Chapter 2
A Review of China's Economy in 2013

2.1 Economic Growth Stabilized, and the Economic Growth Structure Adjusted Slowly

In 2013, China's real GDP grew by 7.7 %, the same as in 2012. Since 2010, the economic growth rate has declined for four consecutive years (Fig. 2.1). Quite similar to the macroeconomic trends and policy control mode adopted in 2012, from mid-2013, the central government launched a series of fine-tuning measures to stabilize the economic growth rate after experiencing sustained downward growth during the first half of 2013. These measures inhibited the declining economic trend in the third and fourth quarters and ensured that the annual economic growth rate for the entire year matched that of the previous year. However, the real annual growth rate of industrial value added was only 9.7 %, a decrease of 0.3 percentage points from 2012, and the lowest since 2009. A constant drop in the growth rate of industrial value added reflects a slowdown in the real economy.

The growth rate of real income slowed down and the contribution rate of consumption to economic growth declined further. In 2013, the per capita disposable income of urban residents grew by 7.0 %, a decrease of 2.6 percentage points from the previous year and 0.7 percentage points lower than the economic growth rate. The per capita net income of rural residents grew by 9.3 %, 1.6 percentage points higher than the economic growth rate, but 1.4 percentage points less than last year. Influenced by the declining growth rates of real incomes of urban and rural residents and restrictions on the "three public expenditures" and other anti-corruption measures, total retail sales of consumption goods grew by 11.5 %, a decrease of 0.6 percentage points from the previous year. The cumulative contribution rate of final consumption to GDP growth dropped sharply to 50.0 %, a decrease of 5 percentage points from the previous year. The cumulative contribution of net exports to economic growth continued to decline, from −2.1 % in 2012 to −4.4 % in 2013. The

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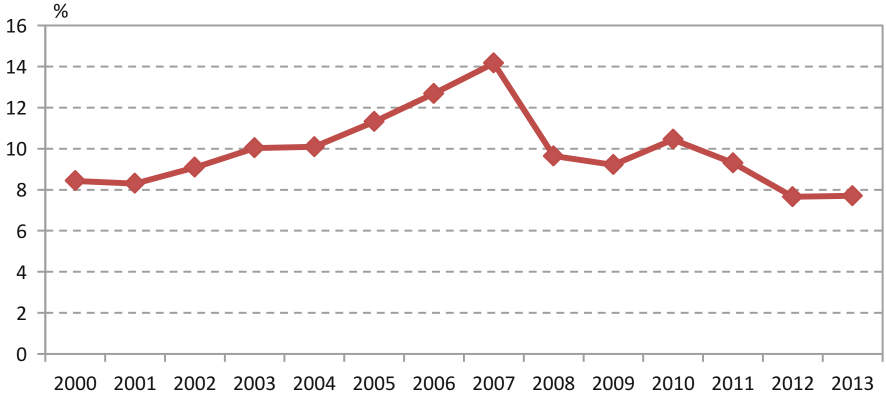

Fig. 2.1 Changes in the real GDP growth rate (Data source: CEIC)

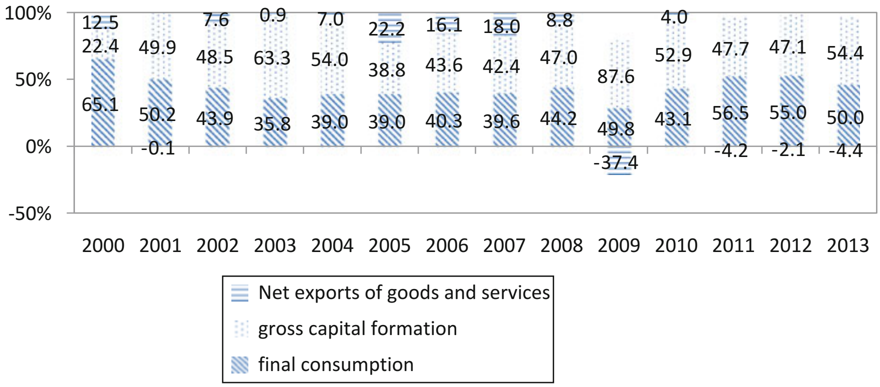

Fig. 2.2 Changes in the contribution rate of GDP growth based on the expenditure accounting approach (Data source: CEIC)

cumulative contribution of gross capital formation to GDP growth thus rose to 54.4 %, an increase of 7.3 percentage points over the previous year (Fig. 2.2).

