

Chapter 2

A Review of China's Economy in the First Half of 2014

2.1 The Economic Growth Rate Continued to Slow Down, the Employment Increased in the Tertiary Industry

In the first half of 2014, the growth rate of gross domestic product (GDP) continued to fall in China. Compared to the same period of last year, the real GDP grew by 7.4 %, which was the lowest in the last 4 years. Specifically, real GDP grew by 7.4 % in the first quarter, and rose to 7.5 % in the second quarter owing to micro-stimulus policies. The major reasons for the slowdown of economic growth were the weak growth of investment in the manufacturing industries and real estate sector. The cumulative growth rate of total industrial added value was 8.8 %, the lowest level since 2010 (Fig. 2.1).

Although the economic growth continued to decline, the share of value-added output of the tertiary industry in GDP kept rising quickly. It reached 46.1 %, 2.2 percentage points (Fig. 2.2) higher compared to secondary industry in 2013, and it rose further to 46.6 % in the first half of 2014, 0.6 percentage points higher compared to the secondary industry. The expansion of the service or tertiary industry guaranteed a stable employment. For example, in 2013, an increase of one billion CNY output in the tertiary industry could create about 11,000 jobs, while the same output in the second industry would only create 9,000 jobs. Although the economic growth slowed down in the first quarter of 2014, the requirement rate remained 1.11 in the labor market.¹ To some extent, it indicated that the slowdown of current economic growth has not yet hindered the labor market.²

¹The requirement of 1.11 means that the employer supplies 1.11 jobs for each job seeker in the labor market.

²Recently the impact of changes in the aging structure of China's population is also of concern. By the late of 2012, the working-age population aged 15–59 (including whose age was under 60) was 937 million, 3.45 million less than the last year; by the end of 2013, the working-age population decreased to 920 million further.

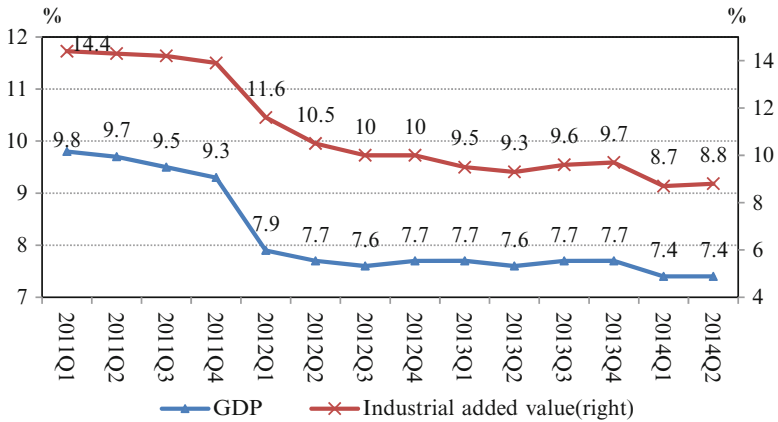


Fig. 2.1 The growth rates of real GDP and industrial added value, on the year-on-year basis (Data Source: CEIC Data)

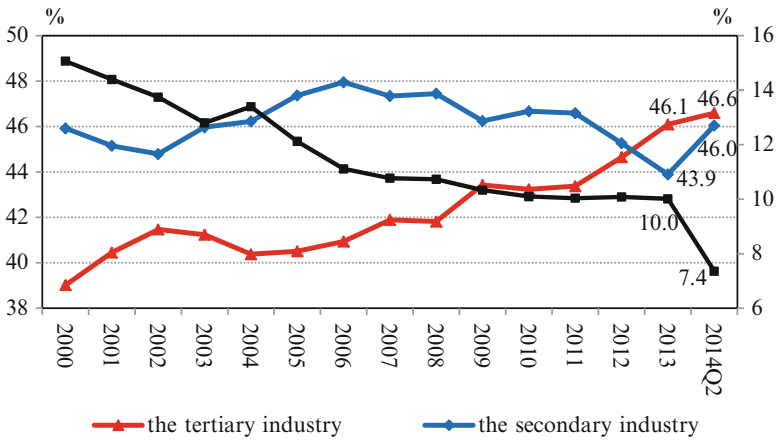


Fig. 2.2 The shares of value added output of three industries in GDP (Data Source: CEIC Data)

