

Quarterly Economic Brief

Macroeconomic Analysis of Q2: The Slowdown Makes Space for Future Growth

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Beijing, 18 July 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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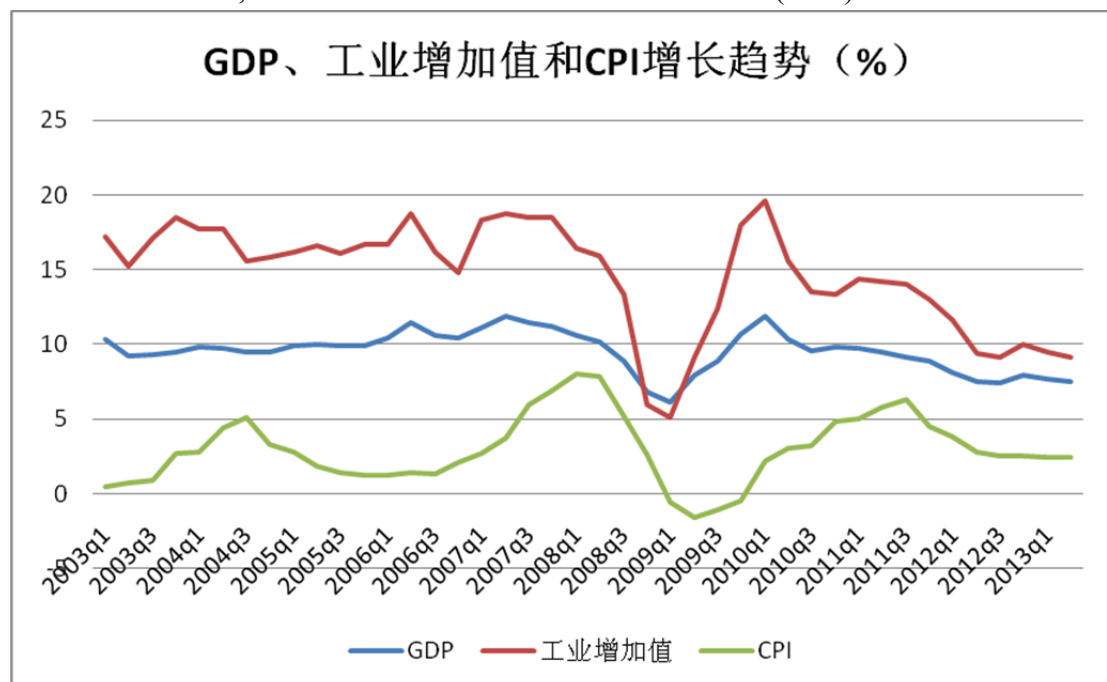
Abstract

In the first half of this year, China's GDP grew 7.6% (7.5% in the second quarter), industrial value added rose 9.3% and the CPI climbed 2.4% (2.7% in June), continuing the steady growth at a slightly decelerated pace. This is positive, because it has made space for the economic slowdown and restructuring. While liquidity was generally sufficient, China experienced a 'money shortage' as a result of the maturity mismatch and idling of bank assets and liabilities. The central bank aptly refused to 'ease' monetary policy, which was conducive to securing long-term financial stability and economic growth at the expense of short-term market fluctuations.

1. Overview of the Economy

In the first half of this year, China's gross domestic product (GDP) grew 7.6% (7.5% in the second quarter), industrial value added rose 9.3% and the consumer price index (CPI) climbed 2.4% (2.7% in June), continuing China's steady growth at a slightly decelerated pace. Although this contradicted what was expected by some scholars, it tied in with the shrinking growth potential of the Chinese economy and accommodated the needs of the country's economic transition. This was positive, because it made space for the economic slowdown and restructuring.

