Quarterly Economic Brief

Macroeconomic Analysis of Q3: Resolving Excess Capacity and Promoting Restructuring

ZHANG Shuguang (Unirule Institute of Economics)
and
ZHANG Chi (Business School of China University of Political Science and Law)

21 October 2013, Beijing

ASIA RESEARCH CENTRE
COPENHAGEN BUSINESS SCHOOL
COPENHAGEN, DENMARK

UNIRULE
INSTITUTE OF ECONOMICS
BEIJING, CHINA

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.

PORCELÆNSHAVEN 24B
DK-2000 FREDERIKSBERG, DENMARK
TELEPHONE: +45 3815 3409
EMAIL: ARC.INT@CBS.DK
HTTP://WWW.CBS.DK/ARC

2-601, YISHUIYUAN, WANLIU DONGLU, HAIDIAN DIST.
BEIJING, 100089, P. R. CHINA
TELEPHONE: 8610-62132181
EMAIL: UNIRULE@UNIRULE.ORG.CN
HTTP://ENGLISH.UNIRULE.ORG.CN/

Macroeconomic Analysis of Q3:
Resolving Excess Capacity and Promoting Restructuring

ZHANG Shuguang (Unirule Institute of Economics)
and ZHANG Chi
(Business School of China University of Political Science and Law)

21 October 2013, Beijing

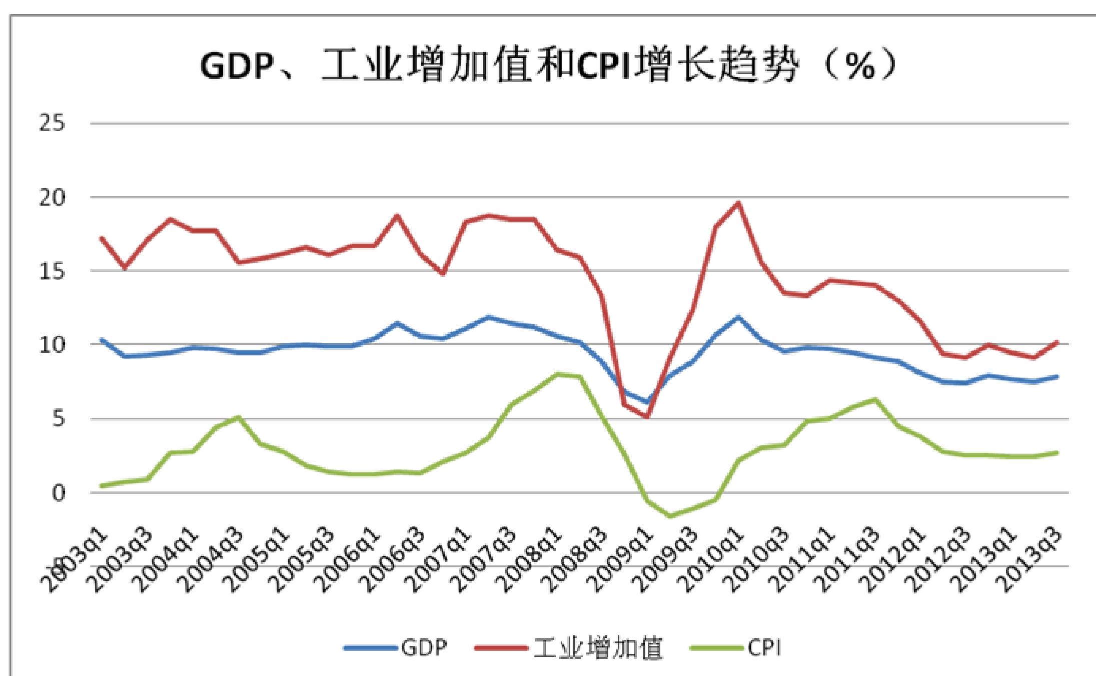
Abstract

China's GDP growth for the first three quarters of 2013 year was 7.7%, 7.5% and 7.8% respectively, forming a V-shaped growth pattern. The recovery guaranteed the accomplishment of the government's goals, but excess capacity increased because of growing dependence on investment. To resolve this capacity surplus, deeper marketization should be applied. It is also worth taking note of the export and import fluctuation represented by a massive deficit in the trade of services, which reveals structural vulnerabilities in the economy. An effective method to restructure China's economy is to loosen regulation and broaden the opening-up, to encourage foreign direct investment and to increase export equipment loans, which will promote the export of products and the development of trade of services.

