September 12, 2012[*]

Chinese Economic Situation/Site Visit Report (July 16-27)
Consistently Steady Chinese Economy

Kiyoyuki Seguchi

The Canon Institute for Global Studies

<Executive Summary>

○ There are three factors driving the economic slowdown that has occurred during the first half of this year: (i) the restrictions on real estate transactions; (ii) the continuation of monetary tightening from last year until March of this year; and (iii) the reduction in external demand. Among other factors, the restrictions on real estate transactions have negatively affected both the "upstream" industry sector and the durable consumables-related sector, and represent the greatest factor driving the recent economic slowdown.

○ Looking forward, the monetary easing that started in April and the stability of the employment situation since the beginning of this year are likely to become factors boosting the economy in the future. Thanks to monetary easing, infrastructure construction has begun to increase and the real estate market has started to pick up. Given these developments, many central government officials and local economists, among others, believe that in and after the third quarter, the economy will be recovering from the cyclical bottom reached in the second quarter.

○ With respect to the restrictions on real estate transactions, it is considered difficult to lift them early in view of certain political factors and the magnitude of economic side effects. Assuming the effect of the economic slowdown continues, the pace of the recovery is still expected to be moderate in future.

○ The minimum lending interest rate was reduced when interest rates were lowered in June and July. At this point in time, the effects of this reduction on major Chinese state-owned banks are likely to be insignificant; however, moves to discount lending interest rates are expected to accelerate gradually in the medium run, and most economists believe that financial institutions will find it more difficult to earn revenues.

[*] The report was originally issued in Japanese on August 13, 2012.

1. Recent Macroeconomic Situation

(1) Factors Driving the Recent Economic Slowdown

According to the major macroeconomic index issued by the National Bureau of Statistics of China on July 13, the real growth rate for the second quarter of 2012 was +7.6%, which almost met the recent expectations of market players. Looking back on previous movements, the Chinese economy was slightly overheated for the year from the second half of 2010 to the first half of 2011 after the rapid recovery in 2009 from the stagnant conditions experienced in the wake of the Lehman Shock. In the second half of 2011, it grew at a slower pace of around 9%, and the rate of growth for 2012 fell further to +8.1% during the first quarter and +7.6% during the second quarter.

This economic slowdown in the first half of this year is considered the result of the following three factors:

(i) Restrictions on Real Estate Transactions

The first factor is the restrictions on real estate transactions. People in general are persistently dissatisfied with the high real estate prices seen mainly in major cities in coastal areas. Since April 2010, the Chinese Government has increased the down payment ratio for residential loans and has implemented stringent regulations and other restrictions on real estate purchases for investment purposes, thereby dampening real estate demand. As these regulations have been reinforced further since last year, real estate transactions have started to slow down remarkably since the fourth quarter of last year. During the first quarter of this year, the value of real estate transactions decreased substantially by 14.6% in comparison with the previous year. This is especially so in Beijing and Shanghai, where they dropped by more than 30% in comparison with the previous year. This decrease in real estate transactions had a large impact on investment in real estate development. The investment growth rate in this sector, which had previously been maintained at a year-on-year increase of more than 30%, has certainly slowed down since the fourth quarter of last year, and has fallen further to +16.6% for the first half of this year.

This slowdown in investment in real estate development has had negative effects on “upstream” industries such as steel, cement, petrochemicals, copper, aluminum and coal. It has also had negative effects on repurchase demand for consumer electronics and automobiles that would result from home purchases. The situation in these sectors is not as trying as it is in the “upstream” industry sector. However, the reason the energy-saving consumer electronics and small car subsidies announced by the Chinese Government in June have brought little results is likely to be that it is difficult to measure repurchase demand for durable goods resulting from home purchases. Thus, the restrictions on real estate transactions have had a negative impact on both the "upstream" industry sector and durable consumables-related demand, which is the greatest factor driving the recent economic slowdown.

However, the value of real estate transactions has been on a recovery track since April due to the impact of a monetary easing policy, and real estate prices have taken an upward turn on a month-on-month basis in many major cities since May. Thus, the atmosphere in the real estate market has clearly changed. Especially in Beijing and Shanghai, where strict trading regulations have been in force for longer, potential demand has accumulated, and it is now said that the pressure on price increases in these cities is the greatest out of the major cities.

Under these circumstances, the central government has repeatedly announced its policy of maintaining the restrictions on real estate transactions, and it is considered difficult to lift the regulations early (see below for the timing of and other conditions for lifting the regulations). Given that the effect of the economic slowdown resulting from the continued regulation of real estate transactions will continue for the time being, the pace of economic recovery is expected to be moderate, although the monetary easing policy in place since April makes it possible for the economy to rebound.