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



It is undeniable that the Chinese economy has already slowed. Consequently, people are starting to look for the bottom. To this end, we compare previous economic declines over the past 15 years to this economic slowdown. The Asian financial crisis triggered the first meltdown. As a result, the Chinese economy grew 8.8%, 7.8%, 7.1% and 8.0% respectively in the years 1997–2000. The international financial crisis spawned the second drop. Consequently, the growth rate of the Chinese economy reached 9% in the third quarter of 2008, fell to 6.8% in the fourth quarter, 6.1% in the first quarter of 2009 and then rose to 7.9% in the second quarter. The ongoing deceleration has led to the third fall in the economic growth rate, which plummeted from a high of 11.9% in the first quarter of 2010 to 7.6% in the second quarter of 2012. Since then, the growth rate has lingered between 7.4% and 7.9%. Many scholars argue that the bottom will be 7%. However, this conclusion merits some debate because the growth rate remained below 7% in two consecutive quarters and even dropped to 6.1%.

Moreover, the triggers for these declines were different. The first two declines resulted from short-term adjustments in response to the impacts of the Asian and international financial crises. The ongoing decline, stemming from economic internalities and trends, is

fuelled by mid-term and long-term economic restructuring. So it is highly inappropriate to ascribe this slowdown to the impact of the ongoing international financial crisis and the withdrawal of incentive policies. Instead, it implies the return to rapid growth rather than the beginning of mild growth. There are three anticipated bottoms for the decline: 7% for the 12th Five-Year-Plan period, 7.5% for this year and 7.3% in order to quadruple China's GDP. The anticipated bottom of 7.5% may apply to this year, but won't necessarily fit for the mid- and long-term scenarios.

The state of the economy was highlighted by the decline in the rate of growth of three demands. First, investment in fixed assets grew 20.1%, down 0.3 of a percentage point over the same period last year, and its contribution to GDP growth reached 53.9%. This proves that the Chinese economy is still driven mainly by investment, and it has to be fuelled by investment. To break it down, investment in the real estate sector climbed 20.3%, up 3.7 percentage points year-on-year. The top bidders for land for construction were frequently reported across China against the backdrop of five measures adopted by the State Council earlier this year to regulate the property market.¹ This signifies that these measures have failed to produce the desired effect and foreshadows the investment trend in the property market. In recent months, many local governments have unveiled their investment plans, the value of which totalled more than RMB 20 trillion. Among them, Sichuan Province plans to invest 4.3 trillion, Guizhou 1.7 trillion and Guangxi 1.5 trillion. On 16 May, the General Office of the State Council issued an official document detailing 117 reforms of the bureaucratic process and issued a list of 104 items, most of which are related to investment and operational activities in key economic sectors and investment by enterprises in civil airports and urban rail transport projects. At the central level, this could streamline the approval process, but locally it may exacerbate the ongoing capital-spending spree.

The second decline relates to retail sales of consumer goods, which gained 12.7%, down 1.7 percentage points year-on-year and contributes 45.2% to the GDP. Although this is partially caused by the decline in consumption of luxury dinners after the central government issued restrictive policies cutting back on spending by officials,² we still have to keep an eye on income and employment.

In the first half of this year, the income of urban residents increased 6.5% and the cash income of rural residents rose 9.2%, both of which represented a fall of 3.2 percentage points over of the same period last year. It should be noted that income serves as the foundation of consumption and is in inverse proportion to the savings rate. Should the savings rate remain unchanged, and if income declines, consumption will fall. In addition to the increase in income, expectation is also an important factor influencing consumption. Currently, while the income increase is slowing, expenses, including payment for housemaid services, private teaching and driving lessons are all rising, resulting in an accelerated growth in the CPI. Naturally, the anticipation of a slowing in the increase of income along with rising expenses

¹ See <http://english.cntv.cn/program/china24/20130221/106944.shtml>, accessed 8 September 2013.

² See <http://www.scmp.com/news/china/article/1119384/xi-jinpings-guidelines-cut-back-extravagance-go-effect>, accessed 8 September 2013.

isn't desirable. Consequently, people are showing cautious consumption behaviour, demonstrated by the fact that the balance of individual savings totalled over RMB 100 trillion at the end of June (RMB 100.91 trillion).