1. Overview

For the first three quarters of 2013, the growth rate of the gross domestic product (GDP) was 7.7%, 7.5% and 7.8% respectively. The economy bounced up in the third quarter after maintaining slow growth for the first two quarters, forming a V-shaped growth pattern, which further guarantees that the economy will meet the goal of a 7.5% GDP growth rate set by the government this year.

FIGURE 1: Growth Trends of the Gross Domestic Product, Industry Value Added and the Consumer Price Index (in %)



However, this slowdown and rebound trend of the GDP growth rate is not consistent with the intrinsic trend of a medium-speed GDP growth rate as China's economy restructures from high-speed growth. This has put many organizations and experts in an awkward position, as earlier this year most economists and organizations predicted that China's economy would show strong momentum and the GDP growth rate would go as far as 9.3%, with most predictions around 8.0–8.5%. However, as it turned out, the growth rate for the first two quarters dipped twice. This caused many institutions to modify their predictions, forecasting another dip in the third quarter, which ended up being mistaken. As a result, discrepancies in the forecasts occurred regarding this bounce and its causes and the tendency for future development. Would GDP growth stay stable, stay stable and then rise, maintain a stable momentum, or would there be larger concerns as political stimuli might lead to an unstable bounce up?

In fact, having a GDP growth rate of over 7% is outstanding, which makes China the fastest growing economy in the world, overshadowing developed countries, as well as the

emerging economies. However, to guarantee a 7.5% GDP growth rate, the government undertook several policy changes. Since June, the State Council Standing Committee has clearly stated (seven times) that it will stay focused on 'stable growth', and maintain balance through 'restructuring and promoting reforms'. A key factor in maintaining 'stable growth' is a stable growth in investments; therefore, an RMB 4 trillion investment plan emerged with new projects hurriedly approved and pending projects restarted.

Purely as the goal for economic growth set by the government, the dip and subsequent bounce in the economy for the first three quarters is not a worrying problem. The National Bureau of Statistics of China released an announcement on 2 September correcting the preliminary results of last year's GDP; the number was reduced by RMB 38 billion, and the GDP growth rate was reduced from 7.8% to 7.7%, in line with the data for the second half of 2012. Naturally, the growth rate for the third and the fourth quarters increased slightly.

What is worth noting is that since 2004, local economic growth rates have been higher than the national economic growth rate. And the gap between them increased for the first half of the year. In 2004, the difference between local economic growth and that of the nation was RMB 3 trillion, accounting for 19.3% of national GDP that year. In 2008, this difference was RMB 2.6 trillion in real terms, or 8.8% of the national GDP. For the first half of this year, the difference was RMB 3,163.02 billion, accounting for 12.8% of the national GDP. Local GDP growth rate data for the first half of 2013 is listed in Table 1.

TABLE 1: China's GDP Growth Rate (in %), Q1 and Q2 of 2013

GDP Growth Rate (%)	Province, City, Autonomous Areas[1]
11.0－12.5	Shaanxi, Ganxu, Fujian, Tibet, Yunnan, Chongqing, Guizhou, Tianjin
10.0－10.9	Hunan, Sichuan, Guangxi, Jiangxi, Hainan, Xinjiang, Anhui
9.0－9.7	Ningxia, Jilin, Shanxi, Inner Mongolia, Liaoning, Shandong, Jiangsu, Hubei
8.3－8.7	Zhejiang, Henan, Guangdong, Heilongjiang, Hebei
7.7	Shanghai, Beijing

Note: [1] data for Qinghai Province excluded.

There is no need to worry since the local GDP growth on average is above 7.7%, making the weighted means around 10%.This shows some issues on the technical side, such as accounting methods. In fact, there is a significant chance of double counting if we take it as the real value. In national accounting statistics, local data can be taken as a finished product, but on the national level, it is just an intermediate product. However, there is less doubt over the growth rate unless massive changes take place in the industrial structure. Because this has been common practice for years, the numbers of sub-national levels are

accepted as final data.

As the economy recovers, structural challenges increase, which makes it difficult to predict whether the economy is on a bounce. Unless structural threats get mitigated, stimulus policies are only effective in the short term. What is really worrying is how to react if the economy slows down again.

2. Dependence on Investment and Excess Capacity

For the first three quarters of 2013, investments in fixed assets increased by 20.2%, which was 0.1% faster than the first two quarters. This contributed 55.8% to economic growth, higher than the 30.3% in the first quarter, indicating that the economy is relying too much on investment and it is getting worse. Pending high-speed railway projects resumed and some other pending projects started, such as the on-going steel project in Zhenjiang, Guangdong. With an unhealthy proportion of investment going to the real estate industry (25% of investment), sales are rising, driving economic growth. As housing prices go up, there are more top bidders and prime lots, contradicting the goals and requirements of macroeconomic readjustment and control by the government.