(ii) Monetary Tightening Policy

The second factor influencing the economic slowdown is the monetary tightening policy that continued from the beginning of last year until the first quarter of this year. The Chinese economy, which had surprised by recovering at an astonishing pace from the stagnant conditions seen after the Lehman Shock, has experienced inflationary pressure since November 2010. In response, the government decided to adopt a policy of moderate monetary tightening and achieved almost all of its aimed goals in the second half of last year, making it possible to virtually stabilize commodity prices and attain a relatively high growth rate.

Combined with the restrictions on real estate transactions, this monetary tightening policy has had a negative effect on regional infrastructure construction. In mainland China, local governments are responsible for raising the funds necessary for constructing infrastructure such as subways, highways, airports and dams. The restrictions on real estate transactions discouraged them from making investments in real estate development, as a result of which fiscal revenues that local governments should have received decreased. In addition, monetary tightening policy hampered local governments from raising funds. At the same time, the central government did not permit any local governments or state-owned companies to start large-scale construction projects. Furthermore, railway construction projects, which are directly controlled by the central government, have been suspended due to various problems within the railway sector surfacing after the high-speed rail accident in July last year. The combination of these factors triggered the economic slowdown from the beginning of this year.

However, circumstances surrounding this second factor have changed substantially since the second quarter. Policy intended to restrain financial institutions from extending loans has been eased since April, and twice base interest rate reductions were announced on June 7 and July 5[1]. In parallel, the central government started giving various local governments permission to start large-scale construction projects in April. Railway construction has also gradually resumed since the second quarter.

(iii) Reduction in External Demand

The third factor influencing the economic slowdown is the reduction in external demand, mainly resulting from the fall in exports to Europe. Growth in exports to Europe has diminished rapidly since the fourth quarter of last year, showing a year-on-year reduction of 1.8% during the first quarter of this year. However, it remained flat (+0.0%) during the second quarter in comparison with the corresponding period of the previous year. During the same period, growth in exports to Japan also diminished, while exports to the United States remained steady (see Figure 1). Some degree of reduction in external demand was anticipated, and the current extent of the negative impact on external demand is within the range of expectations. Among the three factors driving the economic slowdown in the first half of this year, the impact of external demand is seen as insignificant.

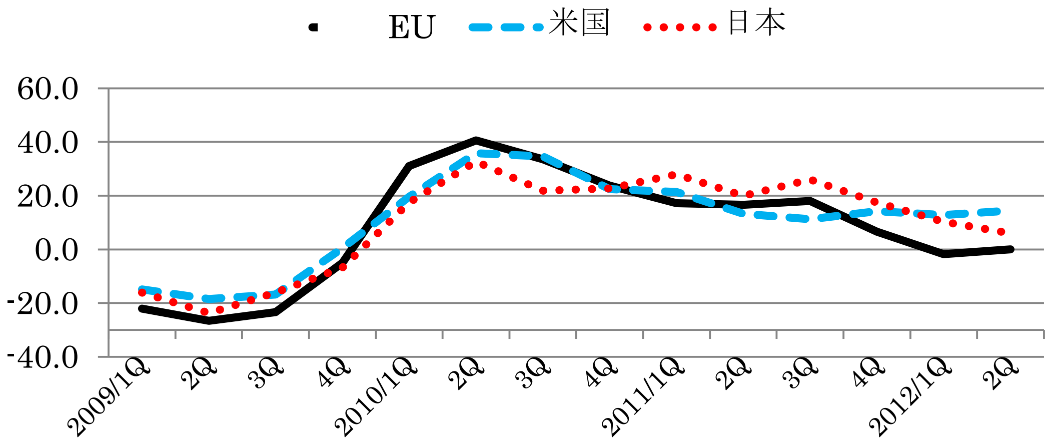
During the same period, subsequent to the first quarter (when a surplus of US$1.1 billion was achieved, a decrease of US$700 million over the same quarter of the previous year), the trade balance recorded for the second quarter showed a larger

---

[1] Announced on June 7 and executed on the next day. The base lending interest rate (1 year) was cut from 6.56% to 6.31%, while the base deposit interest rate (1 year) was cut from 3.50% to 3.25%. Announced on July 5 and executed on the next day. The base lending interest rate (1 year) was cut from 6.31% to 6.00%, while the base deposit interest rate (1 year) was cut from 3.25% to 3.00%.

surplus than that experienced in the same quarter of the previous year (a surplus of US$68.8 billion, representing an increase of US$46.7 billion over the same quarter of the previous year). However, this increased surplus is likely to have resulted from reductions in prices of crude oil, iron ore and other natural resources, as well as a falls in energy prices. For this reason, subsequent to the first quarter, external demand still made a negative contribution to the GDP growth rate in real terms in the second quarter of 2012[2].