Consumption is related to income, and further related to employment. Though employment influences economic growth through income and consumption, it is also a basic factor in economic growth. China has yet to provide reliable and comprehensive statistics on employment or unemployment, making the macroeconomic analysis incomplete. In the first half of this year, 7.32 million new jobs were created in urban areas, up 0.38 million over the same period last year. Accordingly, the slowdown of economic growth will increase unemployment. This is demonstrated by the difficulty that college graduates have in finding jobs. The *Report on Employment of College Students in China 2013* interviewed college students between 29 October 2012 and 10 April 2013. The report revealed that of college students with an associate, bachelor and master's degree, the numbers that signed an employment contract were respectively 13, 12 and 11 percentage points lower than the same period the previous year. By the middle of May, 38.9% of the college graduates in Shanghai had not found a job; those figures showed employment of graduates down 16.7 percentage points over the same period last year. In contrast, 100% of students from some vocational schools signed an employment contract even before their graduation.

While college graduates have difficulty finding jobs, employers find it harder to recruit desired employees. A structural imbalance is caused by the mismatch between supply and demand, which gives rise to the competition between college graduates and migrant workers in the labour market. According to the *Report on Employment of College Students in China 2013*, the average expected monthly salary of college graduates is RMB 3,683.6 this year, nearly RMB 2,000 lower than the equivalent in 2011, which was RMB 5,537.5. According to data released by the National Bureau of Statistics, the average monthly salary of migrant workers reached RMB 2,290 in 2012. A survey by MyCOS, an educational consultancy service provider, shows that the average starting salary of 69% of college graduates with a bachelor's degree is less than RMB 2,000 per month this year. This indicates the high investment, low output and structural imbalance of college education, which leads to the surplus of college students. Moreover, the proportion of college graduates that can find jobs matching their college education is only 15% in China (compared to 60% in Germany), giving rise to psychological pressure on college students. They can't pay back education loans, get married in their thirties, or afford to buy a small apartment with the money they save for many years, painting a picture of faint hope for the future. This poses a major threat to social stability.

The third decline in demand, and what is most surprising in the economic operation in the first half of this year, is the rise and fall of foreign trade. In the first quarter, imports and exports rose 8.4% and 18.4% respectively. Then their growth significantly slowed in the second quarter before registering a negative growth of -0.7% and -3.1% in June. One of the reasons is that the statistics were falsified earlier and the bubble in the statistics was squeezed out later to present the real picture. For example, in the first four months, exports to Hong Kong totalled US\$ 150.59 billion, up 66%. The trade between Shenzhen and Hong Kong rose 130%. The daily exports of the Shenzhen Futian Bonded Zone statistically reached US\$ 1.17 billion in the first half of April. But in May, after the false trade was checked, daily exports

dropped to US\$ 170 million, down 83.8%. In this case, the data, which indicates that imports and exports rose 6.7% and 10.4% respectively in the first half of this year, is unreliable. The real GDP growth rate in the first half of this year is less than 7.6%.

Why is false trade so rampant? Like the ‘one-day trip to Hong Kong’, goods travel back and forth between the two destinations for profit mainly because of the policy adopted by banks to offer credit secured by standby letters of credit from branches in China. The process is as follows: a Chinese company deposits some money into a bank and asks the bank to issue an equivalent letter of credit. Then, an overseas subsidiary of the company buys the goods, to which the letter of credit will be sent. Next, the overseas subsidiary presents the letter of credit to a foreign bank. The roundtrip trade leverages the difference in interest rates between two places for arbitrage. The RMB-denominated loan interest rate is about 2.25–2.50% in Hong Kong, and 3.25–3.30% in the Chinese mainland, a gap of nearly 1%. Moreover, Chinese companies can buy wealth management products whose annual yield is 4.3% as a pledge, further expanding the interest rate gap. If the payment is made in USD and receipt is made in RMB, the gap in the interest rate would be 0.48%. If the principal is RMB 100 million, 100 roundtrips will secure RMB 10 billion for a profit of RMB 248 million. This is the secret to the sharp change in trade statistics.

The decline in export growth has several other causes. First, overseas market demand remains sluggish. According to customs statistics, since the beginning of this year, export orders declined 45% each month. In the first half of this year, China’s trade to Japan fell 9.3% and its trade to Europe dropped 3.1%. Second, the appreciation of the RMB resulted in increasing wages for the Chinese and rising export costs. At the end of May, the real effective exchange rate (REER) index of RMB stood at 116.3, up 5.6% from the end of last year. According to the survey of the Ministry of Commerce, over 73% of the companies surveyed think that the appreciation of the exchange rate is the main factor that affects exports. Third, trade frictions diversified. In the first quarter, 12 countries launched a total of 22 trade remedy investigations, which severely affected China’s export of advantageous products. Fourth, China’s economic growth decelerated and the profitability of sectors with surplus capacity restrained the import of raw materials. These factors are likely to persist in the short term. Therefore, the export situation will remain harsh in the second half of this year, so we should prepare for a slide or even recession.