Unlike consumption and net export, investment constitutes a large proportion of the current period, and the established and completed products from the investment become a part of the total supply. Therefore, the structure of investment directly determines the industrial structure and economic efficiency. If investments flow into sectors and products with insufficient supply, then these investments will increase supply in the market, fulfil social needs, and alleviate the contradiction between supply and demand. If investments flow into sectors and products with excess supply, these investments will increase the capacity surplus and result in wasted assets. Judging from the current situation in China, excess capacity exists in many industries and products. It keeps getting worse because of excessive dependence on investment.

Excess capacity is not an emerging problem. It has been setting back the healthy development of the economy since the 1990s and it continues to have adverse effects. This problem is mitigated when industrial policies tighten, and worsens as policies loosen up. When the first round of macroeconomic readjustment and control was undertaken in 2003, when the State Council released the 'Circular of the State Council on Curbing Haphazard Investment in Industries such as Steel, Concrete, and Electrolytic Aluminium' (State Council Doc No.[2003]103), there were only three industries with capacity surplus listed. From 26 July to 16 September, the Ministry of Information released lists of 19 industries whose outdated production facilities would be closed.

According to official figures, at the end of 2012, production capacity utilization of the steel industry was 72%, the concrete industry 73.7%, electrolytic aluminium was 71.9%, plate glass was 73.1%, and ships and vessels was 75%. This was significantly lower than the international average. Taking the steel industry for example, from 2006 to 2012, crude steel

production capacity decreased by 76 million tons, while production increased by 440 million tons, six times the eliminated outdated production capacity. In the steel industry more production means bigger losses, so it is curious that the production of steel increased. According to the latest statistics released by the China Iron and Steel Association, the average sales profit rate of steel enterprises in the first half of the year was only 0.13%, meaning the profit of a ton of steel is not sufficient to buy an ice cream cone. The deficit of the steel industry in June was 40.7%. More worrying is that the steel industry had capacity surplus in low-end products before the international financial crisis, but capacity surplus also emerged in some high-end sheet products after 2009. Excess capacity has spread to 26 major steel markets around the country, covering all five major varieties of steel.

Moreover, sales of non-ferrous metals and petrochemicals, such as popular products like nitrogen fertilizer and calcium carbide, were also having a hard time as supply overtook demand. Excess capacity also spilled over to emerging industries; for example, the capacity surplus of photo voltaic panels was 95%, and the capacity utilization rate of wind power generators was less than 60%. At the end of the second quarter, industrial capacity utilization was a mere 78.6%. The capacity surplus on such a scale and for such a wide range of products will drag China's economy into a long-term recession if it is not alleviated.

On 15 October, the 'State Council Guiding Opinions on Resolving the Serious Excess Capacity Contradictions' was released, focusing on five major industries: iron and steel, concrete, electrolytic aluminium, plate glass and ships and vessels. It also proposed a 'roadmap' to resolve the problem of excess capacity within five years. The detailed strategy calls for some reduction by increasing internal demands, transferring some excess capacity through the 'going-out' policy, restructuring some excess capacity restructure through mergers, and eliminating some by adopting stricter entry requirements such as environmental standards. This strategy in essence is correct, but the key remains in its practice and implementation.

The root cause of the excess capacity is the institutional structure and its governance. GDP-oriented performance assessment and slow fiscal decentralization have made local governments a major driving force for excess capacity. Industries with excess capacity are easy to enter and hard to withdraw from; enterprises looking to withdraw are faced with asset losses, the handling of debts and settlements with unemployed staff, making readjustment even more complicated. In essence, the problem of excess capacity is a market problem. In a comparatively more mature market economy, fierce market competition will take place if there is excess capacity in an industry. Under the market mechanism, failed or mismanaged enterprises will have to withdraw from the market, bringing the industry back into a healthy balance of supply and demand, with the government out of the game. However, in China, excess capacity is a result of government behaviour and government competition, making it a major concern of the government. The 'Guiding Opinion' is the seventh policy document in a year stressing resolution of excess capacity. For a developing government, it intervenes in the