2.2 The Investment Growth Continued to Decline in the Fixed Assets, but Grew Fast in the Infrastructure Construction

In the first half of 2014, the cumulative growth of investment in fixed assets (excluding the investment of rural households) was 17.3 %, a decrease of 2.8 percentage points over the last year, mainly because of the decreasing growth of investment in the manufacturing industries and real estate industry. As a result of excess production capacity and weak recovery of demand from the external market in the first half year,

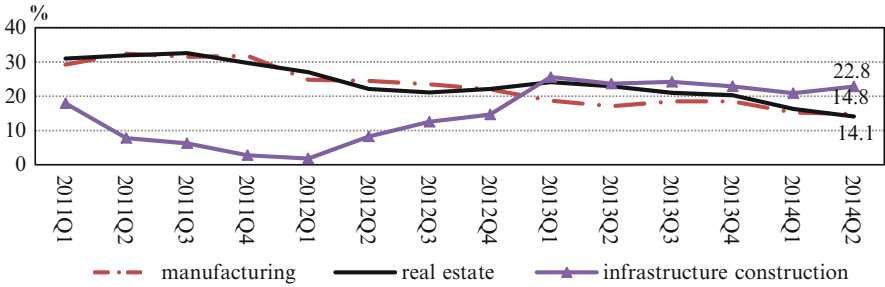


Fig. 2.3 The cumulative growth rate of nominal fixed asset investment in the main industries (Data Source: CEIC Data)

the cumulative growth rate of investment in manufacturing industries was only 14.8 %, a decrease of 2.3 percentage points over last year, which was also the lowest in the last decade. Besides, as the cool down of the real estate market, the growth of housing sales decreased and the housing inventory accumulated. A considerable number of cities experienced a sharp cut in the sales of the real estate,³ which directly undermined the investment growth in the real estate industry. The cumulative growth of the real estate investment was 14.1 % in the first half of 2014, a decrease of 8.8 percentage points over last year. In fact, the rapid growth of the investment in the infrastructure construction had offset the adverse impact of weak investment in the manufacturing industries and real estate industry in the first half of 2014. The cumulative growth rate of investment in the infrastructure construction reached 22.8 %, an increase of 1.3 percentage points over the previous year (Fig. 2.3).⁴ The improvement of infrastructure investment, to some extent, stopped a further decline of investment in the total fixed assets.

Compared the first half of 2014 with the same period of 2013, the cumulative growth of investment from the state-owned and state-holding enterprises, the private sector, Hong Kong, Macao and Taiwan enterprises, foreign enterprises was 14.8 %, 20.1 %, 4.8 % and 0.1 %, decreases of 2.7, 3.3, 2.7, 3.8 percentage points respectively. The substantial decrease of investment growth from the private sector and foreign enterprises was the major reason that led to a decline of investment growth in the total fixed assets. Moreover, viewed by the sources of projects, the investment growth from the central projects was 14.6 %, an increase of 4.9 percentage points over the previous year; the investment growth from the local government projects

³The average prices of new home in 100 cities fell more evidently in July, keeping a decreasing trend in the recent 3 months. Moreover, the price cut was more evident in the big ten cities, exceeding the average level in the country. Quoted from China Index Academy, “China Real Estate Index System and 100 city price index report in July”, <http://www.shenmou.com/caijing/201408/39535.html?news.baidu>

⁴The infrastructure construction included the transportation, storage and postal services, water conservancy, environment and public facilities management industry as well as electricity, heat, gas and water production and supply industry.

was 17.5 %, a decrease of 3.2 percentage points over the last year. Thus, in order to maintain stable growth, a series of stimulus policies were implemented by the central government, especially viewed from the sources of investment projects. At present, the debt of local government is heavy, and 2014 will be the peak time for its debt payment. The local governments would not be able to implement micro-stimulus to maintain stable growth policies.⁵ Finally, viewed from the funds source for investment, the growth rates of funds from the domestic loan, self-raised fund and foreign investment were 12.9, 16.7 and -8.3 %, which were basically just on the same level of the first half of 2013.