Although GDP growth in 2013 was roughly the same as that in 2012, the economy has gradually stabilized during the process of continuous decline since 2008. This seems to presage the formation of a new economic growth platform. However, the economic developments of the past 2 years show that this new growth platform does not have a solid foundation yet. The continuous decline in the growth rate in the first halves of 2012 and 2013, its steady rise after the implementation of mid-year policy measures, and the re-emergence of the downward trend at the beginning of the next year indicated that China's economic growth is still not self-sustaining. Under the existing institutional framework, the drive of economic growth has continued to decline, economic vitality has decreased gradually, and efficiency has continued to drop. To achieve economic growth, the country has had to rely on an external driving force, namely, expansion in government investment. The new central government intensified anti-corruption efforts and encouraged austerity to inhibit extravagant government spending over a period of time. On the surface, all these measures led to a further decline in final consumption. However, basically, the decline in final consumption reflected that the existing economic growth mode had not been fundamentally reversed, the growth rate of household income slowed down, and household consumption remained sluggish. As the economic structure has not been adjusted effectively and a new mechanism for economic growth is not yet to form, once economic growth encounters greater downward pressure, government-led investment expansion will become the final option to stabilize economic growth. The growth rates of real incomes of urban and rural residents declined further in 2013, exacerbating structural distortions.

2.2 Manufacturing Investment Growth Fell Sharply

In 2013, fixed asset investment (excluding rural households) grew by 19.6 %, a decrease of 1 percentage point from the previous year. Among them, the growth rates of investments in the manufacturing and real estate sectors decreased significantly, while those of investment in transportation, storage, and postal services increased. The shrinking real economy directly inhibited investment in manufacturing. Annual manufacturing investment grew by 18.5 %, a decrease of 2.8 percentage points from the previous year, the lowest level since 2000. Real estate investment grew by 20.3 %, a decrease of 2.1 percentage points from the previous year. Transportation, storage, and postal services investment grew by 17.2 %, an increase of 6.0 percentage points over the previous year (Fig. 2.3). Manufacturing investment made up 33.76 % of total fixed asset investment, a decrease of 0.33 percentage points from the previous year. Transportation, storage, and postal services investment accounted for 8.29 % of total fixed asset investment, a decrease of 0.17

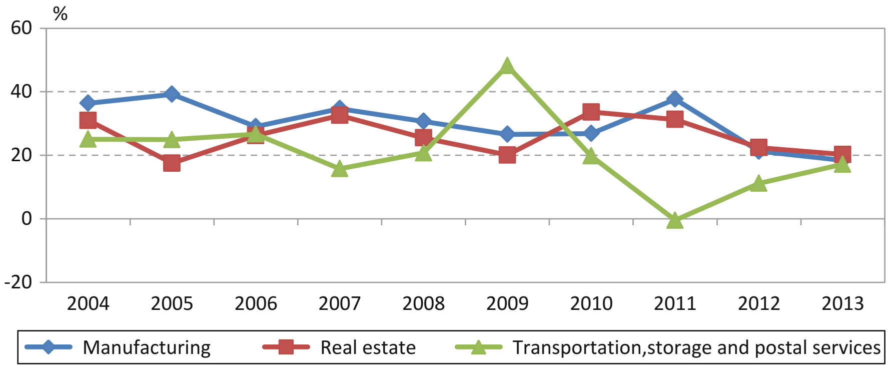

Fig. 2.3 Changes in the growth rate of investment in fixed assets by industry (Data source: CEIC)

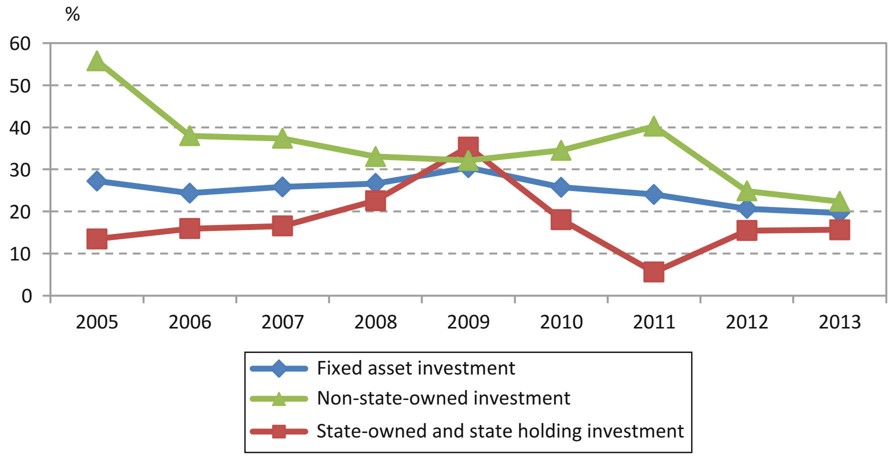

Fig. 2.4 Changes in the investment growth rate in fixed assets by ownership type (Data source: CEIC)