2. ‘Money Shortage’ and Monetary Policy

A money shortage and a subsequent break in cash flows was a significant event this quarter, which began on 6 June and reached a climax on 20 June, creating a minor crisis and foreshadowing the transition towards market liquidity.

On 6 June, the size of the bond issued by the Agricultural Development Bank of China was scaled back due to insufficient subscription. Then there emerged a rumour in the market that the fund position of two shareholding banks showed a warning indicator. On 7 June, the central bank cancelled the Short-term Liquidity Operation (SLO). Around 16:30 the same day, two state-owned banks started to borrow money in the market. On the following day, the overnight Shanghai Interbank Offered Rate (Shibor) skyrocketed to 9.5810%. The situation remained unchanged around time of the Dragon Boat Festival (12 June). The overnight, 14-

day, 1-month and 3-month rates increased 20.70, 73.10, 50.90 and 24.80 basis points respectively. Against this backdrop, the central bank changed its previous practice of keeping the rates in check, standing by and refusing to ease the monetary policy.

The interbank market experienced a ‘strong earthquake’ on 20 June when the interest rates soared and bonds fell sharply. When the early morning trading started, all the banks tried to secure funds at an interest rate of higher than 10%. During the day, the overnight Shibor rate rose to 13.44% and reached 18% at noon. The 7-day pledged repo rate reached its highest level, at 28%. The whole monetary market registered a break in the cash flow. Despite this, the central bank still refused to ease the monetary policy. Financial institutions came to realize almost overnight that the central bank would eventually stop reaching out with a helping hand.

After issuing a letter on administrating the liquidity of commercial banks on 24 June, the central bank issued a press release titled *Reasonably Regulate Liquidity to Safeguard Stability of the Monetary Market* on the evening of 25 June, indicating that the liquidity was generally sufficient and that the seasonal interest rate fluctuations in the monetary market were only temporary. Moreover, heads of the People’s Bank of China (the central bank), the China Banking Regulatory Commission, the China Securities Regulatory Commission and the China Insurance Regulatory Commission gathered at a press release at the Lujiazui Forum in response to market concerns on liquidity. The Industrial and Commercial Bank of China (ICBC), Bank of Communications and Minsheng Bank all indicated that the liquidity was currently normal. Afterwards, interbank interest rates fell significantly. On the same day, the weighted overnight pledged repo rate closed at 5.8270%, down 81.91 basis points. The Shibor rate fell to below 5% on June 28, and further to 3.786% on July 2. The ‘money shortage’ came to a soft landing.

Superficially, the ‘money shortage’ was caused by the supplementary payment of statutory deposit reserves, uniform payment of taxes to the state treasury at the end of June, adoption of prudent monetary policy by the central bank and the refusal to ease liquidity, and anticipated tightening caused by the planned ending of quantitative easing (QE) by the US Federal Reserve. Some hot money flew out, leading to a reduction in base money. As a matter of fact, the fundamental reason is the maturity mismatch and idling of bank assets and liabilities and the imbalanced financial structure behind it. The reality is that there is enough money, but it is misplaced.

In the first five months of this year, RMB 9.11 trillion in total was raised, up 3.12 trillion over the same period of the previous year. The supply of broad money (M2) reached RMB 104 trillion. In five years, the ratio of credit to GDP jumped from 75% to 200%. Fitch Ratings warned that ‘the scale of credit in China was so extreme that the country would find it very hard to grow its way out of the excesses as in past episodes, implying tougher times ahead’.³ In spite of sufficient liquidity, banks suffer ‘money shortages’, and so did the real economy. This is because many banks, trusts and other financial institutions borrow short-term money to make long-term investments and make leverage investments in real estate, local debts and private debts for huge profits. Financial innovation and development of off-

