

Quarterly Economic Brief

Macroeconomic Analysis for First Quarter 2013

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and
Zhang Chi (www.china-review.com)

Beijing, 18 April 2013

Quarterly Economic Brief is a regular update on major macroeconomic developments in China. Its aim is to provide academics, business leaders and policy makers with a comprehensive and concise analysis of the most important economic developments and policy changes. The principal author is Professor Zhang Shuguang of the Unirule Institute of Economics, Beijing, a leading expert on the Chinese economy and economic policy. *Quarterly Economic Brief* is published in cooperation between the Unirule Institute of Economics and the Asia Research Centre at Copenhagen Business School.



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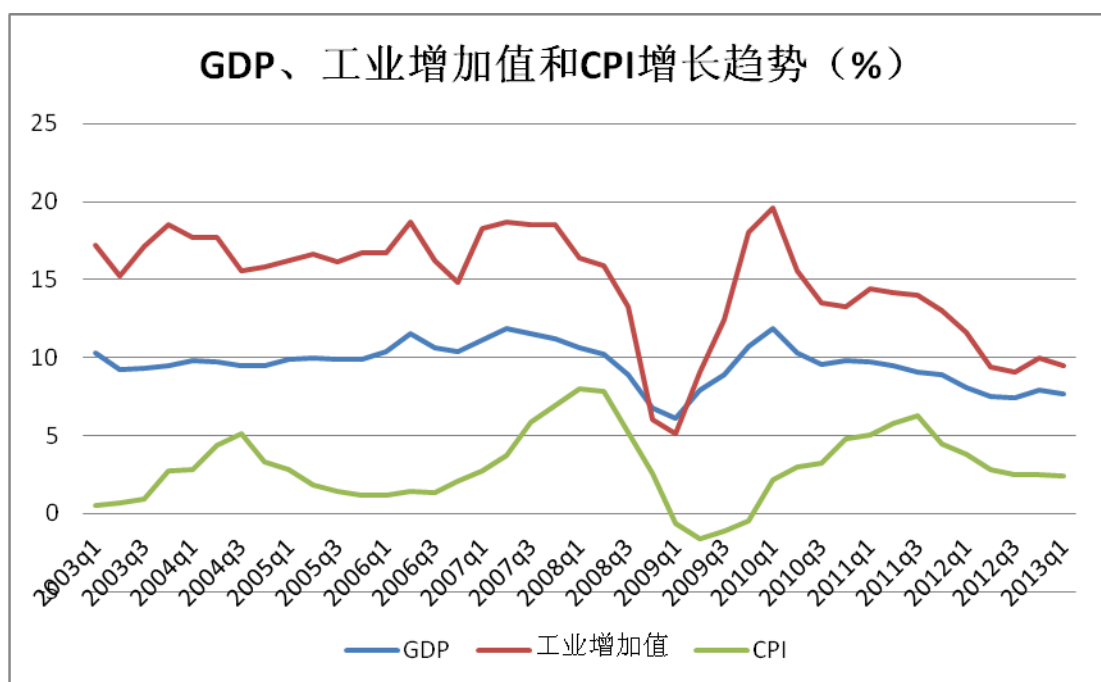
Abstract

In the first quarter, China's GDP grew 7.7%, industrial value added rose 9.5% and the CPI climbed 2.4%, lower than the same period last year and last quarter, as opposed to general predictions. But the decelerating growth presents a good opportunity for economic restructuring and transformation. The balance of broad money (M2) exceeded RMB 100 trillion. However, we cannot determine whether the issue was excessive simply by observing the operation of monetary policy. Instead, we should further check the mechanism adopted by the government for money creation. The on-going gaming in China's property market indicates that policy is defective, and is related to the special money creation mechanism. Finally, the Ministry of Railways was dismantled and the China Railway Corporation created to separate the functions of the government from those of the enterprise, although they are still economically bonded. By settling the ministry's debts, property rights and operating responsibilities should be clearly defined, leading to further railway reform.

1. Macroeconomic Dynamics

In the first quarter, China's GDP grew 7.7%, industrial value added rose 9.5% and the CPI climbed 2.4%, lower than the same period last year and last quarter. Evidently, the economy didn't bounce as expected by most Chinese and foreign institutions and professionals, but it matched what we had predicted. This shows that the Chinese economy is still undergoing restructuring and transformation. From our perspective, it is simply a normal manifestation of macroeconomic operation.