The investment growth is expected to keep declining in the second half of 2014, the main reasons are as follows:

1. It would take some time to cut the excess production capacity due to the high investment during past years.
2. The slump of real estate market since the first half of 2014 and the high inventory would directly undermine the recovery of investment growth in the real estate industry.⁶
3. The large amount of debt repayment, in the first half of 2014, would suppress the investment of the local governments. Furthermore, the huge inventory of the real estate would hinder the local governments from selling land. Hence, the expansion of investment by the local governments would be impossible due to less revenue from selling land..
4. Though a series of policies have been launched in order to promote private investment, the actual effects are quite uncertainty in the second half of 2014.

Therefore, we believe that the investment growth would continue to decline in the second half of 2014, and the slowdown of investment growth would undermine the economic growth in future.

2.3 The Growth of Trade Continued to Fall Significantly, the Increase of Trade Surplus Narrowed

In the first half of 2014, the exports grew 0.9 % (USD), a decrease of 9.5 percentage points over the same period of last year; the imports grew 1.5 %, a drop of 5.2 percentage points (Fig. 2.4). The trade surplus increased 102.9 billion USD, a decrease of 5.09 billion USD. The actual foreign direct investment rose to 2.2 %, an increase

⁵If the government could appropriately reduce the GDP growth target, complete the reforms to match financial power with office authority between the central and local government, regulate the bond financing of local government, it would allow the local governments to gradually get rid of the finance dependence on land.

⁶As the cut of inventory in the real estate is a slow process, although many provinces launched policy such as limitations on the home purchasing in order to stop home price from further falling, the expectation of price cut is difficult to change in the short term once such expectation was formed.

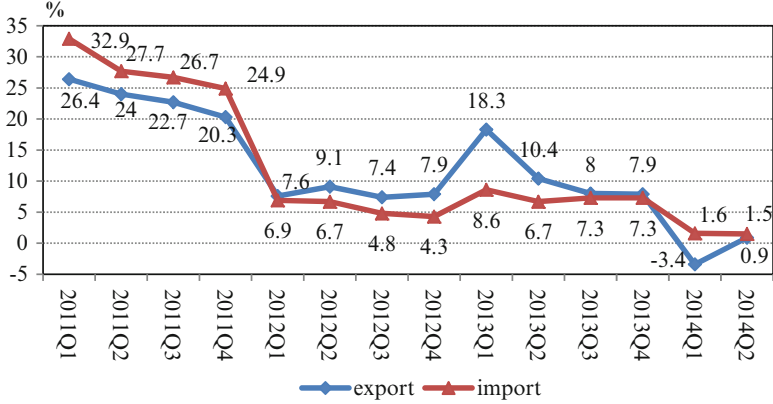


Fig. 2.4 The year-on-year growth of nominal exports and imports (Data Source: CEIC Data)

of 2.7 percentage points; the new foreign exchange reserves reached 169 billion USD, a drop of 8.7 percentage points. The main reason for the decline of export growth was the weak recovery of demand from the external market.⁷ Specially, first, as the United State was affected by the cold snowy weather and its economic statistics were seasonally adjusted in the first quarter of 2014,⁸ it led to a significant contraction of 2.9 % in its GDP growth; Second, the expectation of the exit of QE3 in the United States led to the substantial depreciation of currencies of emerging markets, which also had a negative impact on the exports of China. The decline in import growth was mainly due to the slowdown of domestic economic growth. However, beyond the cyclical factors, the domestic economic restructuring, the transformation of developing mode, the international economic rebalancing caused by the international financial crisis and new changes in the international economic environment perhaps were the further reasons that led to the slowdown of growth in exports or imports recently. As the adjustment of China’s economic growth mode, the foreign trade will enter a new phase and the super high-speed growth of trade during 2002–2007 could not be reproduced and a lower growth rate in foreign trade will be achievable.⁹

⁷In addition, the true export of last year was “over-estimated” by the statistic authority.