economy too much, and therefore blurs the boundary between the government and the market and reverses the relation between them. In particular, local governments are excessive enterprises, and they in fact act like investment companies. These local governments manage capital on local financing platforms where the government is organized just like an enterprise and government officials are like executives in the enterprise. Their major task is to increase investment by any means to create higher GDP and more income for the government. It is in this way that governments get involved in microeconomic activities and become the main entity of market competition without bearing the consequences of this competition. Local governments can then grab profits from the people and transfer the cost to the people within their jurisdiction by the soft power of government budgeting and other powers they have. In the name of attracting investment, and by offering preferential treatment regarding land, taxes and resource allocation, local governments distort the market, facilitate unfair competition and exacerbate the problem of excess capacity. To resolve excess capacity, one needs to rely on the market instead of governments. When governments take control in resolving the excess capacity problem, the market mechanism is side-lined.

Reforms need to be undertaken to resolve excess capacity and to correct the distorted performance assessment mechanism and the unreasonable fiscal system. A clear line between government and the market should be drawn to correct and limit the behaviour of the governments and government officials, to fundamentally resolve the problems of investment impulses and dependence on investment. We need to let the market mechanism allocate resources and allow market competition to resolve excess capacity.

In resolving the excess capacity, it is not the responsibility of the government to close enterprises by force to eliminate outdated production capacity as it is not the government that identifies outdated production capacity, but rather the market. All that governments need to do is to provide a market environment with fair competition and an advanced set of energy consumption and environmental standards to raise the requirements for entry and to ensure the implementation of these standards by enforcement of the law.

In the current system, the game between local governments and the central government has spilt over to other aspects beyond the resolution of excess capacity. The ‘Guiding Opinions’, based on local governments’ intervention in the economy, identified the problems of entry standards and law enforcement and accountability, both of which are underemphasized. The document simply stated that ‘care should be given to law enforcement and accountability. For items and departments that do not meet this requirement, a notice of criticism should be circulated. Extended institutions should be established for accountability’. Therefore, whether the problem of excess capacity can be resolved, remains to be seen.

3. Pushing Foreign Trade and Economic Restructuring through Foreign Investment

Foreign trade increased by 7.7% for the first three quarters of 2013. This number looks solid, but the problems demonstrated by frequent fluctuations should urge caution. Foreign trade

increased by 13.5% in the first quarter due to false trade numbers and decreased to 4.3% in the second quarter due to the fight against cargo transportation. Foreign trade experienced negative growth in June, and a growth of over 7% in July and August. It fell back to 3.3% in September with exports falling by 0.3%. Therefore, dependence on foreign trade fell from 50.4% in the first half of the year to 49.7% in the third quarter. It is worth noting that it is reasonable for foreign trade to maintain a low growth rate and is necessary for economic restructuring, demonstrating the declining dependence of China's economy on overseas market demands.

Although monthly data can hardly represent trends, and the data of September may be related to holiday spending, the economic growth of China is relevant to the economic situation in emerging economies. China's export to emerging economies such as ASEAN countries, India, South Africa, and Brazil, accounts for 17% of the total. China's exports to these countries are influenced by the increase of bond yields and credit tightening, which resulted in the slowing of domestic demand in those emerging economies. However, the emerging economies are recovering along with the USA, and the EU economy is getting back on track. China's exports to the USA and the EU account for a larger share than exports to the emerging economies, which can influence China's trade in a positive way in the future. Because of tension between China and Japan, China's trade with Japan decreased by 7.9% in the first three quarters of the year. However, there are new factors contributing to economic growth, such as technological innovation, especially the energy technologies, which bring down the energy price. The USA has already put forward plans to reshore manufacturing, as China lags behind in technological innovation. In addition, as labour and environmental costs increase, China is losing its advantages, although China's labour cost is still lower than that of the USA. It is hard to predict which manufacturing industries are reshoring and by how much, but such factors should not be ignored.

As 'made in China' loses its glamour and the restructuring of the economy is undertaken, it is impossible for the trade of goods to return to the high rate of growth of the past, with trade of services being more worrying. According to data of the State Administration of Foreign Exchange (SAFE), China's trade of services had a deficit of USD 55.1 billion for the first half of the year, accounting for 51% of the trade surplus of the same period (USD 107.95 billion). Even though the total amount of trade of services has increased, so has the deficit, which not only sets off the trade surplus, but endangers China's strategy to develop a modern service sector.

China is a tourism destination, but the trade of tourist services is the largest source of deficit. For the first half of the year, there was a deficit of tourist services of USD 35.7 billion, an increase of 64% over the previous year. If we compare domestic tourism during the Golden Week, thanks to the bad quality of tourist services, poor management and low level of internationalization, it is easy to see that profits from tourism have gone to other countries.

