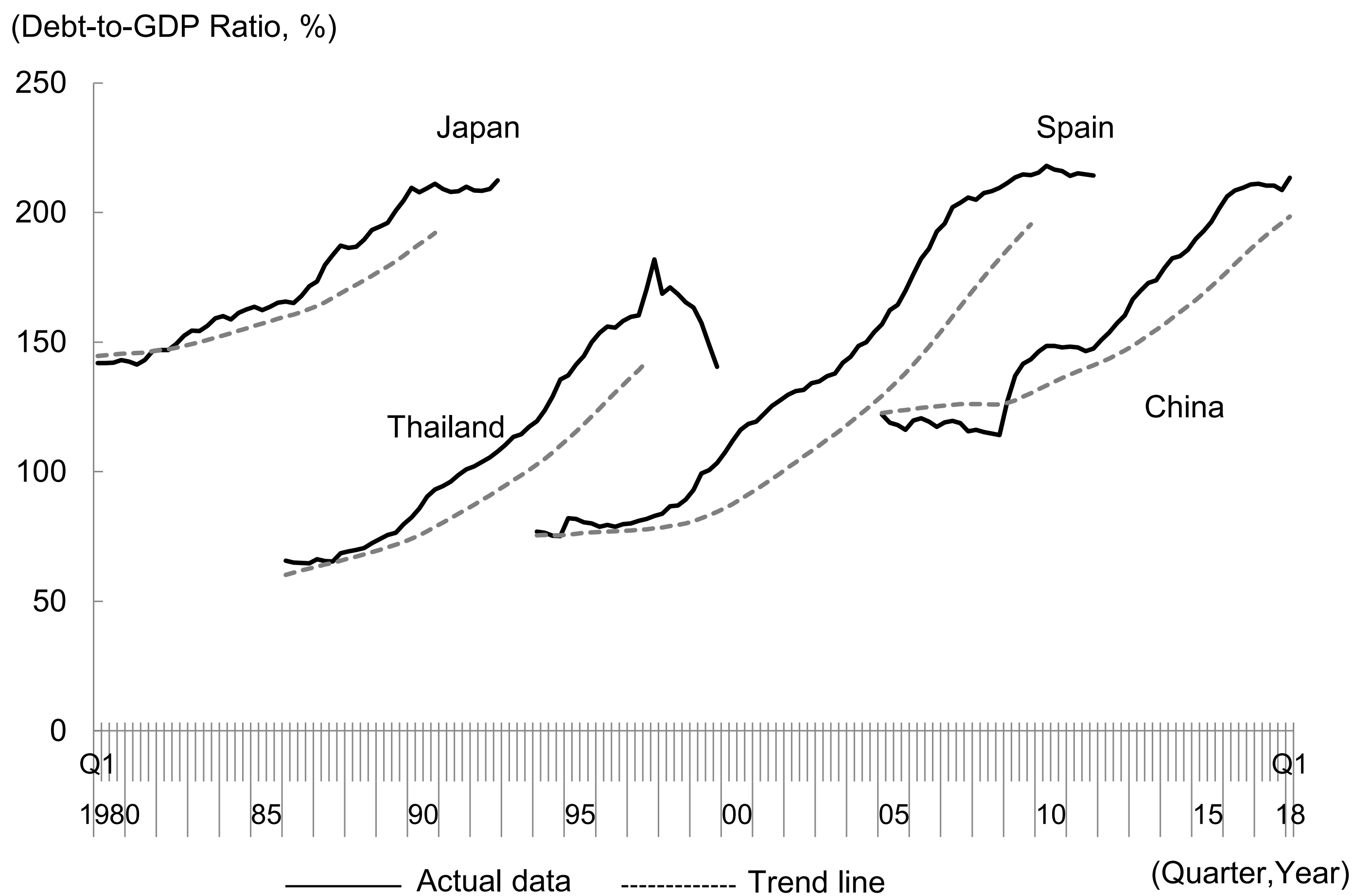

Source: Compiled by Nomura Institute of Capital Markets Research based on BIS data.

Lessons from Japan's Experience during the Bubble Period (Late 1980s)

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- The authorities should monitor potential risks that may destabilize the economy and take preventive measures.
- In addition to the inflation rate, asset prices (real estate prices in particular) should also be taken into consideration when formulating monetary policy.
- To prevent the expansion of an asset bubble, the monetary authorities should pay attention not only to the rate of growth of total credit but also to changes in the structure of loans, particularly the share of loans to the real estate sector.
- Foreign exchange interventions to stabilize the exchange rate have strong implications for the money supply and weaken the effectiveness of monetary policy. China should consider moving faster to a freely floating exchange rate regime.
- In addition to changes in the actual GDP growth rate, changes in the potential GDP growth rate should also be monitored closely. A decline in the potential growth rate should be dealt with by supply-side reform, rather than by monetary loosening.

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Books in Japanese	*The New Normal of the Chinese Economy,* Nikkei Publishing Inc. 2015. *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.
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