⁸The bad weather in the winter had rather a negative impact on the consumption, fixed assets investment and trade in the United States during the first quarter of 2014. Specially, based on the substantial rise of inventory in the second half of 2013, the significant decrease of inventory brought about a decrease of 1.7 percentage points in GDP growth rate for the first quarter of 2014.

⁹Some scholars believe that, besides the GDP growths in the world and China, the proportion of China’s exports accounted for the total exports in the world is an empirical observation data that can be used as basis for further projection. According to such estimates for the next decade, the reasonable range for China’s trade growth rate should be 3–4 percentage points higher than the counterpart in the world, and China’s growth rate of exports is probably 4–5 percentage points higher than the speed in the world. Quoted from Chang Hong Pei: “Building an open economy,” “China Economic Herald”, 2014, Number 14.

Turning to the trade composition, in the first half of 2014, the general trade exports grew 8.4 %, a drop of 1.6 percentage points over the same period of 2013; the general trade imports grew 6.2 %, an increase of 3.2 percentage points. The deficit of general trade accounted for 13.3 billion USD, 10 billion USD less than the last year. The growth of processing trade exports decreased 2 %, a decrease of 1.1 percentage points; the growth of processing trade imports fell 1.1 %, a drop of 5.7 percentage points. As a net effect, the surplus of processing trade narrowed to 167.4 billion USD.

In the first half of 2014, the exports to Association of Southeast Asian Nations (ASEAN) increased to 7.1 %, a drop of 15.6 percentage points over the previous year; the exports to European Union (EU) grew 9.9 %, nearly 14 percentage points more than the previous year; the exports to the United States of America (USA) increased 5.1 %, an increase of 3.4 percentage points over the previous year. On the import side, the imports from ASEAN grew 2.2 %, an increase of 0.5 percentage points; the imports from EU grew 16.2 %, an increase of 18.4 percentage points; the imports from USA grew 5.0 %, a drop of nearly 10 percentage points. By the end of the first half of 2014, the shares of exports in total to ASEAN, EU and USA were 11.6 %, 16.2 % and 16.7 % respectively, an increase of 0.7, 1.3 and 0.7 percentage points over the same period of previous year respectively; the shares of imports in total to ASEAN, EU and USA were 10.2 %, 12.4 % and 8.3 % respectively, an increase of 0.1, 1.6 and 0.3 percentage points over the first half of previous year respectively.

2.4 The Growth of Real Income Rebounded Slightly, the Growth of Total Retail Sales of Social Consumer Goods Kept Falling

In the first half of 2014, the per capita disposable income of urban residents was 14,959 CNY, a growth of 7.1 %. Although it was an increase of 0.6 percentage points of growth rate compared with the first half of 2013, it was a decrease of 2.6 percentage points compared with the same period of 2012.

The per capita cash income of rural residents was 5396 CNY, a growth of 9.8 % compared with the same period of 2013. Though it was an increase of 0.6 percentage points over the same period in 2013, it was a decrease of 2.6 percentage points compared with the same period in 2012 (Fig. 2.5). It shows that the decline in GDP growth in recent years has begun to suppress the growth of real income of urban or rural residents in China.

Due to the slowdown of growth of residential real income as well as the new restrictions on government consumption triggered by anti-corruption actions recently, the growth of the total retail sales of social consumer goods was directly restrained. In the first half of 2014, the total retail sales of social consumer goods grew by 12.1 %, a decrease of 0.6 percentage points over the same period of last year, which was also the lowest since 2008. Specially, according to the urban and

