RIS Policy Brief
CHINA UPDATES
No. 62 December 2013

China's Economy: Stable, but needs to be Sustainable

Just when the world thought that the "Chinese Charm" is losing its sheen with slow economic growth and dipping manufacturing indices, a slew of policy measures have been introduced by China that may stabilise the economy. Several financial reforms are also on the anvil that are likely to bring sweeping changes in China's economy. The National Bureau of Statistics (NBS) has reported a GDP growth rate of 7.8 per cent from July to September, rebounding from 7.5 per cent in the second quarter of 2013.

However, as opposed to the high growth rates observed post-2008 crisis, these growth rates are much lower. In 2012, the economy expanded at 7.7 per cent, down from 9.3 per cent in 2011 and 10.4 per cent in 2010. The IMF has cut its own forecast of 7.75 per cent growth for China's economy predicted in May 2013, to 7.5 per cent recently. An annualised growth rate of 7.5 per cent would mark the slowest pace of expansion in 23 years.[1] While World Bank and ADB also cut their 2013 forecast for China to 7.5 per cent and 7.6 per cent, respectively that are well below their own estimated rates in April this year. The OECD has the highest estimate, as of now, for China's economic growth at 7.8 per cent for 2013.

Although growth may have slowed down for China, and a further grim scenario is predicted by different international organisations for the economy, there are signs of recovery and stability in the economy in the past few months. This policy brief would attempt to track the trends in economic growth and policy changes that have been taking place in China in the recent times and the policy measures on the fiscal and financial fronts that are required to be taken.

Growth Trends

High economic growth has clearly taken a backseat for China, however, the attempts to stabilise and further fuel the economy are on by the government. The economy grew at 7.8 per cent in the third quarter of 2013. The prospects of growth have also been positive in the other sectors of the economy.

According to the latest purchasing managers index (PMI[2]) released by the National Bureau of Statistics (Chinese Federation of Logistics and Purchases, CFLP), the manufacturing and the services sector have shown a sign of growth in the last two months. The manufacturing PMI for November 2013 rose to 51.4, which was the highest this year, although it remained unchanged from the October. The non-manufacturing PMI showed an impressive growth with the PMI reaching 56.3 in October, while falling to 56 in November.

A similar index widely reported is the HSBC Emerging Market PMI which also showed signs of recovery in the manufacturing sector, while a modest

RIS Policy Briefs are prepared to communicate results of RIS research on specific policy issues to the policy makers.

This *Policy Brief* has been prepared by Ms. Ramaa Arun Kumar, Consultant, RIS.

services sector growth in September (see Table 1). Service sector firms operating in China expected activity levels to be higher in one year's time. However, according to Qu Hongbin, Chief Economist at HSBC believes China's services activity growth is stabilising at a faster pace than in the second quarter and this led to a renewed expansion of employment from the contraction in August.

Table 1: Revised Estimates of China's GDP Growth (in per cent) in 2013

	ADB	IMF	World Bank	OECD
Previous Estimates (early 2013)	8.2	7.75	8.3	7.8
Revised Estimates	7.6	7.5	7.5	--

Sources: Biannual East Asia and Pacific economic update, World Bank; China - Economic Forecast (May 2013), OECD; Asian Development Outlook Supplement, July 2013, ADB.

Another sector whose growth determines the industrial progress is the power sector. According to official estimates of NBS, power production saw a growth of 5.2 per cent in the first seven months in 2013, compared to 3.8 per cent growth in the same period last year.

Industrial profits too showed signs of growth owing to the internal re-stocking taking place in companies, increased fiscal spending by the government and also economic recovery of developed economies like the US and the EU boosting external demand. According to the NBS, the industrial profits of enterprises from January to August were 3,486 billion yuan, an increase of 12.8 per cent over the same period last year, which is 1.7 percentage points higher than that in the first seven months of 2013. The NBS collects data on enterprises with revenue from principal business over 20 million yuan.

On the domestic demand front, the growth of retail sales of consumer goods has been sluggish, with retail sales in the first three quarters of 2013 growing at 12.9 per cent. Total retail sales in September hit 2.07 trillion yuan, up by 13.3 per cent over the same period last year, and down slightly from the 13.4 per cent growth registered in August, according to the official estimates (Figure 1).