percentage points from the previous year. Real estate investment accounted for 25.53 % of total fixed asset investment, an increase of 0.14 percentage points over the previous year.

In terms of investor type, the growth rate of investment from non-state-owned enterprises continued to decline, while investment in state-owned enterprises increased month-by-month. In 2013, investment from state-owned and state-controlled enterprises grew by 15.6 %, an increase of 0.2 percentage points over the previous year, and investment from non-state-owned enterprises grew by 22.4 %, a decrease of 2.4 percentage points from the last year (Fig. 2.4).[1] Investment from enterprises located in Hong Kong, Macao, and Taiwan grew by 7.0 %, a decrease of 1.9 percentage points from the previous year, while investment from foreign business grew by 4.5 %, a significant decrease of 9.1 percentage points from the previous year. The shrinking of the real economy led to a significant decline in non-state-owned enterprise and manufacturing investment growth. At the same time, although "The Decision on Major Issues Concerning Comprehensively Deepening Reforms" was adopted at the Third Plenary Session of the 18th Communist Party of China (CPC) Central Committee (which proposed a series ideas to develop the socialist market economy), namely the need to refine the relationship between the government and the market and the promotion of decisive mechanisms in resource allocation, more time is needed for their implementation and for the resolutions to take effect. Improper institutional restrictions on non-state economic sector investment and the investment "glass door" can, to a certain extent, inhibit probable investment growth that may have been fueled by independent market entities.

[1] Fixed assets investment from non-state enterprises = investment from domestic enterprises – investment from state-owned and state holding enterprises.

2.3 The Growth of Imports and Exports Was Weak, and the Trade Surplus Continued to Expand

While the United States and Europe accelerated the process of economic recovery in 2013, the continued appreciation of the RMB and the increase in domestic wages weakened the growth of China's imports and exports. Total exports in USD grew by 7.9 % only, the same as last year, while imports grew by 7.3 %, an increase of 3.0 percentage points over the previous year (Fig. 2.5). The annual trade surplus reached 259.75 billion USD, an increase of 29.4 billion USD over the previous year. Total utilized foreign direct investment reached 117.586 billion USD, a decrease of 3.487 billion USD from the previous year. Foreign exchange reserves continued to increase, reaching 3.82 trillion USD.

Trade structure improved, and the share of general trade increased. In 2013, China's general trade exports (in USD) grew by 10.1 %, an increase of 2.4 percentage points over the previous year. The growth rate of general trade imports was 8.5 %, an increase of 7 percentage points over the previous year. The trade deficit of annual general trade narrowed slightly to 22.1 billion USD. On the other hand, the growth rate of processing trade exports continued to decline to –0.2 %, a decrease of 3.5 percentage points from the previous year and that of imports in processing trade grew by 3.3 %, an increase of 0.8 percentage points over the previous year. The trade surplus of annual processing trade rose to 363.6 billion USD. The share of general trade exports rose to 49.2 % of total exports, an increase of 0.9 percentage points over the previous year, while processing trade exports accounted for 30.9 %, a decrease of 3.1 percentage points from last year. General trade imports accounted for 56.8 % of total imports, an increase of 0.7 percentage points over the previous year. Processing trade imports accounted for 25.5 %, a decrease of 1 percentage point from the previous year (Fig. 2.6). The increasing share of general trade reflected the improvement in China's trade structure.

