



A Look at China’s New Political and Economic Trends Under the New Normal

A Perspective From the 2015 Two Sessions

March, 2015

Executive Summary

The 2015 Two Sessions¹ analyze trends and features of China's economy in order to put forward policies and guidelines under the New Normal economic policy. The following three points summarize our understanding of the economic policies put forward at the Two Sessions.

- ✓ **The Chinese economy will continue to slow down under increased pressure from economic adjustment and proactive reform in 2015:** Due to the impacts of the so-called “Overlap of the Three Distinct Periods” of China's economic reform, this kind of downward pressure cannot be avoided. In 2015 business operations for enterprises are expected to be more difficult.
- ✓ **The economy isn't declining across the board – some industries will benefit from the New Normal:** Under the New Normal, the Chinese economy's growth is slowing from double-digit to single-digit growth, still around 7%. At the same time, the Chinese economy is developing from a primary sector economy to a diverse economy with more value added. Although operations of secondary industries, such as traditional manufacturing, are facing difficulty, industries like high-end manufacturing, the service industry, and high-tech industries will most likely experience an upward trend.
- ✓ **The Chinese government will continue to streamline administration and delegate powers to lower levels of government:** The Chinese government is using reform measures to stimulate private capital as well as free up the marketplace. At the same time, the Chinese government will increasingly invest in projects in order to contribute to sustainable economic growth.

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In conclusion, the US cotton industry should manage their expectations of the Chinese economy and adapt to the New Normal. It will be key to understand how the New Normal will affect the various sectors of the economy in order to identify areas for growth. The US cotton industry should explore opportunities according to industrial, sectoral, and regional priorities which the Chinese government plans to support. China will continue to be an important marketplace for the growth of the US cotton industry.

¹ The 2015 Two Sessions refers to the Third Session of the Twelfth National People’s Congress and the Third Session of the Twelfth National Committee of the Chinese People’s Political Consultative Conference.



Features of the Chinese Economy under the New Normal

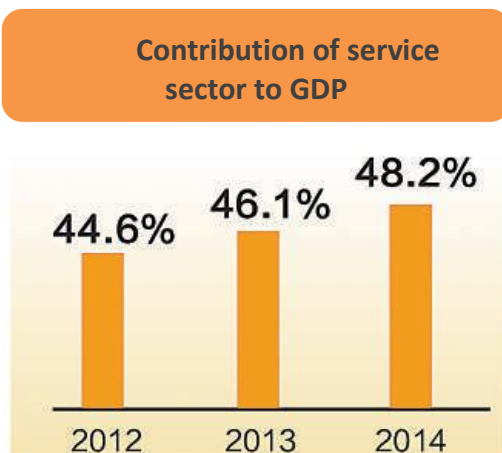
Since 2014, the Chinese economy has stayed in single-digit growth, focusing more on quality over quantity.

- **Negative impact of the Chinese economic shift:** China's economy is experiencing an overlap of three distinct economic periods - these three periods refer to:

1. The economic growth shift from double-digit to single-digit growth
2. The period in which the Chinese economy is developing from a primary sector economy to a diverse economy with more value added
3. The period of adjustment following the massive economic stimulus of 2008. The economy is also affected by environmental and natural resource constraints.



These factors resulted in an overcapacity of manufacturing capabilities and an overall increase in manufacturing costs. Due to a weakening of the traditional driving forces of the economy, mostly due to a slowdown in the real estate industry, China's major economic indices for the second half of 2014, including GDP, PMI, PPI and foreign trade witnessed an overall decline. These trends made the government's goal of stabilizing the economy and business operations more difficult. Under the New Normal, the Chinese people's attention has shifted toward environmental protection and social welfare. These focuses have become the foundation of government policy.



- **Positive impact of the Chinese economic shift:** The Chinese economy in 2014 operated within the reasonable economic growth range predicted by the government and produced 13.22 million new urban jobs – above the government target of 10 million. Performance indices remained stable and the structure of the economy improved. The contribution of the service industry to GDP increased to 48.2%. Domestic consumption's contribution to GDP increased to 51.2%, an increase of 3% year on year. Online retail value in China for the whole year was RMB 2.79 trillion, an increase of 49.7% year on year.