Figure 1: Retail Sales of Consumer Goods for China

Source: National Bureau of Statistics of China.

[1] http://www.ibtimes.com/china-september-economic-data-preview-q3-gdp-inflation-trade-balance-investment-1416076?ft=9r85d

[2] The PMI is a gauge of nationwide manufacturing or services activity collected through a survey of purchasing managers in the manufacturing sector on production/business activity, new orders, export orders, existing orders, finished goods inventory, purchase, import, purchase prices, raw materials, inventory, employees, suppliers, delivery time, production and business activities expectation.

Table 2: Purchasing Managers' Indices for 2013

Year	Manufacturing		Non-Manufacturing	
2013	CFLP	HSBC	CFLP	HSBC
January	50.4	52.3	56.2	54
February	50.1	50.4	54.5	52.1
March	50.9	51.6	55.6	54.3
April	50.6	50.4	54.5	51.1
May	50.8	49.2	54.3	51.2
June	50.1	48.2	53.9	51.3
July	50.3	47.7	54.1	51.3
August	51	50.1	53.9	52.8
September	51.1	50.2	55.4	52.4
October	51.4	50.9	56.3	52.6
November	51.4	50.8	56.0	--

Notes: Chinese Federation of Logistics and Purchases (CFLP), Department of Services, NBS releases monthly PMI. HSBC releases monthly PMI data.

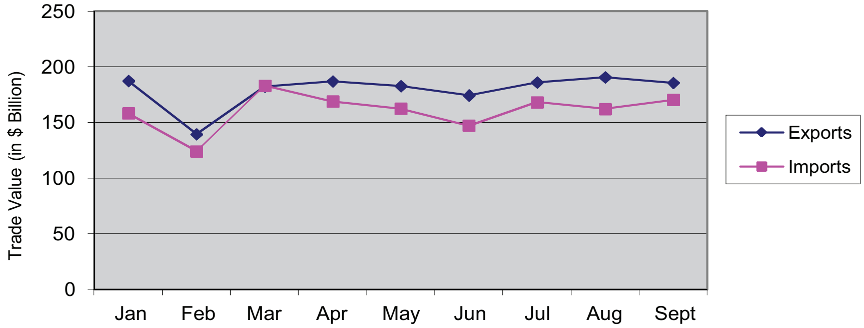
Sources: National Bureau of Statistics and HSBC Emerging Markets Index.

A greater emphasis needs to be given to investments that are channelled to more labour intensive business activities, rather than big infrastructure projects that generate fewer jobs. This would feed into greater household income, and therefore, higher household consumption. The slow growth of retail sales indicates that the domestic consumption demand has failed to pick up and drive the economic growth of China, which has been fuelled mostly by investments and exports.

Investment

Although emphasis has been laid on reforming the economic growth path from an investment-led growth to that of domestic consumption one; in 2013 investments continued to remain the major drivers of growth. According to official estimates, by the end of September, fixed-asset investment (FAI), led by infrastructure and central government-funded projects, accelerated to 20.2 per cent year-on-year to 30.9 trillion yuan ($5.07 trillion). Growth of investment

Figure 2: Monthly Trade Data for China in 2013



Source: Ministry of Commerce, People's Republic of China.

in infrastructure outpaced the overall level, expanding at 25.1 per cent in the first three quarters to 4.8 trillion yuan. Investment-driven growth contributed 55.8 per cent, or 4.3 percentage points, of the overall GDP expansion in the first three quarters.

Loans for FAI are gradually providing a push to economic activity, and growth in production of cement and steel products has picked up. Output of cement from January to July 2013 grew at 9.6 per cent as compared to a much lower rate of 5.3 per cent in the same period in 2012. Similarly, crude steel production and that of steel materials grew at 7.1 per cent and 10.4 per cent, respectively whereas, the corresponding rates in the same period in 2012 were a meager 2.1 per cent and 6.1 per cent, respectively.

On foreign investment front, China attracted $88.6 billion in FDI between January and September 2013, up by 6.2 per cent year-on-year, of which the service sector attracted $44.7 billion, more than 50 per cent of the total FDI. The government also gave green light to the establishment of 16,351 foreign-funded firms in the country, down 9.3 per cent from the same period last year.