Figure 1: GDP, Industrial Value Added and CPI Growth Trends (in %)



Note: 工业增加值: Industrial value added

Moreover, although the growth rate continued to decline, the industrial structure was further adjusted. The growth rate of primary and secondary industries dramatically slowed, while tertiary industry accelerated at a rate 0.8 percentage points higher than last year and 1.1 percentage points higher than that of secondary industry during the same period.

The lack of economic impetus was also reflected by power consumption, railroad freight and employment statistics. Total power consumption grew 5.5% in January–February and 2% in March, which represented the second lowest level in 46 months (since June of 2009) and foretold a possible major setback for the manufacturing sector. In the first quarter, China's railroad freight totalled 99.074 million tons, down 0.78% year-on-year. Cargo freight dropped 0.69% and coal freight fell 1.6%. In March, railroad freight decreased 2.2%. Both the supply of and demand for workers declined in the first quarter. In terms of employment, recruitment has become a regular problem for some enterprises, especially

export-oriented enterprises. The CPI trend was partly a result of this.

Investment, especially investment in property, and exports remained the two major stimulants in the quarter. But the situation was not that positive. As a result of the five measures unveiled by the State Council to regulate the property market and tighten control, the market became quite dynamic and the sales and profits of property developers rose rapidly. Moreover, due to the significant increase in money supply and credit availability, many developers raised their development, sales and performance targets. However, investment-driven economic growth has been trouble for China. Added problems will not only hamper China's economic restructuring and transformation but also reduce the potential for future economic growth. In addition, the bubbling property market is a sword hanging over the Chinese economy. As regulatory policies are tightened, developers may have to bid farewell to the good times, although not in the near future. Enterprises will be more cautious investing, and the investment engine, which has been running on overdrive, may slow down.

Exports registered abnormal development. In January–February, exports grew 23.6% and imports 5% (-15.2% in February). There was a trade surplus of US\$ 44.15 billion in contrast with a deficit of US\$ 4.78 billion in the same period last year. In March, imports outperformed exports, resulting in a deficit of US\$ 880 million. Consequently, people cast doubt on import/export statistics. In particular, the disparity between export volume and value kept widening, with the value increasing at a significantly higher rate than volume. The fraudulent declaration of export prices was quite serious. This might be related to fraud in export tax rebates or efforts to reach export targets in some areas. Moreover, China's exports experienced an increase in trade friction and a worsening trade environment. Last year, 22 countries launched 77 trade remedy investigations involving US\$ 27.7 billion against China, representing a year-on-year increase of 11.6% and 369% respectively. While becoming a trade powerhouse, China has been subject to the largest number of trade remedy investigations, so we should not be too sanguine about trade growth this year.

The slowing growth in consumption (down 2.4 percentage points year-on-year) merits attention. The booming property market in the first quarter spurred auto, household appliance and other related sectors. However, the eight regulatory measures adopted by the central government last year cooled the luxury reception and consumption market, affecting liquor and luxury catering businesses. Some businesses that previously catered to luxury consumption reversed from making profit to incurring losses. Accordingly, the liquor business was no longer booming. The growth rate of catering enterprises above a designated size fell 4.8 percentage points year-on-year. As more attention is paid to food safety, consumption in some trades will be affected. We can anticipate that the outbreak and expansion of the N7N9 avian influenza will cause a slide in the production and consumption of poultry and eggs.

2. Currency over-issue and monetary policy

At the end of March, the balance of broad money (M2) reached RMB 103.61 trillion, up 15.7% over the same period last year, resulting in accelerating growth in money stock. The balance of M2 was RMB 13 trillion in 2000, which rose to nearly RMB 50 trillion in 2008 and RMB 97.4 trillion last year, and is the world's largest. This year, M2 surpassed RMB 100 trillion, representing a six-fold increase in ten years. At the end of last year, the M2/GDP ratio stood at 188% and could possibly rise to 200% by the end of this year. In the first quarter, total social financing amounted to RMB 6.16 trillion, up more than RMB 2.27 trillion year-on-year. RMB bank loans increased RMB 2.76 trillion (RMB 1.06 trillion in March), a year-on-year increase of RMB 294.9 billion. This aroused much debate over currency over-issue and the operation of monetary policy.