³ See <http://www.businessinsider.com/fitch-chinas-credit-bubble-is-a-record-2013-6>, accessed 8 September 2013.

balance sheet business make it more convenient for banks to engage in such high-risk investments. Outside the banking system, shadow banks are expanding wildly. Wealth management products worth RMB 2 trillion of lending are in reality a ‘hidden second balance sheet’ for banks, allowing them to circumvent loan curbs and dodge efforts by regulators to halt the excesses. This gives rise to an interesting phenomenon: ‘water on one side and fire on the other’, i.e. the more the monetary policy is eased, the more difficult it is for emerging sectors and small and medium-sized enterprises to raise funds. The mismatch and idling of funds is deemed by many people as a ‘cancer’ in the Chinese economy. The excess liquidity nurtures the ‘cancer’. Once the ‘cancer’ deteriorates, the consequences will be unimaginable.

On this basis, we think that it is appropriate for the central bank to refuse to ease the monetary policy and that the central bank should maintain its stance. This indicates that both the central bank and the top-level decision makers are proactively piercing the bubble to redirect money into the real economy, lowering the leverage of local governments, banks and other financial institutions and securing long-term financial stability and economic growth at the expense of short-term market fluctuations.

While the ‘money shortage’ was at its height, on 19 June the executive meeting of the State Council addressed the issue. On 5 July, the General Office of the State Council issued the *Guidance on Financial Support in Economic Restructuring and Upgrading* (hereafter referred to as the ‘Guidance’). The central idea is to ‘revitalize the stock’ and to make ‘good use of incremental capital’. The former includes 10 measures and the latter focuses on eight key sectors.

The meaning of making good use of incremental capital is quite clear, i.e. new loans should be directed to eight key sectors displaying higher efficiency, mainly new sectors, small and medium-sized enterprises, the service sector, transition, upgrading and restructuring. This calls for the support of effective preferential policies.

Revitalizing the stock consists of liquidizing the money stock and fiscal funds. The former includes savings of residents, because funds used by enterprises mainly come from bank loans. The money flows out of banks into enterprises and then back into the hands of residents. As the savings rate is higher, residents save some money at banks; that money becomes sedimentary. Currently, the balance of resident savings exceeds RMB 100 trillion. Fiscal funds include treasury deposits. According to the balance sheet of the central bank, at the end of May, the balance of government deposits in the central bank was over RMB 3 trillion, up more than 10 times over 2000.

To revitalize the stock, we must resort to financial innovation. There are two specific measures. First, to allow banks to issue financial bonds and residents to buy bank bonds. As a result, such money will flow into banks as ‘circulating money’, and banks won’t need to ask the central bank for money. If financial bonds have high credit ratings and long terms, it can lower the investment risks for residents and improve the maturity mismatch of assets and liabilities for banks. Second, to securitize assets, i.e. securitize credit assets and corporate assets. For instance, securitized loans can be sold to residents to increase their assets. As a result, bank assets can be revitalized and the money supply can be reduced. China started to launch pilot assets securitization in 2005. At present, securitized assets total RMB 100 billion, which is too small in size and slow in expanding. Assets securitization facilitates the

development of capital markets, increases the efficiency of the financial system and enables finance to better serve the real economy. This constitutes a new opportunity for the growth of the Chinese economy and provides a sound way to address the rapid expansion of shadow banks.

In the Guidance, it is reiterated that private funds should be allowed to establish private banks, financial leasing companies and consumer finance companies on a trial basis. If this proposal is well implemented, it would mark an important step forward to break the existing financial monopoly and help address the difficulty of small and medium-sized companies in raising funds. Also, private banks have experienced some rises and falls and only Minsheng Bank manages to survive. From the initial practice of launching a regional pilot, summarizing the experience and then implementing it nationwide, to the current practice of carrying out plans directly, top-level decision makers seem to have adjusted their approach to financial innovation. Hopefully, they won't let people down again. If they really want to develop private banks, it is advisable to be more aggressive by approving several hundred banks so that there are around 10 banks in each province. On top of that, relevant systems should be established and strictly followed, including a deposit insurance system and deposit entry and withdrawal systems. Take the capital adequacy ratio as example. It should be no less than 8%. If it is less than 7%, a warning should be sent. If it is less than 5%, the bank must correct the problem. If it is less than 3%, the bank should be liquidated and ordered to withdraw from the market.