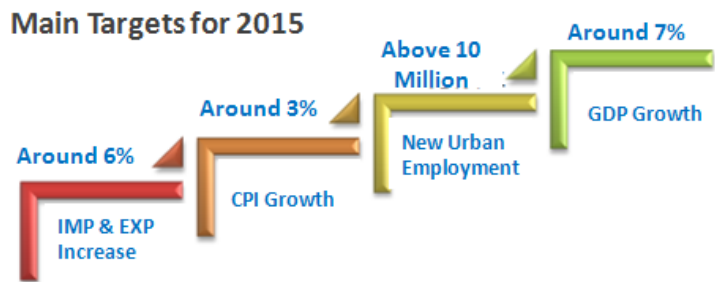


Trends of the Chinese Economy and Policy under the New Normal

⇒ Trends of the Chinese Economy Under the New Normal

1. The Government Work Report indicates that based on the three main drivers affecting China's economic growth (i.e. investment, export and consumption), investment growth is sluggish; the number of new areas for strong consumer activity is limited; and there is no sign of the international market making a significant recovery of demand for exporting. This has made maintaining stable growth more difficult and a risk to the economy still exists in some areas.

In 2015 the Chinese economy's growth rate will continue to decline, and we expect that it will decline year by year at a speed of 0.5%. As the Chinese government set the GDP growth target at around 7% for 2015, we expect that the economic situation in 2015 will be



much more difficult than that of the previous year. It is our expectation that the Chinese GDP growth rate for 2016 might be lowered to between 6 - 6.5%, while the average GDP growth rate might stay at around 6.5% in the next five years.

2. Traditional economic driving forces such as investment in labor, natural resources and capital are weakening, while the economy cannot yet rely wholly on innovation and domestic consumption. Economic growth in 2015 will rely on a combination of both the old model (labor, capital) and the new one (innovation, domestic consumption). The economy will eventually shift more toward the new model step by step.

3. China's period of enjoying high speed growth in imports and exports is over. Between 2002 and 2011, the average growth rate of imports and exports was 23%, while the rate for 2014 was 6%. The growth rate of imports and exports for 2015 is set at around 6%. We expect that Chinese imports and exports will maintain an average growth rate of between 5-10% for the long term. Domestic consumption will play an increasingly important role in the Chinese economy.

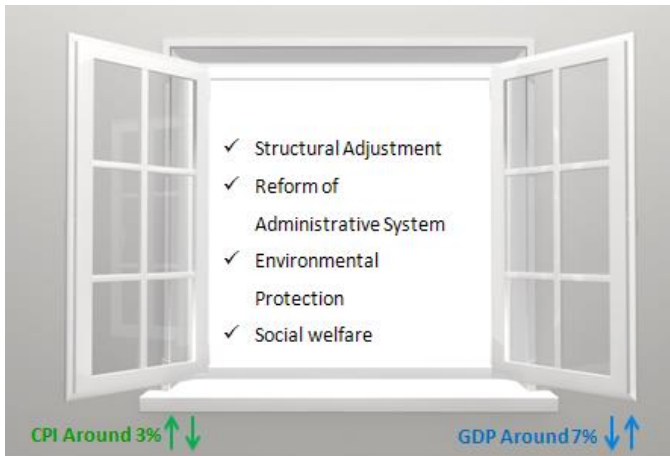
| Three drivers of Chinese economic growth | Contribution to Chinese economic growth |
|--|---|
| Domestic consumption | 51.20% |
| Investment | 48.60% |
| Exports | 0.20% |

4. The growth rate for investment, particularly in the manufacturing industry, is declining significantly, witnessing a fall from 30% to 15%. Investment between 2015-2016 is expected to decline to around 13% and continue to fall. The growth rate in investment and infrastructure will also decline from 25% to 13%. In the meantime the service industry, especially the productive

service industry which supports the manufacturing industry, such as designing firm or consulting firm, will experience rapid growth.