China has granted $1.02 billion in fresh combined quotas to licensed overseas institutional investors in October, which would increase the total quotas issued under the Qualified Foreign Institutional Investor (QFII) programme to $48.51 billion by the end of October from $47.49 billion a month earlier.[3] Institutional investments in China require a license for foreign investors from the securities regulator to be eligible to seek investment quotas from the foreign exchange regulator.

External Trade

China's external trade has also been picking up pace in the recent times. The total trade in the first three quarters of 2013 was $3,060 billion, with a trade surplus of $169 billion, a 14.6 per cent year-on-year growth. This is being seen as another sign of stabilisation in China's economic growth. Especially, compared to the trade performance in the first few months, when both exports and imports registered negative growths compared to the previous months' trade (Figure 2), this rebound along with other indicators point to a recovering economy. In addition, with gradual economic recovery in the developed part of the world, a surge in demand in the US and the EU, which are also the major markets for China, has led to a consistent increase in exports from China.

The bilateral trade between China and the EU, which is the second largest trade partner of China, is likely to increase further with the bilateral currency swap that has been signed in October 2013, for $57 billion (£36bn; 350 bn yuan). This is the largest the People's Bank of China has signed with a foreign central bank outside of Asia. This deal would help provide liquidity support for the renminbi market in Europe and also promote overseas use of the renminbi. EU's intention in signing this deal points to the ambitions of countries like the UK and Germany to become the clearing centers for renminbi in Europe to be able to provide lucrative financial services.[4]

Imports of raw materials have also been on the rise. China forges almost as much steel as the rest of the world combined and to meet the demand of raw materials for steelmaking raw material China's iron ore imports surged to a fresh record in September 2013.

China imported at a new all-time high level of 74.58 million tonnes of iron ore in September, up by 8 per cent from August and up a surprisingly robust 15 per cent compared to last year. Imports of Australia-origin ore totalled 39.19 million tonnes, up by 12.5 per cent month-on-month, while those from Brazil amounted to 13.77 million tonnes, up by 1.3 per cent. South African material accounted for 3.77 million tonnes of China's imports, a 5.2 per cent increase. Imports from India, which had dropped from China's top ten list of suppliers for

[3] http://www.reuters.com/article/2013/10/31/china-investment-qfii-idUSB9N0I600Q20131031

[4] http://www.reuters.com/article/2013/10/10/us-ecb-china-swap-idUSBRE9990A220131010

several months, made a comeback in September. Imports of copper ore registered an impressive growth of 18 per cent in September than the earlier months, owing to a decline in warehouse stocks.

It is believed that the increased raw materials imports to China at this time, which is a traditionally slower period for demand, are going into rebuilding inventories that were drawn down in earlier months this year.

Financial Policy and Economic Recovery

The financial sector plays a key role in determining the growth path of the economy. Research on finance-growth linkage suggests that state owned banks are normally associated with low efficiency, restricted access to credit for Small and Medium enterprises (SMEs), and slow economic growth. China's financial sector is dominated by four big state-owned banks - China Construction Bank (CCB), Bank of China (BOC), and Industrial and Commercial Bank of China (ICBC) and Agricultural Bank of China (ABC) – called the "Big Four" banks.

However, the rapid growth in China since two decades is primarily due to the outward orientation of the economic activity relying heavily upon external trade and big infrastructure projects. The huge inflow of funds into China, due to a burgeoning trade surplus and high savings rate has helped infuse large funds into the economy that is currently invested in foreign securities and foreign direct investment. The finance-growth nexus strongly suggests that the observed high growth rates cannot continue indefinitely without significant reform of the banking system and the legal/financial infrastructure (Berger *et al.* 2009).

The recent reforms in the financial sector point to the changing orientation of the Chinese authorities from a hitherto government controlled financial sector to a market determined one. The government and the central bank are steering their policies towards creating a more liberalised financial sector and following a growth model that relies less on foreign investments and foreign demand and more on domestic consumption and innovation. To this end, the government recently loosened controls on banks' lending rates by allowing market forces to play a larger role in determining the lending interest rates. In addition, the floor on the lending rates was also scrapped to enable competition among banks to compete for customers by reducing cost of borrowing and actively seeking private entrepreneurs which would encourage more innovations.