Many people deny a currency over-issue, but most of them see this issue from the perspective of how the central bank implements monetary policy. Many people think that inflation is the benchmark to determine whether currency over-issue exists from the perspective of monetary policy. Inflation is not high at present and average inflation since 2008 is much lower than before. In this sense, currency over-issue is not as serious as claimed. Actually, the M2/GDP ratio is not necessarily related to inflation. The reason for inflation in China is quite complex, but inflation is eventually realized through currency over-issue. It is untenable to conclude that inflation will occur because of the high M2/GDP ratio. This being so, there is no necessary link between the M2/GDP ratio and asset bubbles. But it raises an issue that merits much attention and further discussions.

Important reasons for China's high M2/GDP ratio are the underdeveloped financial market and high savings rate. Therefore, it is not fair to jump to the conclusion that the issue of currency is excessive simply from the high M2/GDP ratio. This matches the reality in China, including the underdeveloped financial market and low proportion of direct financing, but it fails to grasp the key point of the issue.

The M2/GDP ratio is quite high in China, partly due to currency over-issue. Since the reform and opening up began over 30 years ago, the economy has expanded, market-oriented reform has further deepened and economic monetization has accelerated. Also, economic activities are increasingly dependent on money and other trade instruments. Naturally, the M2/GDP ratio becomes higher. However, the fact that the ratio is nearly 200% and the growth rate is several times higher than that of the economy can't be simply justified by economic monetization. The root cause is the unique institutional background of the Chinese economy and its money creation mechanism.

China's economic growth has been adopting a government-oriented, investment-driven mode. The government's strong investment demand spurs a strong money demand, which is mostly satisfied by bank loans. China's financial system mainly adopts indirect financing and the banking sector is monopolized by state-owned banks. Expanding government investment

magnifies the money injected into the banking sector. Therefore, government investment becomes a lever to create loans for commercial banks, which in turn creates more money. It should be noted that except for high-speed railway projects, which are funded by the central government, economic growth in China is mainly boosted by local government investments, and bank credits mostly go to the public sector and local financial institutions. The undue preference of financial resources for the public sector and the soft budget constraints of the public sector result in lower fund utilization efficiency. The return on net assets of state-owned enterprises (SOEs) reached its highest level, of 40 to 50% in 2007, and then plummeted from 2008 to the lowest level, 20 to 30%. The annual average total factor productivity between 1978 and 2007 was 3.8%. This dropped to 2.2% in 2008-2010, which caused a cycle of government investment and money creation. The spiralling M2/GDP ratio is the result of this money creation mechanism. Money creation in China is characterized by pressure from SOEs on state-owned banks, which relay the pressure to the central bank. Therefore, it is unfair to completely attribute money over-issue to the central bank. This problem cannot be solved by neutralizing or even tightening the monetary policy.

According to some statistics, since 2008, China's credit and money supply have been growing much faster than GDP, widening the gap between them. Since the Chinese economy began to decelerate, the GDP growth has slowed, while the money supply keeps growing. It is the same this year. In the first quarter, while the GDP grew 7.7%, investment expanded 20.9% and the M2 supply rose 15.7%, 2.71 times and 2.04 times higher than the GDP growth rate. This year marks the government changeover: 'A new broom sweeps clean'. According to information revealed during this year's NPC and CPPCC sessions, although the central government set the year's growth rate at 7.5%, 24 provinces, municipalities and autonomous regions set their growth rate to over 10%. If computed using the weighted average method, China's GDP growth rate would be 4-5 percentage points higher than 7.5%. To achieve such a target, it requires a huge amount of investment, which in turn calls for a large quantity of new money supply and credit. This is a serious problem. It is estimated that during the 12th Five-Year-Plan period (2011-2015), local public expenditure spurred by urbanization will amount to RMB 30 trillion. To finance these investments, the money supply and credit will continue to rise. Last week, the international credit rating agency Fitch cut China's long-term local currency issuer default rating to A+ from AA-, because China has mainly relied on investment and credit to boost the economy, which results in accumulating financial and debt risks.

One can argue that an important reason for M2 expansion is increasing foreign currency reserves and foreign currency assets. It is the same story this year. During the first quarter, China's foreign exchange reserves increased US\$ 130 billion, the equivalent of last year's total increase, representing the largest quarterly increase since the second quarter of 2011. This is also a factor beyond the control of the central government. In fact, it is also determined by China's economic growth and financial modes. Driven by investment and

exports, this economic growth mode accelerates the trend of economic monetization and results in an excessively rapid growth in the money supply and credit. Therefore, the reduction of the M2/GDP ratio fundamentally relies on economic restructuring and transformation.