Figure 1: Trends in Exports to Major Countries and Regions (% in comparison with previous year)



(2) Factors Sustaining the Economy in Future

In contrast with the factors discussed above driving the recent economic slowdown, it is pointed out that the following factors is likely to sustain the economy in the future.

First, monetary easing policy has been adopted since April this year, and its effects are expected to come to the surface gradually. The effects on the real estate market are already visible and the atmosphere in the market has changed substantially since May. Local infrastructure construction started to pick up in the summer, and its effects are expected to become even clearer from October onwards. This recovery of the real estate market and increased infrastructure construction will underpin the economy.

The second factor is the stability of the employment situation. During the January-May period, 5.74 million people were newly employed. As the economic growth rate was expected to decline from the beginning of this year, the annual new

[2] The ratio of the contribution of external demand to the GDP growth rate was -0.8% for the first quarter and -0.6% in total for the first half.

employment target was 9 million jobs, lower than the estimate of over 11 million jobs in a normal year. However, new jobs are increasing strongly at a faster pace than in normal years.

The increase in employment against the backdrop of a slower economic growth rate is likely to reflect economic development of the service sector. The service sector typically creates more jobs than the manufacturing industry, even with lower capital investment. As a result, the increasingly high weight of the service sector is likely to have the effect of creating more jobs, while it is likely to contribute less to the GDP growth rate through increased investment.

Looking at the rate of wage increases during the same period, the percentage of wage increases in local cities stands in the early teens this year, compared with around 20% last year. Nevertheless, reflecting the tight labor supply, the average rate of minimum wage increases has grown at almost the same pace as last year (the average rate of wage increases rose by 13.1% in the first half of this year, compared with 15.3% for the same period of last year) (Source: CEIC)).

As discussed above, monetary easing and the stable employment situation are likely to become factors underpinning the economy in future.

(3) Outlook for Future Movements in GDP Growth Rate

Reflecting the views discussed above, very few central government officials and local economists believe the current economic slowdown will become more serious. Most of them consider the GDP growth rate for the third quarter will rebound to around 8% from the lowest level of +7.6% reached in the second quarter, and will rise further to just over 8% during the fourth quarter. It is generally considered that the full-year growth rate will stand at around 8%. An economist for a certain government-affiliated institution points out that the quarter-on-quarter growth rate is highly likely to have hit the lowest point during the first quarter[3]. A certain well-known Chinese economist has stated that conservatively speaking, the GDP growth rate will fall to its lowest level of +7.4% in the third quarter and start to pick up (to a level slightly below 8.0%) during the fourth quarter, with a full-year average growth rate of +7.8%.

[3] Quarter-on-quarter GDP growth rate trends (seasonally adjusted) are as follows: +2.2%, +2.4%, +2.3% and +1.9% for 1Q, 2Q, 3Q and 4Q last year, respectively, and +1.6% and +1.8% for 1Q and 2Q this year, respectively.

In late April, most economists estimated the full-year growth rate outlook at 8.5% to 9.0%. However, the outlook after second quarter data were published was adjusted downward by more than 0.5%. Most of them still believe it will recover during the third quarter, or even during the fourth quarter on a more conservative basis. Thus, the current economic slowdown is not regarded as particularly serious.

Looking forward to next year, it is highly likely that large state projects will start and infrastructure construction will peak every five years, as the new leadership system of the Chinese Communist Party is due to be set up in autumn this year and the new administration will take office next year. As a result, the growth rate will be boosted, mainly driven by investment. However, continued restrictions on real estate transactions will work against the economy, and it is unlikely that the growth rate will increase rapidly, with a moderate recovery expected.

(4) Commodity Prices

The rate of year-on-year increase in CPI stood at the 4% level between November 2011 and January 2012, which exceeded the warning threshold of 5% experienced between March and October last year, and has remained stable at the 3% level since February. Reflecting the economic slowdown between April and June, it fell to +3.4% in April and +3.0% in May, ultimately falling below 3% to +2.2% in June[4]. This rapid decrease in the rate of increases in CPI was greater than government economic policymakers had expected. The rate of month-on-month increase fell by 0.1% in April, 0.2% in May, and a remarkable 0.6% in June. One of the factors affecting the stability of CPI after the beginning of this year was the substantial decline in pork prices[5], followed by the reduction in vegetable prices in June[6].