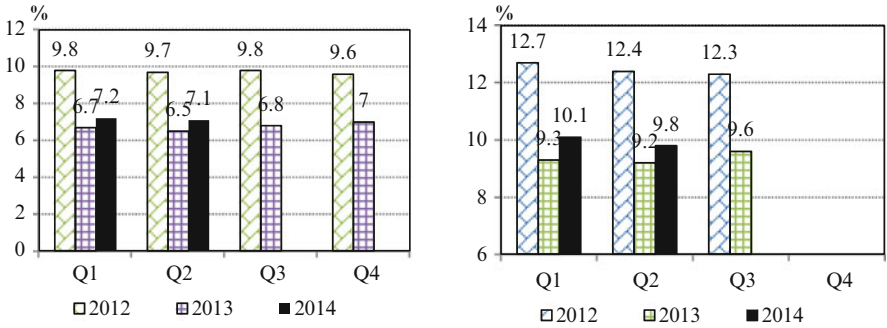


Fig. 2.5 The cumulative year-on-year real growth rates of urban per capita disposable income (*left*) and rural per capita cash income (*right*) (Data Source: CEIC) (Note: The National Bureau of Statistics does not publish the year-on-year real growth rate of the per capita cash income of rural residents at the end of the year)

rural areas, the retail sales of consumer goods in the urban area, which accounted for the 86 % in total, grew by 12.0 % that decreased by 0.5 percentage points compared with the first half of previous year; the retail sales in the rural area grew by 13.2 %, a decrease of 1.1 percentage points over the same period of last year.

2.5 CPI Maintained a Low Level, PPI Dropped More Slowly

At the end of June of 2014, the consumer price index (CPI) rose by 2.3 % over the same period of the previous year (Fig. 2.6), of which 65.2 % was contributed by the carryover effect, 34.8 % by the current price factors. The core CPI (excluding food and energy) and non-food CPI both rose by 1.7 %. The producer price index (PPI) is still negative but declined more and more slowly. In June, the PPI fell by 1.1 % compared with the same period of last year. On one hand, the long-lasting decline in PPI indicated the excess production capacity in the mining industry and some downstream manufacturing industries; On the other hand, the more and more slow decline of PPI means that the serious excess production capacity is gradually resolved.

2.6 Monetary Policy Was Targeted Easing; The Fiscal Policy Was Proactive and Prudent

In the first half of 2014, the People’s Bank of China (PBC) continued its sound monetary policy, maintained the monetary aggregates at stable levels and optimized the structure. In the first quarter, the broad money (M2) rose by 12.1 %, 3.6 % lower

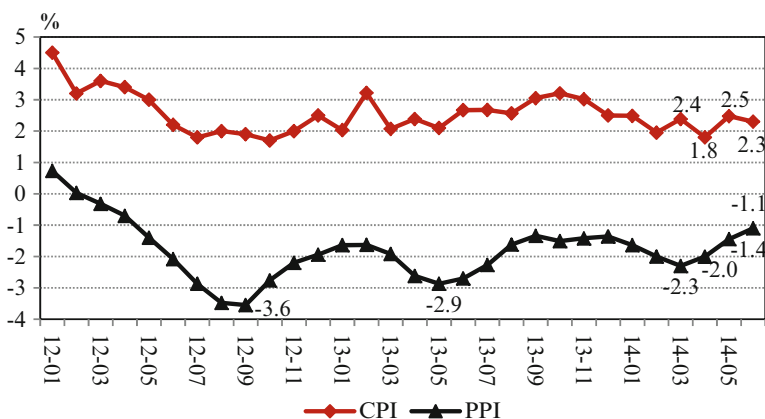


Fig. 2.6 The monthly year-on-year growth rates of the consumer price index (CPI) and the industrial producer price index (PPI) (Data Source: CEIC Data)

than last year. However, because of the targeted easing monetary policy¹⁰ aiming at relieving downward pressure on economic growth in the next quarter, M2 rose by 14.7 % in the second quarter, 0.7 % higher than the same period of last year, and also exceed the 13 % target set by the PBC earlier this year. Therefore, the monetary policy is quite expansionary.

In the first half of 2014, RMB loans increased 5.74 trillion CNY, 659 billion CNY more than the same period of last year. Each month had almost 1 trillion of new CNY loans on average. Meanwhile, total social financing funds expanded rapidly to 10.57 trillion CNY, an increase of 414.6 billion CNY over the same period of previous year, also the highest since 2011 (Fig. 2.7). It is worth noting that while total social financing funds rose from 7.76 trillion CNY in 2011 to 10.57 CNY trillion in 2014, but the real GDP growth rate decreased from 9.6 to 7.4 % during the same period. It implies that the efficiency of investment has been deteriorated, which also means that investment-GDP ratio is increasing.