The previous system of controlled lending rates helped channeling cheap loans to state-owned enterprises and other big businesses while maintaining a wide margin for bank profits. This led to misallocation of financial resources. Therefore, this move would also help allocate resources better, which would also lead to a more stable macro economic growth of China. However, it is being said that this move may not bring any tangible changes because for long the Chinese banks have been charging high interest rates on lending which were way above the floor rates. Thus, a removal of the floor rate would not have much effect on the borrowing structure. The central bank's own data shows that just 11.4 per cent of loans are currently made below the benchmark, suggesting that the share of borrowers that stand to benefit from low rates could be small.[5]

Apart from freeing the lending rates off the controls, the other part of controls still remain in the financial system, for example, the ceiling on deposit rates, mortgage rates, etc. The removal of these controls would be considered a landmark reform in the financial system. The long period of control on deposit rates which are abysmally low has been a major factor in weakening the banking system. With very low rates of return on their deposits, and controls on borrowing, the domestic savers have turned to a parallel system known as "shadow banking", which is an unregulated system of

[5] http://online.wsj.com/article/SB10001424127887324448104578615430573714510.html

[6] Paul Mackel, "Focus on Renminbi". HSBC News and Insights. 7 August 2013.

lending and borrowing and other financial products mostly based on trust. The value of this sector is estimated to be 36 trillion yuan ($5.86 trillion), almost 69 per cent of China's GDP.

Therefore, the need for financial reform is much warranted, given the recent liquidity crunch in June 2013 that was caused due to tighter regulation, smaller investment flows as well as seasonality. In addition, liquidity tends to tighten towards the end of June when regulators check the loan-to-deposit ratios of banks (HSBC[6]). The short term interest rates soared to as high as 30 per cent. The seven-day interest rate reached 12.5 per cent.

Challenges Ahead

While the Chinese government seems to be committed in taking steps to stabilise the macro economic situation, there are numerous challenges ahead for the authorities. The need of the hour for China is to restructure its macro economic framework and steer its policies from relying excessively on investments and exports to domestic consumption. However, some of the steps that the government has taken recently do not indicate that. The monetary stimulus provided recently aimed at fuelling investments rather than domestic consumption (Saran 2013). The country is teeming with overcapacity; therefore, any further investments would only add to their excess capacity rather than translate into any real growth.

Moreover, due to the overcapacity, the non performing assets (NPAs) of the banks have risen manifold. Although the official figures show that the NPAs of Chinese banks form only 1.1 per cent of the GDP, the true picture may not be shown as the state-owned banks "…routinely roll over debts of large state-owned enterprises and local government entities" (Saran 2013).

With inflation on the rise, the fiscal and monetary policies have to work together to rebalance. Another stimulus will have no real effect on growth and will only add to the overcapacity and feed into inflation, while a tighter monetary policy will only aggravate the plight of the already credit-hungry industrial sector. A better channelisation of funds is required at the moment towards the small and medium companies while ending the easy access to credit by the sectors with overcapacity such as infrastructure. In addition, domestic entrepreneurship and innovation should be encouraged. With rising labour cost, there is a likelihood of the foreign invested firms shifting out their firms from China in the long run. Investment in infrastructure would not be enough if a simultaneous absorption of the same takes place through a corresponding rise in industrial activity.

A strong financial system can provide a boost to the confidence of domestic as well as foreign entrepreneurs to carry industrial activity in China. Reiterating the policy recommendation discussed, the financial system of China needs to be liberalised, in terms of freeing the ceiling on deposit rates and mortgage rates for better channelisation of funds in the economy.

References:

Berger, Allen. N, Iftekhar Hasan, Mingming Zhou. "Bank Ownership and Efficiency in China: What Will Happen in World's Largest Nation?". *Journal of Banking and Finance*, Vol. 33, 2009.

Saran, Shyam. "China's Flawed Rebalancing". *Business Standard*, 10 September 2013.

RIS

Research and Information System for Developing Countries

Core IV-B, Fourth Floor
India Habitat Centre
Lodhi Road, New Delhi-110 003, India.
Ph. 91-11-24682177-80
Fax: 91-11-24682173-74-75
Email: publication@ris.org.in
Website: www.ris.org.in