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Trends in Macro Economy, Shanghai City, Shandong Province

“Current Points of Note in the Chinese Economy:

Coping with the Inflation Risk in the First Half of 2010”

(Report on business trip to Shanghai, Jinan, and Beijing:

October 21 to 28)

< Highlights from the Report >

- From April to June 2009, the Chinese economy clearly has been on a recovery path to high economic growth and it appears certain that it will achieve high growth in 2010, surpassing the 2009 record. With these prospects, the most serious policy agenda will be how to cope with the return of the risk of inflation in 2010.
- It is now clear that even the Shanghai economy is on its way to recovery. Among the principal coastal cities, Shanghai was the last to recover. Looking to the future, the Shanghai Hongqiao Development Zone project is promoting industrial clusters, which will be, after the Shanghai Expo, the engine for the Shanghai economy.
- Since Japanese corporations commenced their operations in China, they have been focusing on exports. Many are now starting to shift their business focus to China's domestic market by increasing their distribution routes. It is noted that the biggest problem they confront in attempting to enhance their presence in the domestic market is the difficulty of collecting bills.
- Since December 2003, based on the “Shandong Peninsula City Complex Project,” Shandong Province has been promoting the local economic development of major eight cities, such as Jinan, Tsingtao, and Yantai. Shandong Peninsula is remotely located in the Bohai Rim Economic Area and is close to both South Korea and Japan. For this reason, there is substantial direct investment by companies from these two countries and the province tends to pay closer attention to economic cooperation with South Korea and Japan, as compared with the attention it pays to the Bohai Rim Economic Area.

1. Analysis of 8.9% GDP growth during the months of July to September

(1) Highlights from the main economic data

On October 22, the National Bureau of Statistics released the main economic data for the months of January to September. Highlights are as follows (all figures are comparisons with the same period in the previous year): real GDP growth for July-September was 8.9% (January-March 6.1%, April-June 7.9%), value-added of industry (real) +12.4% (January-March +5.1%, April-June +9.1%), investment in fixed assets in urban area (nominal) +32.9% (January-March +28.6%, April-June +35.9%), total retail sales of consumer goods (nominal) 15.3% (January-March +15.0%, April-June +15.0%). These figures demonstrate strong economic expansion, clearly indicating the return of the Chinese economy to a path of rapid growth. During these periods, CPI stayed negative at -1.3% for July-September (January-March -0.6%, April-June -1.5%), but the monthly negative figures are steadily getting smaller, at -1.8% for July, -1.2% for August, -0.8% for September, -0.5% for October. The export figure released before these figures were still substantially negative at -20.5% for July-September (-19.8% for January-March, -23.5% for April-June.) During these periods, imports were -11.8% (-30.9% for January-March, -20.4% for April-June), heading rapidly towards positive numbers, which reflects a growth in domestic demand and the trade surplus was 39.2 billion dollars, a big drop from the previous year's surplus of 83.3 billion.

(2) Analysis of the main economic data

Before the main economic data were released, it was expected that GDP growth for 2009 would surpass 8%. With the release of the data, this expectation was confirmed. It now looks as if it will, in fact, reach about 8.5%. Many expect that the growth figure for 2010 will be above 10%, reflecting the comparison with the low growth rate in the first half of 2009.

The principal reason for the Chinese economy maintaining its rapid growth lies in the large increase in fixed asset investment. With the 4 trillion yuan economic stimulus package, fixed asset investment will continue to expand, mainly in construction of infrastructure, as well as in housing.

The export figure for September (on a dollar basis) was -15.2%, as compared to September 2008, but that decline was smaller than during the April-June (-23.5%), July (-23.0%), and August (-23.4%) periods. After adjusting for the number of holidays, the figure for September figure showed a decline of over 20%, indicating

that the sharp decline continued. The September figure for imports was -3.5% , or -10% after adjusting for holidays, indicating a shrinking of the decline, which is a reflection of the expansion in domestic demand. This lessening of the decline in imports resulted in a sharp decline in the trade surplus. It is expected that the trade surplus will shrink to half of last year's figure.