The share of China's exports to Asia continued to increase, and imports from Europe and the United States rebounded rapidly. In 2013, the growth rate of China's

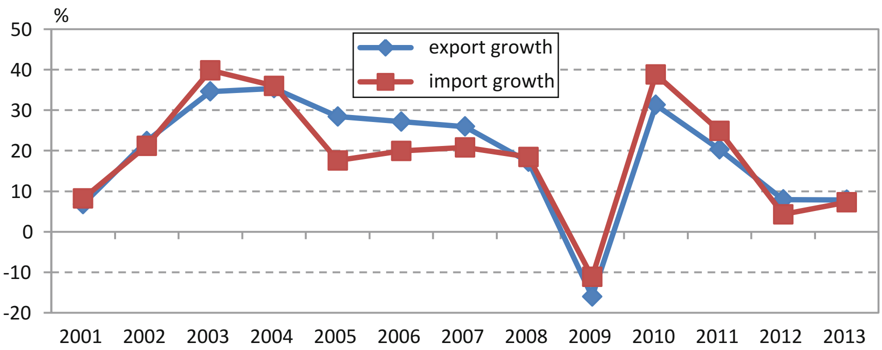

Fig. 2.5 Changes in the growth rates of total exports and total imports (USD) (Data source: CEIC)

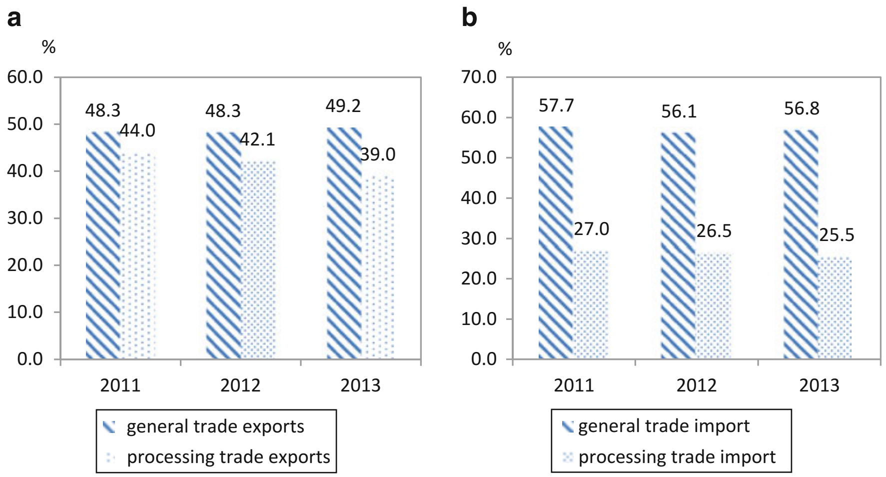

Fig. 2.6 Changes in the composition of exports and imports by trade type. (**a**) Export composition. (**b**) Import composition (Data source: CEIC)

exports to Asian countries was 12.7 %, a decrease of 0.7 percentage points from the previous year, while the growth rate of exports to the United States was 4.7 %, a decrease of 3.8 percentage points from last year. The growth rate of exports to Europe reached 1.2 %, shifting from negative growth in 2012 to positive growth, an increase of 7.4 percentage points over the previous year. Compared with 2012, the share of China's exports to the EU and the United States in total exports was 15.3 % and 16.7 %, respectively, a decrease of 1 and 0.5 percentage points. The share of exports to Asia continued to rise, reaching 51.3 %, an increase of 2.2 percentage points. On the import side, the growth rate of China's imports from the United States increased greatly, reaching 14.8 %, an increase of 6 percentage points over the previous year. The growth rate of imports from Asia and the EU was 5.0 % and 3.5 %, respectively, an increase of 1.6 and 2.9 percentage points, respectively. The share of China's imports from Asia and the EU in total imports was 56.0 % and 11.3 %, respectively, amounting to a decrease of 1.3 and 0.4 percentage points, respectively. The share of imports from the United States was 7.8 %, an increase of 0.5 percentage points (Figs. 2.7 and 2.8).

2.4 The PPI and CPI Trends Show an Expanding "Scissor" Shape

PPI continued to decline, whereas the CPI was relatively stable. In the first half of 2013, year-on-year PPI declined faster, dropping from −1.64 % at the beginning of the year to −2.69 % in June. In the first half of 2013, the year-on-year growth rate of the CPI was below 3 % for all months except February. In the second half of 2013,