It should be pointed out that we are not sure whether the existing financing and loans includes non-governmental financing. It probably does not. The available information indicates that non-governmental financial enterprises are quite active. Because the money raised through governmental channels is mainly used for large SOEs and investment projects, small and medium-sized enterprises can only address their financial needs through non-governmental financing. This is the reality of China's financial system. Financial regulation betrays the basic principle of free trade, borrowing and payment, resulting in a distorted financial order.

The mismatch between M2 growth and GDP growth also poses a challenge to monetary policy. Current monetary policy takes the M2 quantity as the control target and policy variable, mainly targeting money suppliers and failing to curb the insatiable money demand and demand side. As financial channels diversify and non-credit financing increases, this quantity-oriented control method can no longer accommodate the diversification of the social financial structure. The central government needs to shift its focus from quantity only to both quantity and price, because only price measures can control both the supply and demand side of money, and improve the fund utilization efficiency as in the past.

3. Five regulatory measures and control of the property market

In the first quarter, as the five regulatory measures and implementation rules were unveiled, the property market and control of the market were once again highlighted. In this context, it is necessary to review and discuss the control of the property market in China.

3.1. Background

On 20 February, Wen Jiabao convened the last executive meeting of the State Council of his tenure, arranging for continued control of the property market and issuing the so-called five regulatory measures. The major goals are to: (1) improve the system of responsibility for maintaining property prices; (2) crack down on speculative and investment-oriented purchases; (3) increase the supply of common commercial apartments and land; (4) accelerate the planning and construction of low-income housing projects; and (5) enhance market regulation. The most important part of the measures is to tighten restrictions on purchases and extend the pilot areas of property tax reform.

On February 26, the central government reiterated the system whereby the provincial governor is responsible for stabilizing housing prices; those who fail to do so will be held accountable. It proposes measures to restrict property purchases and loans and levy taxes. For

instance, in cities where property prices are growing too rapidly, the down payment rate and interest rate for loans for second properties should be increased, a tax equal to 20% of the income from transfer of a personal estate should be levied and the threshold for the advance sale of commercial housing should be raised. Guangzhou was the first to unveil the local implementation rules and other local governments followed before the 31 March deadline. The rules enacted by Beijing are the strictest and most practical. First, commercial housing for living and improvement purposes will be gradually incorporated into the regulation of price-capped property. Second, the restriction is extended to local residents and the purchase of second properties by single adults is severely restricted. Third, measures to levy the 20% tax of income from transfer of a personal estate are specified. In contrast, Dalian, Hefei, Wuhan and Chengdu only unveiled a general property price control target. The implementation rules unveiled by Nanjing, Guiyang and Changsha were very short and the result is predictable.

The measures also emphasized that ‘the prices for advance sales of commercial housing should be clearly marked, one property should have one price and the properties should be sold at the declared price’. The National Development and Reform Commission named eight developers who violated this regulation, including Shanxi Fuji Real Estate Development Co., Ltd., imposing fines of more than RMB 10 million.

3.2 Review of this year’s property market

In January, property prices showed a structural rise, where prices of some properties rose while others fell. In February, the situation was quite different, as the prices of most properties increased. Out of 70 medium- and large-sized cities, the price of newly built commercial housing projects only fell in one city, remained unchanged in three cities and climbed in 66 cities, with the largest increase amounting to 3.1%. On a year-on-year basis, eight cities reported a decline in property prices and 62 cities registered increases, with the increase in some cities reaching 8.2%. This further justifies the need for new property market control policies. However, the situation worsened in March. Guangzhou witnessed a 50.7% year-on-year increase and a 60.3% sequential rise in online contract signing for newly built commercial properties. The average price skyrocketed to RMB 16,817/m², an increase of 34.9% over the same period last year. Spurred by the mindset of ‘catching the last bus’, the transaction of second-hand properties in Shenzhen nearly quadrupled over the previous month, marking the second highest level since 2006. Prices also climbed. On 1 April, the share prices of most property developers rose; the share price of Vanke and Poly went up nearly 4%.