On the other hand, due to the expansion of the M2, the interest rate of interbank market remained at a low and stable level (Fig. 2.8). However, the enterprises in the real economy still suffered from ever-increasing cost and limited access to financing. The deviation of the wholesale interest rate and retail interest rate indicated that

¹⁰ In April, the PBC cut required reserve rate of deposit (RRR) for country-level rural commercial banks and rural cooperative banks; In June, this targeted reduction of RRR policy have been extended to finance company, financial leasing company, auto leasing company and commercial banks that have compiled with prudential requirements and have reached the required ratios in their lending to the agricultural sector, rural areas, farmers, or to small and micro enterprise. Meanwhile, the China Banking Regulatory Committee (CBRC) also slightly relaxed the legal ratio of loan to deposit for commercial banks.

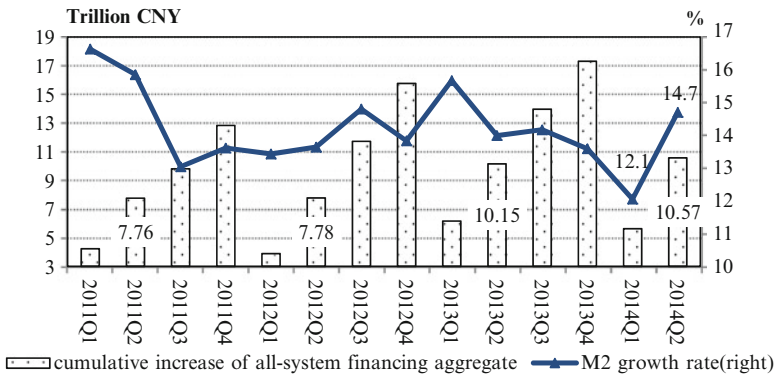


Fig. 2.7 The new incremental amount of total social financing funds and the growth rate of M2 (Data Source: CEIC Data)

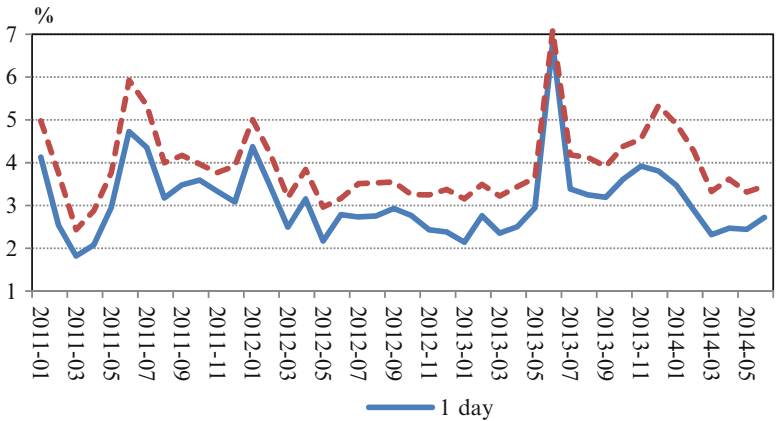


Fig. 2.8 The changes in the weighted average 1-day and 1-week interbank interest rate (Data source: CEIC Data)

the resource misallocation problem rooted deeply in the Chinese financial system, and the efficiency of funds allocation was still low in general.¹¹

Moreover, the exchange rate of the CNY against the USD stopped appreciating on February 17 and depreciated dramatically thereafter.¹² On March 17, to build a two-way floating exchange rate regime that based on market supply and demand,

¹¹ There were other causes, including under development of the stock market and the high ratio of debt to asset for the enterprises.

¹² The depreciation can be largely explained by the ever-rising central parity of the CNY against the USD by the operations of PBC since Jan 14 of 2014. There are two purpose of PBC's action: first, to discourage the arbitrage behavior between the on shore and off shore CNY market; second, to set the stage for the widening of the floating band of the CNY exchange rate.