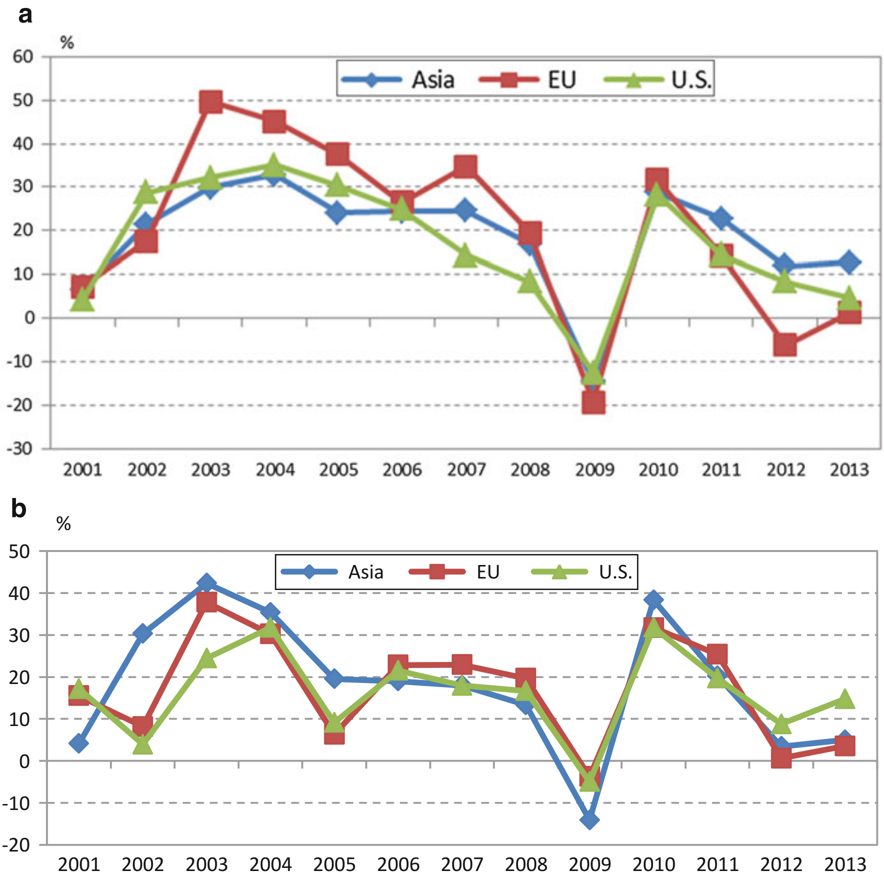

Fig. 2.7 (**a**) Changes in the growth rate of China’s exports to major regions. (**b**) Changes in the growth rate of China’s imports from major regions (Data source: CEIC)

influenced by the policy signals promoting “steady progress” and the clarification of the economic growth limit by the central government, both PPI and CPI began to recover. The annual PPI decreased 1.9 % compared with last year, while the CPI increased 2.6 % over the previous year (Fig. 2.9). In all categories of the CPI, the CPI excluding food and energy and year-on-year non-food CPI in 2013 remained steady within the 1–2 % range. From the eight CPI categories, CPI for food, housing, and clothing increased by 4.7 %, 2.8 %, and 2.3 %, respectively. It can be seen that the rising prices of food and other commodities with less price elasticity of demand were the major causative factors of inflation in 2013; the changes in the remaining CPI categories were relatively small.

After 2011, the CPI and PPI have continued following opposing trends, emphasizing the downward trend of the real economy and the serious excess production capacity in the industrial sector. From the third quarter of 2011, the month-to-month