The market for houses with limited property rights¹ was even greater than for commercial properties. At the end of last year, the average price of houses with limited property rights was RMB 4,000/m² in Shenzhen. After the Spring Festival, the price rose to RMB 5,000/m², and even to RMB 7,000/m² on 8 March. The average price of commercial houses near them was over RMB 20,000/m². Houses with limited property rights were priced at only one third of commercial houses. Therefore, it is reasonable that they are popular.

Pushed by the scoring system for school admission² and the implementation rules of the five regulatory measures, the prices of school district properties also jumped. The turnover and prices of properties close to good schools in Shenzhen hit record highs. Small-sized school district properties were more favoured. The knock-down price of a 44-m² low-rise property reached RMB 2.3 million. The price of a high-rise property even climbed to RMB 2.5 billion; the average price reached RMB 57,000/m², nearly as high as the price of luxury houses and even villas. The situation in Beijing was even worse. The prices of school district properties were sky high. At the end of March, a 37 m² school district property at Huaqing Jiayuan was quoted at RMB 3.5 million. The price of another property at a primary school district exceeded RMB 100,000/m². In general, the price of a school district property is RMB 10,000 higher than a non-school district property.

While the housing market boomed, the land market also prospered. Both Beijing and Shanghai reported high value land deals. On 10 April, Shanghai Pudong Development (Group) Co., Ltd. acquired a 120,000 m² residential land lot for RMB 3.775 billion, at a premium rate of 65.43% and an accommodation value of RMB 18,200/m², which marked the highest in Shanghai this year. On 11 April, Fuzhou Taihe Real Estate Development Co., Ltd. won the bid for the Taihu land lot at Tongzhou District of Beijing at RMB 1.93 billion, at a premium rate of 112% and an accommodate value of RMB 11,800/m². This shows that after the five regulatory measures and the implementation rules were unveiled, the land market and new property market remained prosperous. The second-hand property market recently declined.

¹Houses with limited property rights are those built on collectively owned rural land but sold to buyers who are not part of the collective land ownership and therefore do not have legal protection for property rights.

² In most Chinese cities, parents cannot choose schools for their children, but they can usually choose a school close to their property. Parents must pay high costs if they want to choose another school located in another district, where they are not living. In addition, schools can choose students through exams. This is the core of the scoring system for school admission.

3.3 Reasons for poor price control

Controls over the property market failed to yield the desired effect. Property prices rose each time new regulatory measures were unveiled. There are multiple causes but the root cause is not hard to find.

First, the property market is basically a distorted seller's market. The Chinese people are quite familiar with a seller's market. Under the planned economy, the government controlled everything and the supply of commodities fell short of demand. The more regulation there was, the more serious shortages were. Shortages and surplus co-existed, resulting in much waste. As there was no market and the planned price remained unchanged, the seller's market could only be reflected in acute shortages. It is more so in today's property market. The difference is that there is a market now, but the government still wants to control the price. So the property price gets higher each time new regulatory measures are unveiled. There are also some 'ghost towns', where few people can be seen in the day and few lights are on at night. Erdos is a famous one, but there are many across China, such as the new city areas of Changzhou of Jiangsu, Hebei of Henan and Shiyan of Hubei. Since the reform and opening up began, the seller's market has changed into a buyer's market. The property market should follow the same path.

Second, restricting purchases and prices is not the right way to go. It is not macro control, but market regulation, which never works. To evade restrictions on non-local residents, some people use two household registrations, one in Beijing and one elsewhere, one for public services and one for business. The failure of the regulatory measures can be seen by the exposed cases where some officials had multiple properties and household registrations. It's better to cancel the regulation, deregulate the market and enhance the management, since regulation fails to work. In fact, the household registration system should have been put in a history museum long ago. But we still cherish it as a treasure.

The right way to control the market is through differential interest rates and taxation, which should be implemented and adhered to. On 28 March, the General Office of the State Council proposed the adoption of a unified property registration system next year.³ This is a fundamental part of property market regulation, and a prerequisite for levying property tax. We need to re-establish the land management system and measure, value and re-register properties, which we should do carefully. However, the result of some policies might be the opposite of what the designers intended. Take the 20% tax on income from the transfer of a personal estate, for example. Let's put aside the market rebound and fluctuation caused by people's rush to 'catch the last bus'. Whether the tax can curb the property price remains a question. This is because the 20% tax will not necessarily be paid by the sellers, but in most cases is assumed by the buyers.