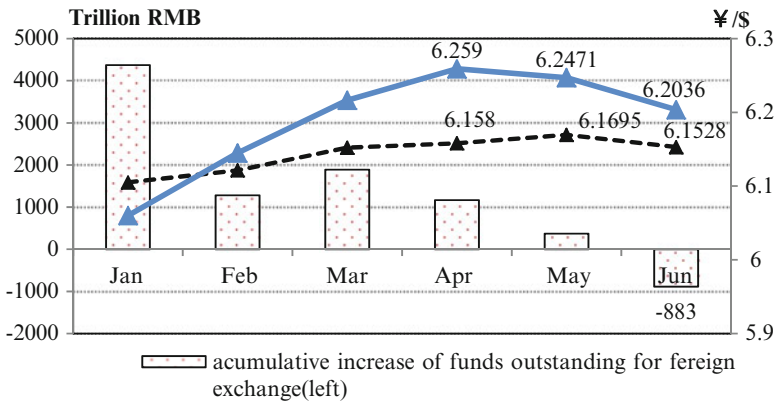


Fig. 2.9 The monthly cumulate increase of funds outstanding for foreign exchange, the spot market exchange rate and the central parity of the CNY against the USD (Data source: CEIC Data)

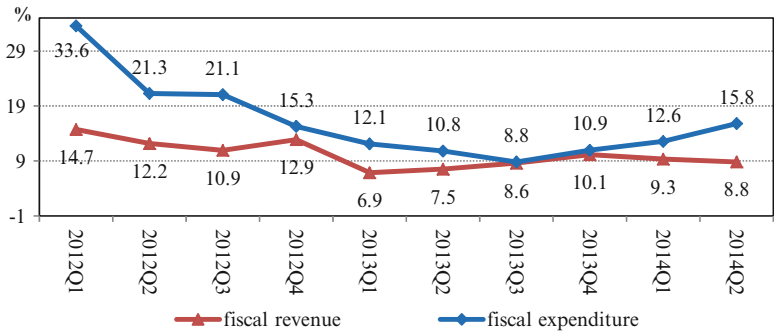


Fig. 2.10 The nominal growth rates of public fiscal revenue and expenditure (Data source: CEIC)

the PBC decided to enlarge the floating band of the exchange rate of the CNY against the USD on the interbank spot exchange rate market from 1 to 2 %. The CNY kept depreciating until June when it returned to the original rising track. At the end of June, the exchange rate of CNY reached 6.20 CNY per USD, up by 2.53 % since 2014. During this process, the funds outstanding for foreign exchange rose dramatically from January to April, and then gradually turn to negative in June whenever the funds outstanding for foreign exchange decreased by 88.3 billion (Fig. 2.9).

As to fiscal policy, the government fiscal revenue rose by 8.8 % in the first half of 2014, 1.3 % higher than the same period of last year (Fig. 2.10). Specifically, the tax revenue rose by 8.5 %, 0.6 % higher than the last year; the non-tax revenue rose by 11.1 %, 5.8 % higher than the last year. Although the growth rate of government fiscal revenue has decreased since 2014, the growth rate of government fiscal

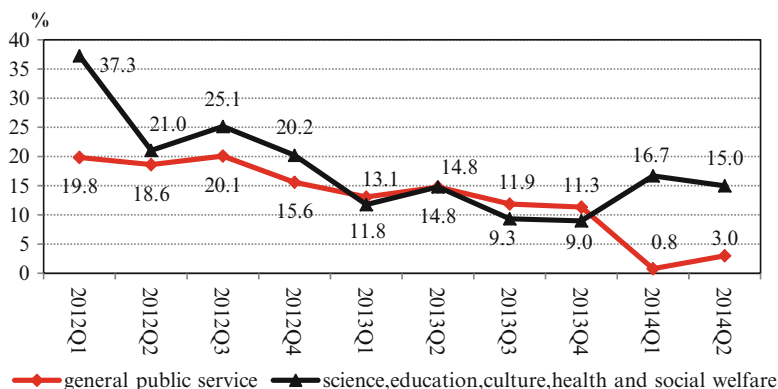


Fig. 2.11 The nominal growth rates of government expenditure by items (Data source: CEIC Data)

expenditure accelerated significantly (Fig. 2.10) whose accumulated growth rate reached 15.8 % at the end of June of 2014, 5 % higher than the same period of last year. As a net effect, the expenditure grew 7 percentage points faster than the revenue.