Meanwhile, overproduction in steel, fertilizers and etc. has contributed to a large surplus in distribution inventory. This will no doubt have to be reduced, which will have a negative impact on future prospects. As for the automobile inventory level, it is within the normal range.

Automobile sales have been brisk, beyond the expectations of foreign automobile companies, and major manufacturers have not been able to maintain production of all types of cars to meet demand. It is expected that auto sales in China will reach 12.5 million units in 2009, and 14 million in 2010.

Other than the automobile sector, the construction equipment sector is doing well thanks to the 4 trillion yuan economic stimulus. Machine tools, agricultural equipment, department stores, and supermarkets are also doing well, due to the growth in the inland domestic demand. With this growth in domestic demand, several foreign supermarkets and department stores have aggressive plans, in the next few years, to increase the number of their outlets in major cities in the East China region, centering around Shanghai.

(3) Stock Market

The stock market was vibrant with surplus money flowing in, prompted by unrestrained monetary liquidity. During this period, European and American financial institutions were selling stock in order to take profits. Accordingly, foreign institutions were selling and Chinese state owned enterprises (SOE) were buying. In September, as planned, the government lifted the ban on large scale sales of SOE's untradeable shares, which caused stock prices to plunge. These turn of events were expected, however. When, thereafter, the listed companies' business results were released, indicating better than expected performance, the stock market recovered, reaching 3000 in October. It is expected that the market will surpass 3300 – 3400 by the end of 2009.

(4) Monetary policy to date, and its side effects

Since the beginning of 2009, the People's Bank of China has been modifying its monetary policy towards financial institutions as follows:

From January to May, it requested that financial institutions engage in active lending, without instructing them as to the sectors to which they should control their loans. In June, the Bank instructed them to be careful about the nature of their loans. In September, it notified them to restrain limit their lending to six sectors.¹ Since July, the China Banking Regulatory Commission also has resumed its strict inspection on bank lending.

In the first half of 2009, financial institutions rapidly increased their lending and some of the money lent flowed into the stock market and the real estate market, causing asset prices to rise. The monetary authorities were quick to recognize this; they were praised for their quick action in nipping in the bud any trend that could have resulted in a bubble.

Some, however, are critical of the nature of the increased lending that resulted from the extreme by loose monetary policy. In addition to loans made to the construction sector and to individual mortgages, as well as investments in real estate through subsidiaries of corporate borrowers, about half of increased lending in 2009 seems to have resulted in real estate investment. Those lendings are used for the development project in local areas. In the past, construction in areas of development would attract factories, including those that are foreign owned, and would be profitable. Recently, however, with the global recession, foreign corporations have pulled out. Buildings in such areas of development are unable to attract companies, as before, and there are instances in which the projects result in the red. If these cases increase in the future, there is a risk that some developers will go bankrupt, with negative consequences for the local economy; this could occur because local governments do not fully guarantee the financing, unlike state level projects, where the finances are guaranteed by the government. The China Banking Regulatory Commission has taken note of this risk of non-performing loans, and drew it to the attention of financial institutions.

(5) Future policy agenda and policy management

①Coping with the risk that inflation recurs

After April-June, the Chinese economy clearly has been on a path back to rapid

¹ On September 30, the State Council announced “the guideline to curb production overcapacity and duplicate investment.” The guideline was targeted to limit infrastructure investment in six sectors (steel, cement, flat glass, coal chemistry, polycrystal silicon for solar batteries, wind power facilities.) In addition to imposing a limit on lending, the State Council simultaneously adopted multiple measures, such as with respect to land policy and environmental standards.

growth rate and it appears certain that growth in 2010 will surpass 2009. With this prospect, the most important item on the agenda for future policy is the risk that inflation will recur in 2010. The Chinese government is split on the question of how to approach macroeconomic policies. Some expect that if the CPI reaches 4% in the first half of 2010, after April 2010, the government will tighten credit. Some expect that, if the GDP growth figure for October-December (released in January 2010) surpasses 10%, then the probability of a hike in interest rates will increase. By contrast, others are concerned about negative impact on the economy from the low growth in exports. They take the position that any movement toward monetary restraint should be carried out with discretion.