³ 'Notice on Implementing the Plan of the State Council Institutional Reform and Transformation of Government Functions'

Third, because of gaming the system, whether the five regulatory measures can be implemented is an open question. The root cause is the huge interest involved. If this is not properly addressed, State Council decrees won't have much effect. According to Zhou Gongjian, chief editor of Forbes China, the sales of property amounted to RMB 6.4 trillion in 2012. The deed tax was RMB 287.4 billion, property tax RMB 137.2 billion, business tax RMB 405.1 billion, and land appreciation tax RMB 271.9 billion, totalling RMB 1.1 trillion. The balance of property loans reached RMB 12 trillion and the interest RMB 840 billion. The revenue from land transfers reached RMB 2.8517 trillion. The government and banking sector gained RMB 4.7917 trillion from the real estate sector, accounting for 75% of property sales. This estimate has a drawback, i.e. the revenue from land transfers included the land requisition cost, such as compensation to those displaced. In fact, the local governments are highly dependent on revenue from the property sector, which they will not give up voluntarily. Consequently, the effect of the control policy will be greatly reduced. It is said that implementing the five regulatory measures has only hit the 'pause button' for the property market.

3.4 Historical review

China began to deregulate the property market in 1998 and began to control property prices in 2002. Property prices have risen for 10 years despite 10 years of regulation. The more regulatory measures adopted, the higher the property prices. The control of the property market is now in a trap.

- In 2002, the government put an end to the practice of assigning land by agreement,⁴ kicking off 'a new round of land revolution'. Since then, property prices have risen rapidly.
- In 2004, the government stipulated that assigned land should be developed in two years; land not developed in this period would be taken back and would not be assigned within a given time frame.⁵ This is the so-called '831 deadline'. Lifting the deadline was followed by a surge in property prices.
- In 2005, the government issued the 'Notice on Stabilizing Housing Prices', the so-called 'eight regulatory measures', to regulate the market by means of interest rates and business taxes. After that, a number of policies and regulations were adopted, resulting in a sluggish property market and a strong wait-and-see atmosphere in the market. After that, property prices rebounded.
- In 2006, the government unveiled the so-called 'six regulatory measures'⁶ and other

⁴ 'Rules on the Assignment of the State-owned Land Use Right by Means of Bid Tendering, Auction and Quotation'

⁵ 'Notice on Further Carrying out Supervision on the Assignment of Use Right for Profit-Oriented Land by Means of Bid Tendering, Auction and Quotation'

⁶ 'Opinions on Adjusting the Housing Supply Structure to Stabilize Housing Price', and the 'Notice on Issues Concerning the Levy of Personal Income Tax for Property Transfer'

measures stipulating that properties smaller than 90 m² should make up at least 70% of new housing projects, the down payment should be no less than 30% of the total price and the exemption threshold term for business tax should be extended from two years to five years. However, the result was unsatisfactory.

- In 2007, another notice was issued,⁷ followed by restrictions on outcomes, restrictions on the purchase of second properties and a rise in the interest rate. As a result, the property market went from overheated to freezing cold.
- In 2008, to meet the 8% GDP growth target, the government lowered the interest rate for property loans further and exempted the taxes. It also tried to boost the property sector with other measures.⁸
- In 2009, property prices skyrocketed and the price for the transfer of state-owned land use rights hit record highs. On 27 December, Wen Jiabao proposed four measures to curb the rapid growth of property prices.
- On 10 January 2010, the General Office of the State Council issued the (2010) No. 4 document, also called the ‘11 regulatory measures’, to curb the overheated property market. However, after the NPC and CPPCC sessions, property prices in Beijing, Shanghai, Shenzhen and some other cities rose at an accelerated rate instead of falling. On 17 April, the State Council issued the ‘10 regulatory measures’,⁹ adopting a stricter differential credit policy, ‘the most stringent control policy in history’. However, it failed to work. In December, property prices in 70 medium and large cities rose 6.4%. Most strikingly, total land transactions reached RMB 2.7 trillion that year, up 70.4% year-on-year.

The above analysis indicates that the failure of property market control lies in the fact that we failed to properly address the root cause or even adopted wrong measures. Although the problem is reflected by the property market, the root cause is the institution. Some regulatory measures were not properly selected and implemented, and some of them failed to target the heart of the problem, and were not well implemented. As a result, when one thorny problem was solved, another cropped up, prompting the government to issue more regulatory measures. A new mindset is needed to regulate the property market.