From late March, the State Council initiated series of micro-stimulus packages, including the tax cut for small and micro enterprises, rebuilding of rundown urban areas, the railway construction in the middle and western parts of China, financial support to the agricultural sector, rural areas, and farmers, promotion of exports, improvement of employment, acceleration of water conservancy project constructions, etc. Among the fiscal expenditure, the general public service expenditure rose by 3.0 % and accounted for 8.6 % in total expenditure in the first half of 2014, 11.8 and 1.8 % lower than the same period of last year respectively. The expenditure of science, education, culture, health and social welfare rose by 15.0 % and accounted for 38.3 % in total expenditure in the first half of 2014, 0.2 % higher and 0.2 % lower than the same period of last year respectively (Fig. 2.11). On the other hand, the expenditure of infrastructure construction and government-subsidized housing rose dramatically. Among them, the transportation expenditure rose by 22.1 % and accounted for 6.37 % in total expenditure in the first half year, 24.5 and 0.33 % higher than the first half of last year respectively. The agriculture supporting expenditure rose by 17.6 % and accounted for 8.74 % in total expenditure in the first half year, 6.14 and 0.13 % higher than the first half of last year respectively. The government-subsidized housing expenditure rose by 30.2 % and accounted for 2.92 % in total expenditure in the first half of 2014, 34.5 and 0.32 % higher than the first half of 2013 respectively.

In Conclusion, the Chinese GDP growth rate has decreased gradually since the global financial crisis, from 14.2 % in 2007, dramatically dropped to 9–10 % during 2008–2011, dropped to 7.7 % in 2012, and then dropped further in 2013.

In the first half of 2014, the real GDP growth rate dropped slightly to 7.4 %. The main reasons include: (1) The investment growth dropped dramatically. Specifically, the investment and output of manufacturing industries grew slowly due to the excess

production capacity problem accumulated during decades. Moreover, the growth of investment in real estate decreased even more significantly due to the stagnant sales and high level of inventory. (2) The decreasing growth of net export was the result of the slow recovery of the global economy. (3) The domestic consumption demand was still weak: the growth of retail sales of social consumer goods was slow, the growth of real income of residents was not significant and the government spending on official overseas visits, official vehicles, and official hospitality was curbed.

Due to the stagnation of residential income, the efficiency of the micro-stimulus and targeted easing policies still has to rely on the investment in infrastructure construction to maintain stable growth. In the last 3 years, the micro-stimulus policies mainly focused on two areas: (1) the infrastructure construction such as railway, public facilities and water conservancy projects; (2) the construction of government-subsidized housing and reconstruction of rundown urban areas. However, as the monetary supply as well as all-system financing aggregate continued to expand rapidly, the marginal effect of the investment on promoting economic growth was diminishing. Therefore, China's economy still relies heavily on the investment, a situation hard to change fundamentally.

It takes time to fix the problem of the excess production capacity. Therefore, the local governments who suffer large amount of debts would be not able to start a new round of large-scale investment projects. Meanwhile, although packages of stimulus measures aiming at supporting the private investment have been introduced since earlier of this year, the efficiency of these measures is still unclear. As a result, the investment growth would continue to decline inevitably in the second half of 2014.

It would merely be a huge waste of social resource through investment of the government in order to maintain high economic growth. Thus, the central government should realize that Chinese economic growth had entered a new phase of development. The domestic economy is experiencing a transition period in economic growth rate; painful period of structural adjustment; preliminary adaptation stage of stimulating policies, and thus Chinese is changing their lives with positive attitudes to adapt to an economy of "new normal". The central government should avoid setting an economic growth target as high as before. In our opinion, the labor market and employment should remain robust if the growth target is properly reduced and the government could take advantage of the adjustment of industrial structure. Moreover, the government should take advantage of "the new normal", and concentrate on deepening reform, correcting the distorted financial system, and transforming the developing mode.

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