If there are any further changes in monetary policy, they are likely to be announced at the Central Economic Work Conference at the beginning of December. Close attention is being paid as to the kind of monetary policy the central government may signal at the Conference for coping with the risk that inflation recurs.

②Decline in trade surplus

The prospect for trade balance in 2010 is as follows: exports will recover to the level of +10% over 2009. Imports will increase more rapidly than the exports, reflecting the increase in domestic demand. As a result, the 2010 trade surplus is expected to shrink, just as it did in 2009. During some months, the trade balance may result in a deficit. At this point, macroeconomic policy experts in the Chinese government assess this decline in trade surplus as not problematic. They believe that, taking account of the past few years' substantial increase in foreign currency reserves, this actually affords a welcome opportunity for adjusting the reserve.

2. Local economy in Shanghai

(1) Economic recovery since summer 2009

The Shanghai economy is at the core of China's economy. Because the Chinese headquarters of many foreign financial institutions are concentrated in Shanghai, the city was especially affected by the global economic downturn and, among the local economies, it was notably late in its recovery. Now, Shanghai is finally showing recovery trends. GDP figures were + 3.1% for January-March, + 5.6% for January-June, + 12.4% for January-September. Consumption has been recovering since the summer and it is expected to recover to the pre-Lehman Shock level before the end of this year. In the meantime, in the real estate market, in

August, surplus housing inventory was cleared, and the office occupancy rate also has been recovering. For example, at the Shanghai World Financial Center, the occupancy rate was about 40% until last summer, but it reached about 50% in October, and it is expected to reach 60% in the spring of 2010.

(2) Hongqiao commercial area project: Expansion of Yangtze River Delta

Since the summer of 2009, the Hongqiao commercial area project has been discussed as a major development project after the Shanghai Expo. The Hongqiao area has been the center for transportation, including the Hongqiao Airport, which is a central hub for domestic airlines, as well as major roads to Jiangsu Province, and Zhejiang Province. The plans for the project include developing a concentration of railway and other transportation terminals, and creating an industrial cluster.

For example, the transportation networks will consist of a station for the bullet trains between Beijing and Shanghai, a central terminal for bullet trains that connect major cities in the Jiangsu Province, and the Zhejiang Province, and magnetically-levitated trains that connect the Shanghai Pudong International Airport and the Hongqiao Airport. The existing trains will become high speed, so that the trip between Shanghai and Nanjing will take less than 1 hour, compared to the present 90 minutes, and between Shanghai to Wuhan will take 3 hours, rather than 6 hours. In addition, the Hongqiao Airport will be expanded, so that it can serve as an international airport with flights to and from Asian countries. As a result, the Yangtze River Delta will be expanded. In addition to Jiangsu Province and Zhejiang Province, the nGreater Yangtze River Delta will include Anhui Province and Hubei Province.

This new development project is noted as being the new engine for the Shanghai economy after the Shanghai Expo. The region already has a close relationship with Japan, with a concentration of Japanese subsidiaries, as well as the presence of a Japanese Consulate. Enhancing convenient access to the area will be beneficial for Japan in deepening its economic relations with China.

(3) Deeper economic relations between Shanghai and Japan

Major cities in the coastal area, such as Shanghai, now allow individual Chinese to travel to Japan, without tour conductors, and the number of Chinese travelers to Japan has increased. At the universities in the Yangtze River Delta, students are more interested in studying Japanese, so that they can work at Japanese corporations. This indicates some move on the part of the Chinese to build closer

relations with Japan.

(4) Formation of giant industrial clusters

As if responding to the expansion of the Yangtze River Delta, with its center at Shanghai, the Nantong city Yongkou port on the other side of the Yongkou is promoting its plan to build a new deeper port, so that it can serve ships importing energy and raw materials. In order to have access to a deep-water port, a 16 km bridge will be built to the location of the new port. This is just like Shanghai's Yangshan deep-water port, which is accessed by a 35 km bridge. When completed, the Nantong city Yongkou port will be the largest port in China in terms of the cargo weight that it handles annually. There is a plan to build a new petrochemical industrial complex near the port.