4. Restructuring government organizations: Ministry of Railways

4.1. Highlights and drawbacks

During this year’s NPC and CPPCC sessions, a new round of restructuring of government organizations was begun. Four ministerial-level organizations under the State Council were dismantled: Ministry of Railways, Ministry of Transport, State Administration of Radio, Film and Television and General Administration of Press and Publication. The number of organizations under the State Council was reduced to 25, excluding the General Office. It was the sixth restructuring of government organizations since the reform and opening up began.

⁷ ‘Notice on Strengthening the Management of Credit for Commercial Property’

⁸ ‘Notice of the State Council on Saving Land and Promoting Intensive Use of Land’

⁹ GuoFa (2010) Document 10

This year's restructuring highlights were 1) the dissolution of the Ministry of Railways, the last administrative monopoly that combined both government functions and enterprise management, 2) the establishment of the China Food and Drug Administration, as food and drug safety is becoming a major social issue in China, and 3) the establishment of the State Oceanic Administration, because oceanic development will become important in the future. The biggest disappointment was the failure to re-establish the State Commission for Economic Restructuring and to reduce the power of the National Development and Reform Commission. Given that there has been a lack of political reform in recent years, the National Development and Reform Commission, which symbolizes the planned economy, is entrusted with increasing power. Its power should be reduced and it should be restructured into an anti-trust commission.

4.2 Government functions and enterprise management separated

The plan to dissolve the Ministry of Railways to separate government functions from enterprise management was proposed as early as 2003, but it didn't become a reality until ten years later. This shows how difficult it is to carry out reform in China. As Lu Xun said, 'it is not easy to move even a table in China'. Today, the table has finally been moved. However, if the high-speed train hadn't derailed the year before last, the corruption of Liu Zhijun (former Minister of Railways) wouldn't have been disclosed and reform of the ministry would probably have been further delayed.

Nevertheless, the dissolution of the Ministry of Railways and the establishment of the State Railway Administration under the Ministry of Transport and the China Railway Corporation marked the organizational separation of government functions from enterprise management, marking a breakthrough in the reform of China's railway sector. Consequently, more reform measures can be put on the agenda for further discussion.

However, the organizational separation of government functions from enterprise management is only the first step. Economically, government functions are still combined with enterprise management through debts and property rights, which must be settled. Debts of the former Ministry of Railways will be assumed by the China Railway Corporation. On the one hand, this makes China Railway Corporation unable to operate like an enterprise or become a real market player, because the debts were not caused by its decisions. On the other hand, the government currently can't remove its hand and the two will remain connected.

Due to the great leap forward movement in the railway sector, the Ministry of Railways borrowed a considerable amount of money from banks and issued bonds. According to the audit report of the financial statement prepared by the Ministry of Railways for the third quarter of 2012, by the end of September of 2012, the assets of the ministry totalled RMB 4.3 trillion, and the debts RMB 2.66 trillion, bringing the asset-liability ratio to 61.86%. This is the legacy that the China Railway Corporation inherits.

Moreover, despite the RMB 2.66 trillion in existing debts, more money needs to be borrowed to fund massive ongoing railway construction. The planned investment for this year amounts to RMB 650 billion, including RMB 520 billion for 5,200 km of new railways. On 8 March, the Ministry of Railways issued RMB 20 billion worth of short-term financial billings. The issuer and its subordinates have already issued a total of RMB 759.1 billion unmatured financial instruments. On 1 March, the Ministry of Railways received the registration notice for RMB 60 billion mid-term bills and will issue the bills at a chosen date. Moreover, it applied to issue RMB 150 billion bonds for railway construction in 2013, rolling over old debts with new borrowing.

4.3 Define the property rights and operating responsibilities by settling the debts

Our focus is on how to define the property rights and operating responsibilities by settling the debts, so as to reform and develop the railway sector and change the China Railway Corporation into a real market player.