China ranks first in the world in terms of trade volume. This helps to enlarge the

international logistics market and to increase the price of logistics. However, as Chinese logistics enterprises are not as internationalized, many orders flow to foreign logistics enterprises. Chinese logistics companies are unable to build ports, airports and storage facilities overseas, surrendering logistics orders of food, fresh goods and large scale commodities to foreign logistics enterprises and ‘import’ logistics services. The deficit of logistics services for the first half of the year accounted for USD 26.3 billion, right after that of tourism.

This situation exists not only in traditional industries such as tourism and logistics, but also in high-end service industries such as finance, insurance and consulting. Services in such areas are even more disadvantaged, accounting for a smaller portion in the trade of services, with lower competence. In the first half of the year, the total value of exports and imports of financial services was USD 2.8 billion, and the trade deficit resulting from royalties of financial and insurance services amounted to over USD 17 billion. It will take time for the situation to improve.

The huge deficit of China’s trade of services is related to the overall underdevelopment of the service sector. By the third quarter of 2013, the added value of China’s tertiary sector accounted for 45.5% of GDP, much lower than in the USA (80%), and lower than many other developing countries like China. It is hard for resources to be allocated in service sectors, especially the high-end service sectors, as manufacturing is highly marketized and there are many government regulations in the service sector. The participation rate and production rate of production factors are also obviously lower than those of the manufacturing sector. It is difficult for the service sector to develop quickly without breaking up monopolies, deregulating and promoting the free flow of factors.

Moreover, a more serious challenge is that as technology advances, with digital transactions and electronic payment facilitating economic development, the structure of the trade of services is undergoing big changes. As traditional services decline, the emerging services account for a larger portion of GDP growth. Developed countries such as the USA, EU member states and Japan join the competition on the international level with their advantages in high-end service industries, hoping to grow in developing countries and markets like China. According to recent reports by both the Japanese Chamber of Commerce in China and the American Chamber of Commerce in China, it is recommended that China’s financial, consulting, telecom, express mail service and medical treatment industries are opened up. Under these circumstances, if we cannot push market reforms further and break unnecessary regulations and monopolies in the service sector, especially the high-end service sector, it will be impossible to restructure the Chinese economy and to strategically pivot for a modern service sector.

Ever since the reform and opening-up, China has been practicing mercantilist policies, expressed through an emphasis on attracting foreign investment, encouraging export production and undervaluing the currency. It was the right thing to do in the early phase of

industrialization; otherwise, it would have been hard for the economy to take off. But after three decades, with domestic industries developed, excess capacity has emerged and export growth has slowed. Besides, China has accumulated huge foreign reserves. Thus, it is a key step to take to develop foreign investment and promote exports of products for China to make more room for economic development and facilitate the restructuring of the economy. From January to September this year, the utilization of foreign capital decreased by 3.8%, and it is illustrated by the increase of non-financial foreign investment by 18.5%. After three decades of development, China is now ready to carry out deeper reforms and the most important thing is the conception and practical solutions.

For instance, we have gone from 'made in China' to 'created in China' for some brands in domestic electrical appliances thanks to efforts in technological innovation, marketing and branding. Brands such as Haier and Midea have already gone international and have some international influence. One of the preconditions for domestic brands to enter the international market is the development of the financial market, which enables enterprises with potential to obtain financial support, undertake mergers and acquisitions overseas and increase the competence of these brands in the international market.

As another example, in recent years the high-speed railway industry has been booming. High-speed rail operation mileage has grown 10,463 kilometres, ranking first in the world. The high-speed railway system has a chain of three parts: the upstream railway infrastructure, midstream train and related equipment manufacturing, and the downstream operation services. By technology transfer and independent innovation, breakthroughs have been made in core technologies and components, which have created comparatively strong competence in the market. Practical applications have been made in domestic construction and operation, building a solid foundation for the export of high-speed railway technologies. As the domestic market for high-speed rail has reached saturation point, it is necessary to develop foreign markets. Even though there are still gaps between technologies in China and those in developed countries in Europe and the USA, exports of high-speed railway technologies to Europe and the USA have begun. Recently, a memorandum on 'deepening cooperation in railway construction' has been concluded between China and Thailand, symbolizing a new phase in exports of high-speed railway technology.