This port construction plan is an important project in the Jiangsu Province coastal development plan. It is a key element in the Jiangsu Province coastal area development, which centers in the three cities of Nantong, Yancheng, and Lianyungang. When the port is completed, it is expected to be the central distribution center for major cities in the Yangtze River region, such as Nanjing, Hefei, and Wuhan.

Just as the Yangtze River Delta is expanding, the Pearl River Delta also is expanding, from Guangdong Province to Guangxi Province. With these two expansions, China's coastal area region will consist of the three major industrial clusters of the Bohai Economic Area, the Pearl River Economic Area, and the Huanan Economic Area. The expansion of these three industrial clusters will further stimulate the urban economies of each region. This stimulus for urban economy in China will create a major opportunity for Japanese corporations that cater to urban economies.

3. The task for Japanese corporations targeting China's domestic market is to cope with the difficulty of collecting bills

With stronger domestic demand in China, many Japanese corporations are shifting their focus from exports to strengthening their distribution networks in the domestic market. It is noted that a problem for Japanese corporations in developing their markets in China is the difficulty of collecting bills.

Drafts in China, especially those of major small and medium-sized companies, are not reliable. For this reason, Japanese corporations would prefer to rely on bank acceptances issued by local banks in China. There is, however, no benefit for the

banks to do so; therefore, they are reluctant to issue bank acceptances. Even local banks are inclined to issue bank acceptances only for large corporations, not for those of a medium size. Therefore, Chinese corporations rely on their personal connections with local governments and public security officials in order to collect their bills. Japanese corporations do not have such connections. So, their bank acceptances are not trusted and they lack reliable means for settling payments. This lack of trustworthy acceptances was, six years ago, already a problem for Japanese corporations wishing to enter the Chinese market. After that time, however, exports from China became doing well and Japanese corporations' main business was exports, so the issue came to be not so urgent. Now that Japanese corporations are shifting their focus from exports to China's domestic market, this issue has resurfaced anew. The issue is important for China itself, and it has been so noted by the People's Bank of China and the China Banking Regulatory Commission, but their reactions have been slow. Only recently, the Commission asked that major Japanese banks submit ideas for improving the market for bank acceptances and checks. In the meantime, having learned from their past experiences in trying to collect bills, Japanese corporations, such as textile companies, deal with military customers, which have no problem in paying, while avoiding private companies that are high risk.

This issue is especially serious for small and medium-sized Japanese companies entering the Chinese market. Customers of certain products, such as Lexus cars and Komatsu construction equipment, have a strong desire to purchase and, for those with low credit, they do so in cash. This is not the case, however, with ordinary small to medium-sized Chinese companies. Japanese banks can only discount bank acceptance but they cannot do more. This issue of credit enhancement in the Chinese domestic market is both an old and a new problem.

This problem, however, can be turned around as an incentive for attracting Japanese corporations. If a local government wishes to attract Japanese companies, it can issue credit guarantee or have a local bank issue credit guarantee when a Japanese company is selling to a local company. If local governments ensure such support, that will work to increase the entry of Japanese corporations into the Chinese market.

4. Report on a visit to the Bohai Economic Area (Meeting with the Shandong Province Academy of Social Sciences)

(1) Macroeconomic overview

The GDP export ratio is 36% for Shandong Province, which is relatively small compared to 80% for Shanghai or Guangdong Province (2008). For Shandong Province, this has meant that the impact of the global financial crisis since the fourth quarter of 2008 has been relatively minor. GDP growth is showing a steady recovery at +7.1% for January-March, +9.9% for January-June, +10.5% for January-September, 2009. Fixed asset investment for January-September showed 23% growth, less than the national average of 33.3%. Total retail sales of consumer goods grew at 18%, however, demonstrating more robust growth than the national average of 15.1%. It should be noted that 70%, a relatively high percentage, of the fixed asset investment in the province is by private sector.