As the old debts and new debts are borrowed and assumed by different entities, they should be separated and taken into overall consideration. Some debts are bank loans, so the bank should be partly accountable. As the bank–enterprise relationship does not involve reform, the problem is relatively simple. The relevant parties should negotiate whether the loans should be extended, new loans should be taken out to repay old debts, the interest should be reduced or exempted, and other measures. As the old debts were incurred by the Ministry of Railways, the government should be partly liable for them. As China Railway Corporation inherits the assets, it should repay part of the debts. This involves further reform and should be carefully discussed.

As the debts taken on by the China Railway Corporation should be linked to the assets it inherits, it is a top priority to define the nature, business scope and asset conditions of the China Railway Corporation. We think that it can be named the trunk line company to run main railway lines in China, including Beijing-Shanghai, Beijing-Guangzhou, Longhai and Beijing-Shenyang railways, and take on debts in proportion to the assets it inherits. All branch lines can be handed over (sold) to local governments or individuals that can establish railway companies to run them. The revenue can be used to repay the debts and the balance can be settled by the state treasury. This can be addressed by establishing asset management companies or auctioning the property rights.

Pre-arrangements should be made before incurring new debts to define who should make the decisions to invest, borrow money, run the railways and repay the debts. They shouldn't be mixed. In this case, the lines that the China Railway Corporation, local governments and individuals want to invest in and run can be handed over to them respectively. If no one wants to build and run the line, or it is proven that the line is not worth investing in, it should be cancelled.

It's now time to take some money to engage research and academic institutions to carry

out research and propose some plans. Then we can discuss and compare these plans to select the most suitable ones. It should be noted that some people propose to divide the railway sector into profit making and public services and ensure the national economic security. We think this proposal sounds plausible. Public services can be bought by the government. To ensure national economic security, railways can be taken over by the government in case of emergency. What really matters is to define the property rights and operating responsibilities.

5. Predictions

This year, the international economy is mixed with highs and lows. The US economy is propelled upward, but it grew sluggishly, restricted by mid-term structural factors. The European debt crisis continues. The Cyprus crisis undermines the stability of the European financial market and highlights the inadequacy of banking regulation in the EU. If the supply and demand of credit continues to deteriorate, it may affect employment recovery and private investment in heavily indebted countries. The Japanese economy is beginning to pick up. However, the effect of stimulating exports by depreciating the Japanese yen is limited and the Japanese economy is unduly dependent on exports. The BRICS countries are further enhancing their cooperation, vowing to establish the BRICS Development Bank and a joint BRICS foreign exchange reserve pool to cope with the economic downturn. At present, an easy monetary policy is still the main theme of macro policies in developed countries. As the EU and US continue to adopt a quantitative easing monetary policy, Japan unveiled an ‘unlimited monetary easing’ policy. This will increase the inflow pressure of hot money, which could in turn spur inflation. Combined with the economic realities in China, inflation is an issue demanding considerable attention.

The Chinese economy is now at a critical moment of restructuring and transformation, which includes the transformation from high-speed growth to lower growth, from investment and export-boosted growth to internal-demand-driven growth, from relying on inputs to increasing efficiency, and from ignoring the environment to saving resources and improving the environment. To upgrade the Chinese economy, the new government needs to withstand the pressure of a 7-8% GDP growth rate to do something to accelerate the restructuring and transformation. Under the current circumstances, the macro policy will remain stable and won't experience a major change.

Accordingly, our predictions for the economy in the second quarter are summarized in Table 1.

Table 1: Actual and Projected Growth, 2012-2013

Quarter	2012 (Actual)	Q1of 2013 (Predicted)	Q1of 2013 (Actual)	Q2 of 2013 (Predicted)	2013 (Predicted)
Indicator	Growth (%)	Growth (%)	Growth (%)	Growth (%)	Growth (%)
GDP	7.8	7.4	7.7	7.6	7.6
Industrial value added	10.0	10.0	9.5	10.5	10.5
Investment in fixed assets	20.6	20.0	20.9	21.0	20.4
Retail sales of consumer goods	14.3	14.5	12.4	12.8	13.0
Exports	7.9	7.5	18.4	8.0	8.5
Imports	4.3	5.5	8.4	10	10.5
Consumer price	2.6	2.5	2.4	3	3.2

Notes:

1. The growth rate of GDP and industrial value added are calculated at comparable prices, and other indicators are calculated at current prices;
2. Investment in fixed assets refers to total investment in fixed assets;
3. The industrial value added refers to the added value of state-owned enterprises and non-state-owned enterprises whose annual sales income reaches RMB 5 million.