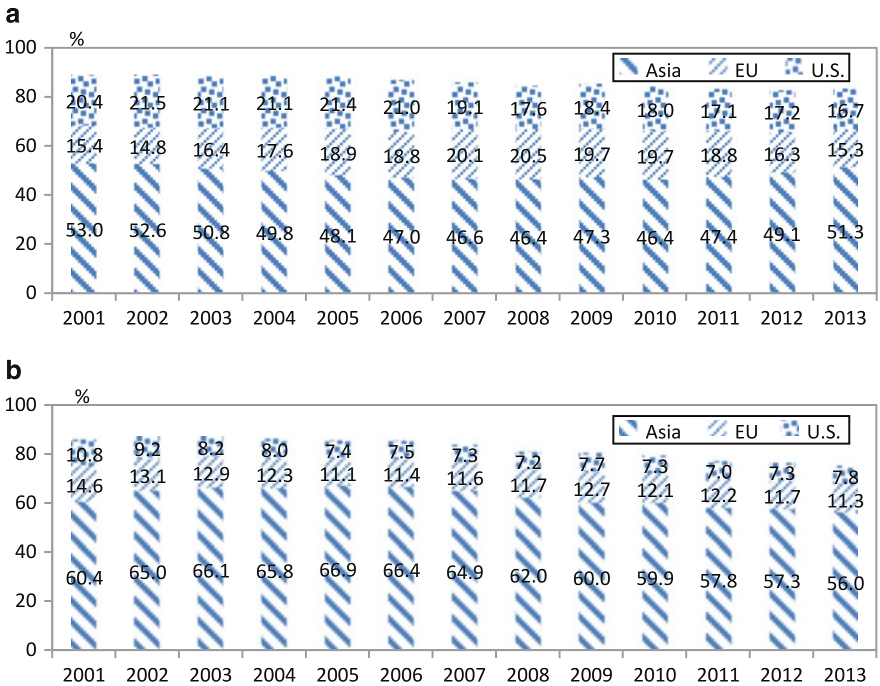

Fig. 2.8 (**a**) Changes in the composition of China's exports by region. (**b**) Changes in the composition of China's imports by region (Data source: CEIC)

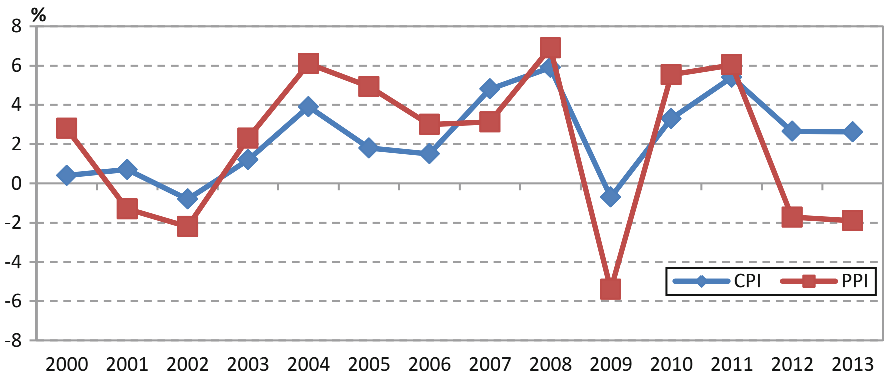

Fig. 2.9 Year-on-year changes between CPI and PPI (Data source: CEIC)

growth of the CPI exceeded that of the PPI by nearly a percentage point or more in nine consecutive quarters; the trends of the CPI and PPI showed a very clear "scissor" movement in the last 2 years. A look at the year-on-year growth since the first quarter of 2012 shows that the CPI and PPI have always maintained a gap of more

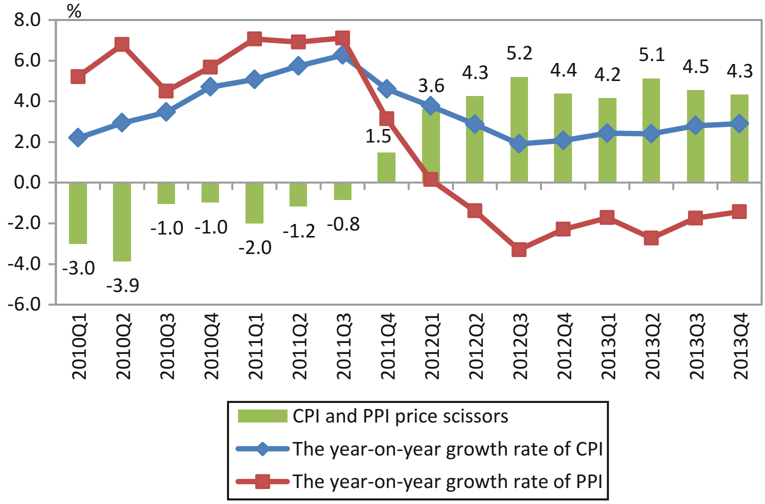

Fig. 2.10 The "scissors" trend of the year-on-year growth rates of the CPI and PPI (Data source: CEIC)

than four percentage points (Fig. 2.10). Apparently, this fact cannot be simply explained by price transmission mechanism disorders. Provided the growth rate of money supply (M2) maintained a high long-term level, the deviation between the CPI and PPI reflected the continuous downturn in the real economy, serious excess production capacity in the industrial sector, lack of liquidity in the real economy, some capitals in unproductive circulation, and so on. On the one hand, the conflicting trends of the CPI and PPI indirectly increased the capital cost of the actual production sector; on the other hand, due to the decline in expected profit, they inhibited the level of investment in the actual production sectors.