China's construction machinery industry started relatively late, but in the last decade, as China underwent great construction, China's construction machinery industry achieved a great leap forward in technological innovation, product development, machinery manufacturing and operation of the industry chain, asserting itself in the international market. Among the top 50 construction machinery manufacturers, 11 are from China, and three of the top 10 manufacturers are from China. Some major companies are able to manufacture 26 common construction machines of the same quality as foreign manufacturers. The export of construction machinery products accounted RMB 7.289 billion in the first half of the year. Sany Heavy Industry bought Putzmeister at RMB 2.7 billion, and Guangxi Liugong Group

bought the construction machinery department of HSW from Poland at RMB 335 million. Through international mergers and acquisitions, restructuring and integration, Chinese enterprises have achieved a leap forward in products, research and development, technology, corporate management and marketing.

These cases show that entering the international market, developing investments in foreign countries and enlarging foreign trade will not only resolve the domestic excess capacity problem, but also promote restructuring and a shift of development mode, which is the right option to further guarantee the healthy and stable development of China's economy. To accomplish this, we need to speed up marketization reforms, loosen and break government regulations and improve efficiency and services. For example, China now holds more than USD 3.6 trillion in foreign exchange reserves. If China supports enterprises in international mergers and acquisitions, provides loans for the export of equipment, and supports purchases of Chinese equipment, Chinese enterprises will be more international and more competent in the international market, which will further alleviate the risks and pressure of holding large-scale US foreign currency reserves. In fact, the lessons learned when foreign enterprises came to China to invest and created many enterprises of 'three import and compensation trade'[1] and Sino-foreign joint ventures, should be that we can do the same to encourage Chinese enterprises to go abroad and invest, mainly in developing countries, and take the chance to go to developed countries.

With the development of overseas investment and the internationalization of Chinese enterprises, relevant services should also follow, for example, financial services and insurance services are necessary to provide equipment export loans, as are logistics services. In this way, trade of services will also be developed. This may be the route to take for China's economic transformation and upgrading.

4. Forecast

The economy of the USA is recovering as of this year, and the euro zone has stepped out of the shadow of recession. It seems that Japan has also put an end to its 20 years of recession. The global economy as a whole has no severe risks. But challenges remain. There are at least five euro zone countries in perilous recessions, and the global capital flow has taken a shift as the US Federal Reserve cut debt purchase expectations. Some emerging economies are going through a slowdown of economic growth, inflation, and currency devaluation. The causes are multi-faceted, as the slowdown of economic growth is a result of cyclical factors and decreased potential for growth. As chief economist of the World Bank, Mr Kaushik Basu

[1] These are enterprises that process imported raw materials, manufacture products according to imported samples, assemble imported parts and those that repay loans for imported equipment and technologies with products.

stated, the global economy will be faced with a 'very difficult time' for the next one to one and a half years. The latest issue of the IMF's *World Economic Outlook Report* on 8 October downgraded expectations for global economic growth for this year and next year to 2.9% (down by 0.3%) and 3.6% (down by 0.2%). Its forecast of China's economic growth rate is 7.6% and 7.3% for 2013 and 2014.

Judging from domestic situations, as the government increases economic stimuli and investments and new projects, economic growth maybe influenced to a certain extent. It is estimated that the economic growth rate of the fourth quarter may be around 7.8%, which makes the annual growth rate no lower than 7.7%. The detailed forecast is shown in Table 2.

TABLE 2: Economic Indicators 2012-2013, Actual and Predicted

Quarter / Economic Indicator	2012 Whole Year (Actual)	3rd Quarter of 2013 (Predicted)	3rd Quarter of 2013 (Actual)	4th Quarter of 2013 (Predicted)	2012Whole Year (Predicted)
	Increase (%)	Increase (%)	Increase (%)	Increase (%)	Increase (%)
GDP	7.8	7.4	7.8	7.8	7.7
Industrial Added Value	10.0	9.3	9.6*	10.5	10.2
Investment in Fixed Assets	20.6	20.5	20.2*	21.0	20.3
Retail Sales of Consumer Goods	14.3	12.5	12.9*	13.2	13.0
Exports	7.9	3.0	8.0*	6.0	7.5
Imports	4.3	5.0	7.3*	8.5	8.0
Consumer Price	2.6	3.0	2.5*	3.2	3.0

Notes:

1. The growth rate of GDP and industrial added value are calculated by comparable prices, the rest are calculated based on the current prices;
2. Investment in fixed assets refers to the total social investment in fixed assets;
3. Industrial added value refers to added value of non-state-owned enterprises with venues over RMB 5 million and that of state-owned enterprises;
4. * refers to data for the first three quarters.