Looking forward, most economists believe that commodity prices will turn upward after bottoming out in August. Commodity prices are expected to go up by between +1.5% and +1.7% in August compared with the same period of last year, and it is generally understood that the rate of growth will stand at the 2% level on a full-year basis, although it may rise from September onwards. For this reason, it is considered that in the latter half of the year, the government might start to liberalize longstanding

[4] In July, it fell further to +1.8%.

[5] Year-on-year comparisons of pork prices: 48.6% and +28.9% for 3Q and 4Q last year, respectively, and +17.4% and -2.5% for 1Q and 2Q this year, respectively.

[6] Year-on-year comparisons of vegetable prices: +27.8%, +31.2% and +12.1% in April, May and June this year, respectively.
Month-on-month comparisons: -5.8%, -6.9% and -15.2% in April, May and June this year, respectively.

regulations governing prices of electricity, gas, water supply/sewage and other utility charges, as well as those governing resources and other prices.

(5) Evaluation of Monetary Easing Policy

(i) Unexpected Interest Rate Reduction

While CPI has remained stable since the beginning of this year, the negative impact of the restrictions on real estate transactions on related industries has spread, significantly reducing the growth rate for the second quarter to 7.6%. The National People's Congress held in March set a target growth rate of 7.5% for this year. However, government officials do not believe achieving this rate will suffice, and it is presumed that the central government basically believes it is desirable to achieve growth of around 8% this year. Fortunately, because the central government managed to keep CPI stable, in April decided to implement a policy of monetary easing mainly to relax the regulations under which it had restrained financial institutions from increasing the amount of loans they extended. Additionally, the central government unexpectedly reduced interest rates twice in June and July. Given the fact that in early July, almost all market players expected the economy to turn around in the near future, some consider the government should not have implemented the second reduction in interest rates.

(ii) Reduction in the Minimum Lending Interest Rate

In connection with the recent change in monetary policy, the substantial reduction in the minimum lending interest rate is likely to have had a more substantial impact than the reduction in the base interest rate (for details, see Figure 2).

Figure 2: Introduction of More Flexibility into Regulations on Lending and Deposit Interest Rates

	Minimum lending interest rate (1 year)	Maximum deposit interest rate (1 year)	Maximum margin
Previously	Base lending interest rate minus 10% 6.56%×0.9=5.904%	Base deposit interest rate 3.50%×1.0=3.50%	2.404%
On and after June 8	Base lending interest rate minus 20% 6.31%×0.8%=5.048%	Base deposit interest rate plus 10% 3.25%×1.1=3.575%	1.473%
On and after July 6	Base lending interest rate minus 30% 6.00%×0.7%=4.2%	Base deposit interest rate plus 10% 3.0%×1.1=3.3%	0.9%

Previously, with respect to the yuan-denominated lending interest rate in mainland China, the lending interest rate was allowed to be set at a rate up to 10% lower than the base lending interest rate (base interest rate x 0.9) established by The People's Bank of China, depending on the creditworthiness of the borrower. The minimum range within which the lending interest rate can be reduced was extended to 20% (base interest rate x 0.8) at the time of the June 2012 change of policy, and further to 30% (base interest rate x 0.7) at the time of the July 2012 change of policy.

During this period, the base deposit interest rate was not allowed to be set higher than the applicable base interest rate, and setting a deposit interest rate 10% higher than the base deposit interest rate was permitted at the time of the June 2012 change of policy. However, further flexibility was introduced into the lending interest rate at the time of the July 2012 change of policy, whereas no flexibility was introduced into the deposit interest rate.

As a result of the more flexible settings for the minimum lending interest rate and the maximum deposit interest rate, the maximum margin financial institutions could earn diminished substantially from the previous level of 2.404% to 0.9%. Financial institutions would earn as revenues the interest gap representing this margin from which their fixed expenses are deducted (if the margin is 0.9% and fixed expenses are equivalent to a 0.5% margin, the interest gap the financial institution can earn as revenue from which such fixed expenses are deducted is 0.4%). For this reason, there are concerns that if the lending interest rate applicable to many customers is substantially reduced, its effect on financial institution revenues will become very serious.

However, the prime rate is applicable only to certain exceptional companies and does not apply to all customers. It is highly likely that companies to which no interest rate lower than the base lending interest rate has previously applied will be exempt from application of this policy. At this point in time, financial institutions do not seem to be reducing interest rates by 20% or 30% from the base lending interest rate for all of their customers to which a 10% reduction was previously applicable. For this reason, the effect on Chinese state-owned banks is likely to be relatively immaterial. However, it is expected that lending interest rates will be discounted gradually over the medium term, and most economists consider it possible the earnings environment surrounding financial institutions will become increasingly challenging.