2.5 The Monetary Policy Maintained Prudent, and Financing Costs Continued to Rise

In 2013, the central bank continued to implement a prudent monetary policy, and money supply slowed down. The annual broad money (M2) amounted to 110.65 trillion CNY, an increase of 13.6 % compared with last year, while the growth rate dropped by 0.2 percentage points. Narrow money (M1) grew by 9.3 %, an increase of 2.8 percentage points over the previous year. Currency in circulation (M0) grew by 7.1 %, a decrease of 0.6 percentage points from the previous year.

Nevertheless, the economy still faced the pressure of rising financial cost. In June 2013, the "money shortage" incident became a turning point for capital markets throughout the year. After a modest adjustment in the monthly weighted average

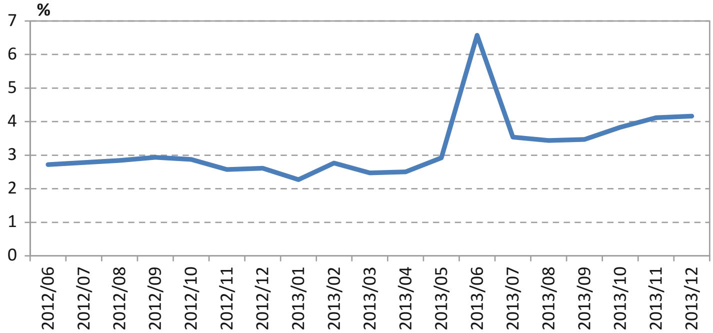

Fig. 2.11 Changes in the weighted average interbank interest rate (Data source: CEIC)

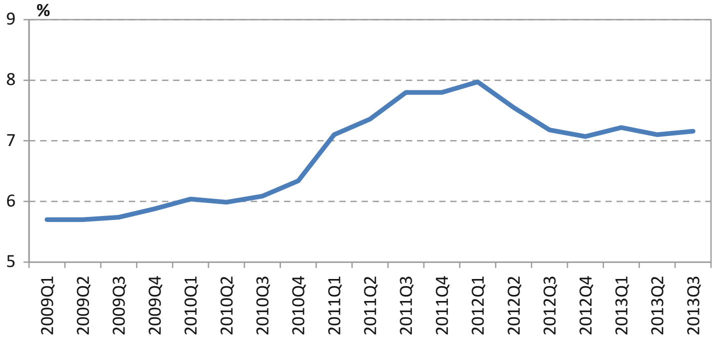

Fig. 2.12 Changes in the general weighted average lending rate (Data source: CEIC)

interbank interest rate in the first 5 months of the year, it suddenly jumped to a record high of 6.58 % in June. In the second half of the year, the capital market maintained a tight supply of state funds, and the interbank rate rose steadily during the remaining months, except August. It rose to 4.16 % until December, the second highest rate after June (Fig. 2.11). Money market tensions pushed financial institutions to improve lending rates to nonfinancial institutions and other departments: the general weighted average lending rate in RMB in the third quarter climbed to 7.16 % (Fig. 2.12). In addition, the share of loans with interest rates exceeding bench interest rates began to decline significantly after June.

On the other hand, the effectiveness of funds continued to decline. In 2013, the total amount of social financing reached 17.29 trillion CNY, an increase of 1.53 trillion CNY over last year. Among them, the new RMB loans amounted to 8.89 trillion CNY, an increase of 8.4 percent over the previous year. Corporate bond financing amounted to 1.8 trillion CNY, a decrease of 20.2 percent compared with last year. Trusts and entrusted loans amounted to 4.39 trillion CNY, an increase of 70.9 percent over the previous year. Promoted by trust and entrusted loans financing, the total amount of social financing reached 6.17 trillion CNY in the first quarter of

2013, an increase of 2.28 trillion CNY (58.54 %) over the previous year. However, the huge sums of money invested did not accelerate economic growth effectively; it continued to decline until the second quarter. In fact, since the outbreak of the financial crisis, despite the rapid expansion in social financing, economic growth continued to decline in most years. In fact, the scale of social financing required for each percentage point of economic growth continuing to expand, thus reflecting that the potential growth of economic system and economic development were in constant decline.

2.6 Both Growth Rate of Fiscal Revenue and Expenditure Declined, and Local Debt Continued to Increase

Until November 2013, the accumulated government revenue grew by 9.87 % to reach 11.97 trillion CNY, a decrease of 2.04 percentage points compared with the previous year. The tax revenue accounted for 85.98 % of this amount, a slight increase of 0.08 percentage points over the same period last year. Excluding price changes, real revenue growth was lower than the economic growth rate over the same period, ending the 15 consecutive year history of the annual revenue growth being significantly higher than real economic growth rate in the same period from 1997 to 2012.[2] Due to the decline in revenue growth, expenditure growth slowed down significantly. By November, expenditure had grown by 9.34 % to reach 11.47 trillion CNY, a decrease of 8.58 percentage points compared with the previous year.