(2) Shandong Peninsula city complex project

Since December 2003, Shandong Province, based on the Shandong Peninsula city complex project, has been developing local economies, with the eight cities of Jinan, Tsingtao, Yantai, Zibo, Weihai, Weifang, Dongying, and Rizhao, at its core. The project has not been approved by the State Council, however, and the project has not yet enjoyed infrastructure investment backed by significant national capital, as seen in Tianjin and Liaoning Province. As a result, fixed asset investment growth in Shandong Province was 23% for January-September 2009, less than 44.2% for Tianjin, 41.3% for Liaoning Province, and 52.5% for Hebei Province.

When the project started, Tsingtao, Yantai, and Weihai were the economic centers, but now, with development in the Bohai Economic Area, there is a possibility of development that centers around the petrochemical industry in the Yellow River Delta.

Shandong Province is hoping that the Shandong Peninsula city complex project will be approved by the State Council as a national project in the near future.

(3) Infrastructure investment

Shandong Province is the region in China where highways are the most highly developed. The highway that connects Jinan and Tsingtao was completed in 2000 and, in 2008, another highway between these cities that parallels this highway was completed. Other highways connecting major cities are under construction. A high speed railway between Tsingtao, Yantai, and Weihai has been completed and, in 2008, construction of a high speed railway between Jinan and Tsingtao commenced, to be completed around 2012. When completed, the travel time between these two cities will only be 90 minutes, compared to 4 to 5 hours at

present.

(4) The Shandong Province view of the Bohai Economic Area

The Bohai Economic Area has less concentration of industrial clusters, as compared to the Yangtze River Delta and the Pearl River Delta. Shandong Province and Liaoning Province traditionally have been independent from Beijing, Tianjin, Hebei Province city complex. Shandong Peninsula is remotely located in the Bohai Economic Area; it is close to South Korea and Japan and there is a large amount of direct investment by corporations of these two countries. So the province tends to pay more attention to economic cooperation with South Korea and Japan, rather than with the Bohai Economic Area.

5. The cause for Japanese economic slowdown as seen in comparison with the Chinese market

In a meeting with Japanese economists working in China, they raised the following interesting points:

(1) Effects of drastic discount by large corporations

Compared to prices in the Chinese market, those in Japan appear to be drastically low. Some examples of such low prices can be seen in automobiles, supermarkets, and convenience stores. Although these large businesses can, with a discount, still make a profit with high sales volumes, small to medium-sized subcontractors and suppliers are facing severe financial conditions. As a result, pay for employees in those small and medium-sized companies has decreased, leading to depressed consumption. This is the reason why Japan has been slow to make an economic recovery.

At present, where there is only slow growth in sales over a long time, quality products and services commonly are provided at discount. This discounting was welcomed as a “pricing revolution” Formerly. One should recognize, however, that this revolution is dependent on the sacrifices of employees of subcontractors and suppliers, as well as of these companies themselves. It was noted that the pay of employees should be secured at a level that is appropriate, by enhancing sales efforts without providing drastic discounts.

(2) Effects of expense account cuts

Another point that differentiates China and Japan is the use of expense account. Japanese corporations formerly had large expense account, which contributed to

robust consumption. Chinese corporations and local government organs spend a large sum of expense account, which constitutes a large source of revenue for restaurants and other businesses. The Chinese income levels for individuals are still low and, generally speaking, they are unable to go to expensive restaurants using their own money; however, they use them for business meetings, so expensive restaurants remain very prosperous. As a consequence, individual income levels are increasing, which enables individuals to go to such restaurants with their own money. Unless they first had gone to these restaurants for business, they would not have returned with their own money. This development indicates that expense account spending can, in some way, contribute to individual spending. In Japan, many corporations have minimized their expense account, so one cannot expect a similar effect. It was pointed out that, considering the macroeconomic aspects of entertainment budgets, their increase will have a positive impact on economic recovery.