On the other hand, small- and medium-sized financial institutions in China are not generally highly profitable, while the percentage of credit they extend to excellent companies is not as high as that of the major banks. Therefore, there are concerns that the effect of this policy change on their business operations will become more serious.

(6) Visions on Additional Fiscal Stimulus Policy

Given the economic outlook and assessments on the effects of the monetary easing policy discussed above, the visions of the Chinese Government in adopting additional fiscal stimulus policy have changed dramatically from the vision it had when it implemented the so-called “4 trillion yuan economic stimulus policy” in November 2008, shortly after the Lehman Shock.

When the previous 4 trillion yuan economic stimulus policy was implemented, not much time had elapsed since the full-scale shift from export and investment-driven growth to domestic demand-driven growth[7], and it was difficult to identify the possible effect of lower external demand on the Chinese economy. For this reason, the Chinese Government, which was inexperienced in the risks faced in the Lehman Shock and the subsequent stagnation of the world economy, rushed to adopt ill-thought through measures to expand domestic demand. As a result, the Chinese economy returned to a high-speed track at a faster pace than expected, prompting the shift to domestic demand-driven economic growth straight away. However, the Chinese Government faced the following two problems that emerged as side effects: inflationary pressure and the sharp rise in real estate prices resulting from the overheated economy, and non-performing loans caused by the excessive supply of funds through a sharp increase in credit extended by financial institutions[8]. The number of those criticizing the side effects caused by the economic stimulus policy adopted at that time has been increasing each year since 2010.

Reflecting these circumstances, many Chinese Government officials have shared in the mistake of bringing about these two significant side effects. Strong evidence of this

[7] It was in 2005 that the government undertook the yuan rate reform, mainly consisting of a revaluation of the yuan, and initiated measures to promote wage increases, and it was early in 2008 that the government substantially reduced export tax incentives and decreased corporate tax rates applicable to domestic companies. It was in September 2008 that the Lehman Shock took place.

[8] A typical example is the rapid expansion of investments in real estate development by local governments through the use of financing vehicles (i.e., a kind of financing platform). For details of such financing vehicles, refer to pages 2 and 3 of the author’s column entitled “Current Situation of Chinese Economy and Japan-China Relations after the Great East Japan Earthquake <Report on the Business Trip to Beijing and Shanghai (April 18-28)>” in the “Columns and Papers” section of the CIGS website.

can be seen in the National Development and Reform Commission granting local governments permission to start large-scale construction projects, in parallel with monetary easing policies, from April this year onwards. In addition, the recent actions of the Chinese Government remain calm in comparison with those it took in the wake of the Lehman Shock, reflecting the substantial progress made in the shift to a domestic demand-driven economic system in comparison with 2009, shared confidence that the Chinese economy is sufficiently robust to secure the desired growth rate without relying on external demand thanks to the actual results achieved since 2009, and the recent stability of the employment situation.

Given these considerations, in its recently adopted additional fiscal stimulus policy, the Chinese Government has adhered to the policy line of only implementing projects that are highly productive and efficient, and has conformed to the amended structure it is aiming for, incorporating elements such as environmental protection, energy saving and high technology-focused projects. Therefore, the recent policy move is unlikely to produce any side effects similar to those of the previous 4 trillion yuan economic stimulus policy.

(7) Views as to Timing for Lifting Restrictions on Real Estate Transactions

The major factor driving the current economic slowdown is the restrictions on real estate transactions. It is evident that lifting these restrictions on real estate transactions will have a substantial effect in stimulating the economy. However, according to central government officials, it unlikely that the restrictions on real estate transactions will be lifted before the end of next year. The reasons are described below:

(i) It would be politically difficult for a politically unstable new administration to suddenly change a policy so emphasized by the current administration; and

(ii) As a result of the central government implementing its monetary easing policy without easing real estate policy, the atmosphere in the real estate market has changed, resulting in real estate prices returning to an upward trend, mainly in Beijing, Shanghai and other major cities. If the government elects to ease the restrictions on real estate transactions all at the same time, it is inevitable that real estate prices will rise sharply. For this reason, even if the government elects to ease the restrictions, it has no choice but to undertake a limited and modest program of deregulation.

If, however, the outlook for the economic growth rate is adjusted further downward and there is a stronger belief that it will remain at a rate below 7.5% this year and next, it is likely that the restrictions on real estate transactions will be lifted earlier. However, this is considered unlikely for the time being.