Local government debt grew rapidly. According to the announcement released by the National Audit Department on December 30, 2013, until June 2013, the local government debt balance (broad caliber) reached 17.89 trillion CNY, an increase of 12.62 % over the end of 2012. Of this amount, the debt borne by the provincial, city, and county governments reached 10.58 trillion CNY, an increase of 3.87 trillion CNY over the end of 2010. The average annual outstanding debt grew by 19.97 %. Between 2008 and 2012, the growth rate of both the narrow government revenue and the broad government revenue[3] was always lower than the growth rate of local government debt balance (Fig. 2.13). Thus, the continuous rise in local government debt levels and possible debt will pose significant risks to China's economy in the coming years.

In conclusion, although the Third Plenary Session of the 18th CPC Central Committee clarified the future direction of comprehensively deepening reforms and

[2] From 1997 to 2012, on average, the real growth rate of revenue exceeded economic growth by 5.5 percentage points over the same period. In 2012, the growth rate of fiscal revenue exceeded economic growth by 2.2 percentage points. Source: CQMM Research Group, Center for Macroeconomic Research, Xiamen University: *"China's Macroeconomic Forecast and Analysis - 2013 Fall Report" (August 2013).*

[3] Narrow government revenue refers to government public revenue, while broad government revenue refers to the sum of government public finance income and income from government funds.

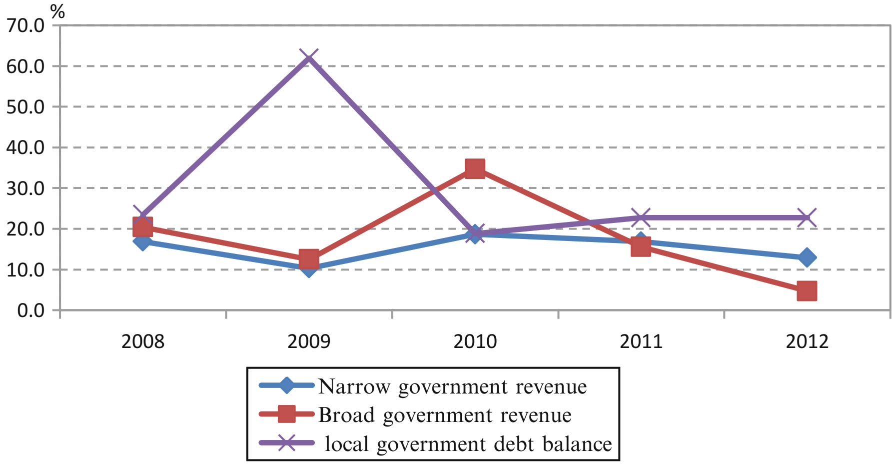

Fig. 2.13 Comparison between growth rates of government revenue and debt balance (Data source: CEIC)

outlined a series of major reform strategies, its effects will become evident only after some time. The deepening reform of China's economic system, the adjustment of its economic structure, and the transformation of economic development still have a long way to go. The declining growth rates of urban and rural household incomes and the renewed anti-corruption movement caused the contribution rate of final consumption to GDP growth rate to decline significantly. The economy of the United States continued to accelerate its recovery process, and the haze of the European sovereign debt crisis gradually dispersed; however, export growth continued to remain weak, private investment willingness remained low, and thus, public investment appears to be the major driving force for stabilizing economic growth at present. This shows that domestic causes will determine whether China's economy can maintain stable development in the future.

In 2013, the rapid rise in public investment offset the decline in manufacturing and real estate investment growth to some extent, ensuring investment in fixed assets and the steady growth of the economy. However, a rapid expansion in the scale of local government debt has increased the government's default risk. The rigid demands of local government financing platforms and real estate investment funds induced the financial sector to expand the scale of its balance sheet operations, and the central bank's cautious attitude toward liquidity further exacerbated the level of tension in the capital market. The ability to effectively control the size of local government debt, optimize its financing structure, and reduce local government default risk, has become key for comprehensively deepening reforms, especially the fiscal and financial reforms planned in the next stage.

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