⇒ Policy Trends Under the New Normal

1. **Growth Still Key:** The government work report set the overall targets for 2015. They are:



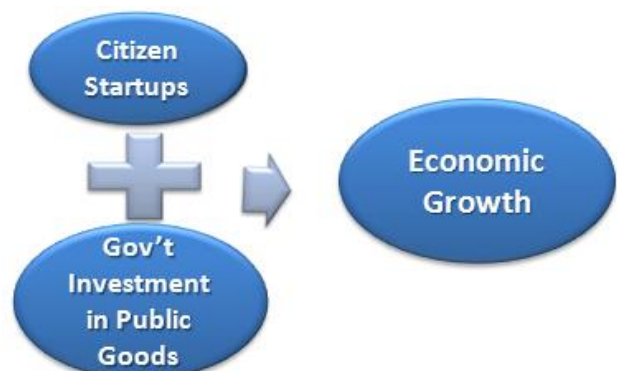
Actively adapting to and guiding the New Normal in China's economic development. adhering to the general principle of seeking progress while keeping performance stable; ensuring that the economy performs within a reasonable economic growth range; focusing on strengthening the quality and benefits of economic development; giving greater priority to transforming the growth model and making structural

adjustments; tackling tough problems involving reform head on; pursuing innovation-driven development; strengthening risk prevention and control; and strengthening safeguards for people's standard of living.

The Chinese government's priority is to maintain balanced economic growth. The goal is to keep the economy operating within a reasonable growth range. The Chinese government plans to achieve this goal through measures to maintain coherency and consistency for the government's macroeconomic policy, to maintain a proper balance between maintaining steady economy growth and making industry restructuring, as well as to identify and develop new drivers of economy growth. In the meantime, China's policy trends will be centered on both increasing economic quality and efficiency. The government's goal is to maintain high single digit economic growth and enhance the quality of Chinese economic output .

2. **Explore New Growth Drivers By**

Strengthening Reforms: Due to insufficient forces driving traditional economic growth, the Chinese government will continue to explore new economic drivers by strengthening reforms. Specific measures include: Streamlining administration and delegating more powers to lower level governments and to society in general while improving regulation; reforming the investment and financing system; accelerating price reform; reforming the fiscal and taxation systems; reforming state owned enterprises; and making more effective use of foreign capital.



strengthening risk prevention and control; and strengthening safeguards for people's standard of living.



The purpose of these reforms is to further free up the market and create more room for economic growth. The Chinese government will encourage the public to start their own businesses and to innovate. It is hoped that this will not only create more jobs but also promote investment. At the same time the Chinese government will try to stabilize the economy by increasing investment in public projects. The aim of this increased public spending is to create two engines driving economic growth - public startups and government investment in public projects.

As well as freeing up the market for domestic companies, the Chinese government is also developing the 'Foreign Investment Law' and relaxing market entry restrictions to foreign investment to China.

During the Two Sessions, the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM) published the 2015 Revision of the 'Catalogue for the Guidance of Foreign Investment Industries'. The Revision loosens the restriction on the service industry and the general manufacturing industry by reducing restricted items from 79 items to 38.

Restrictions over the proportion of foreign equity were eased, in addition to loosening restricted investment items on joint ventures and cooperative enterprises from 43, which was the case in the 2011 version of the Catalogue, to 15. In principle, there will be no more restrictions over the proportion of foreign equity for non-forbidden/restricted catalogues. Specific requirements for proportion of foreign equity are now clearly stated. At the same time, the Chinese government continues to exercise stronger oversight and enforcement on production and post-production, especially in sectors such as environmental protection and food safety.

- Promote Emerging Consumption Areas:** The Chinese government will promote six new areas in consumption trends, including IT products and services, tourism, education/culture/sports, environmentally friendly products and real estate. The Chinese government in particular will encourage people to improve their living conditions by issuing real estate policies for different cities on a case by case basis in order to maintain a healthy and sustainable development of the real estate market and lay the foundation for economic improvement under the New Normal.
- Upgrade the Manufacturing Industry Through "Made in China 2025" and "Internet Plus" Strategy:** The Chinese government will absorb overcapacity and use its Internet Plus strategy to upgrade the Chinese manufacturing industry. It will also, through the "Made in China 2025" Strategy², upgrade the traditional manufacturing industries to a diverse manufacturing industry that involves more value added, smart and green technologies.