3. Forecast

The current international economic situation can be briefly described as 'robust growth in the USA, weak growth in Europe, improvement in Japan and a slowdown in emerging economies'.

The US economy grew 1.8% in the first quarter and slightly higher in the second quarter. Although the growth rate is lower than anticipated, some key economic indicators, including the unemployment rate, construction of new houses, the sale of existing houses and consumer confidence, are improving. The real economy is starting to stabilize. So, after three rounds of QE policies, it is more likely that QE will end. In late May, the US Federal Reserve implied that it might slash bond purchases. On 19 June, the Fed chairman Ben Bernanke indicated that if economic indicators met with expectations in the future, the Federal Reserve would reduce the purchases of QE3 this year, continue to cut purchases in the first half of next year and completely end it in the middle of next year. The unemployment rate is the key indicator. The US unemployment rate dropped to 7.5% in April and 7.6% in May from a high of 9.7% during the financial crisis. So, it is likely to fall to 7%.

In contrast, the European economy is still haunted by the debt crisis and an imbalance in growth in the Euro zone. Economic growth dropped for four consecutive quarters, registering a contraction of 0.2% in the first quarter over the last quarter of 2012. Germany is faring better than peripheral countries such as Greece, Spain and Portugal, which are plagued by problems that are proving hard to resolve. Core countries including France and Italy are also to the brink of recession again. Industrial production in Italy has dropped 25% from the highest level in history, and unemployment, particularly unemployment among young people, is quite high. According to statistics released on 1 July, over a quarter of job hunters under the

age of 25 in the European Union can't find a job. This rate is up to 59.2% in Greece and 56.5% in Spain. These young people are well educated and have a bachelor or master's degree. If this scenario continues, it will lead to falling birth rates, exacerbated social unrest and rampant political extremism.

Stimulated by 'Abeconomics' and the policy of unlimited monetary easing, the momentum of the Japanese economy picked up somewhat in the first half of this year. However, whether this is sustainable is uncertain.

Due to the impact of the staggering world economy and internal restructuring, the growth of emerging economies is starting to slow. Except for China, which still maintains a growth rate of 7%, Brazil, India and Russia present a situation that brooks no optimism. In particular, because of the anticipated end of QE3 by the US Federal Reserve, the international capital flow may change and these countries may experience an outflow of capital.

In a nutshell, the world economy is confronted with an array of challenges and risks arising from interweaving new and old patterns and the ongoing transition from the old to the new, which renders the future highly volatile. As a result, the International Monetary Fund has lowered its forecast of world economic growth for this year and the next.

The Chinese economy is currently transiting from rapid growth to moderate and slow expansion, posing a huge downward pressure. In June, the manufacturing PMI (Purchasing Managers Index) stood at 50.1%, close to the 50% demarcation line and down 0.7 of a percentage point over the previous month, which marked the lowest level in four months. This indicates that the Chinese economy is still stabilizing and the manufacturing sector remains sluggish. Plus, the fall of the PPI (producer price index) is likely to continue. Consequently, the economic indicators will continue to fall in the second half of this year. Even if the economy grows at a rate lower than 7.5%, it is still a remarkable achievement.

Accordingly, we forecast the economy to operate as follows in the third quarter and the whole year (Table 1):

TABLE 1: Economic Forecast for the 3rd Quarter and the Year 2013

Indicator	2012 (Actual)	Q2 2013 (Actual)	First Half of 2013 (Actual)	Q3 2013 (Predicted)	2013 (Predicted)
	Growth (%)	Growth (%)	Growth (%)	Growth (%)	Growth (%)
GDP	7.8	7.6	7.6	7.4	7.5
Industrial added value	10.0	10.5	9.3	9.3	9.5
Investment in fixed assets	20.6	21.0	20.1	20.5	20.4
Retail sales of consumer goods	14.3	12.8	12.7	12.5	13.0
Exports	7.9	8.0	10.4	3.0	5.5

Imports	4.3	10	6.7	5	6.5
Consumer prices	2.6	3	2.4	3	3.2

Note:

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

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