² The "Made in China 2025 Strategy" - China will use a span of three decades to shift from a big manufacturing country to an advanced manufacturing country. The Strategy is the guideline for the next ten years and is also a roadmap and timeframe. The main points in the guideline include focusing on growth driven by innovation, making quality the top priority, green development, structural improvement and improving the skills and knowledge of the Chinese people. China hopes to enter the second tier of the global manufacturing matrix after the first ten years of effort.



5. **Push Regional Economic Synergistic Development:** China will continue to focus on the synergetic development between different regions, especially to promote the initiatives like the “One Road One Belt”, the Yangtze River Economic Belt, and the Beijing-Tianjin-Hebei Integration. They will also focus on promoting expansion of market demand and efficient allocation of resources between regions.
6. **Promote Outbound Investment and Imports/ Exports through the New “Go Abroad” Strategy:** The Chinese government will accelerate the implementation of the Free Trade Zone (FTZ) strategy and advance multilateral and bilateral trade negotiations in order to push China's foreign trade. The Chinese government seeks to: Sign free trade agreement with the Republic of S. Korea and Australia; step up negotiations on the China-Japan-RoK Free Trade Agreement; make progress in negotiations on free trade zones with the Gulf Cooperation Council and Israel respectively; endeavor to complete negotiations on the upgrade of the China-ASEAN FTZ; establish the Regional Comprehensive Economic Partnership and contribute to the establishment of the Asia-Pacific FTZ.

The Chinese government will continue negotiations on the Bilateral Investment Treaty with the United States and the investment agreement with the European Union. At the same time China is working with over fifty nations who will be involved with the “One Road One Belt” initiative in order to discuss and implement mutually beneficial strategies. China aims to boost infrastructure construction in areas affected by the “One Road One Belt” initiative to enlarge the overseas market for China.

7. **Stricter Environmental Law Enforcement:** In response to the strong reaction at home and abroad, the Chinese government will implement a stricter environmental policy. It will emphasize stringent implementation of the newly issued Environmental Law. During the Two Sessions, Premier Li Keqiang stated that “Environmental Law enforcement is not a cotton swab but a powerful right hook”. The Chinese government said that businesses producing illegal discharge will be accountable in accordance with the law regardless who they are. The Chinese government is sending a message, stating that ‘the price for violating our environment will be extreme’.
8. **Continue Anti-corruption Campaign to Gain Public Trust:** The Chinese government will continue to promote the Anti-corruption Campaign and improve people’s livelihood to further gain the Chinese people’s trust, so that they can continue to support the smooth implementation of the government's reform programs.

The Possible Impacts on US Cotton

- In 2015, China’s economy will continue to experience downward pressure. Chinese traditional industries, particularly traditional manufacturing, will bear the brunt of the oncoming economic slowdown. The textile industry, as one of China’s typical traditional manufacturers will continue



to face such challenges as decreasing orders, increasing costs and declining profits. Most domestic mills may cut their demand for cotton in 2015 due to the continuing weakness in domestic demand and exportation for textile products. Meanwhile both increasing utilization of artificial fiber in textile products and record-high national cotton reserves also contribute to the decrease in demand for cotton in 2015. The shrinking demand for cotton will result in a decrease in domestic cotton planting area in 2015 as well.

- However, both the Chinese government and textile industry are seeking to stem the economic downward trend. The government has been making efforts to promote upgrades in domestic industries and economic restructuring. The domestic textile industry is also trying to mitigate the influence of the economic downturn through upgrading their products and producing high quality and high value-added products. However domestic cotton does not meet mill's quality requirements, causing an increasing number of Chinese mills to prefer US and Australian cotton with high quality. In particular during this year with the Chinese government's strictly controlled import quotas, those mills are very interested in purchasing high quality US cotton over low quality Indian cotton. As such, US cotton is projected to gain an increased market share in 2015.
- The Chinese government will continue its target price subsidy program in Xinjiang and inland cotton planting provinces so as to prevent cotton farmers from losing too much money.