Analysis and Forecast of Chinese Economy
The State Information Center, Beijing


1.1 Chinese economy is in a stabilizing and improving trend since July.

In the first half of this year, the Chinese macro economy stayed in a reasonable range, yet still faced relatively big downward pressure. Since July, Chinese economy has been in a significant stabilizing and improving trend, with an estimated economic growth of 7.8% in the third quarter. Firstly, the central government specified the target range for macro control, which has boosted market confidence and stabilized market expectation. After the economic growth dropped to the lower target limit of 7.5% in the second quarter, the government released a series of policy signals of Stabilizing Economic Growth with a Lower Limit. The signals, to some extent, led to better enterprise expectation and further recovery in industrial productivity. Secondly, the government deepened reform to restore market vitality. More than 200 administrative approval items were readjusted or abolished. The pilot program to replace the business tax with a value-added tax has been expanded. The interest rate liberalization, the investment and financing system for railway and other infrastructure, the prices for resource-based products, as well as many other areas have seen the reform to boost market vitality. Thirdly, companies sped up their inventory replenishment. In addition, the electricity generation, transport and other physical volume indicators have increased. These factors, together with the low base effect of the third quarter last year,
all suggest that the economic growth is stabilizing and improving.

1.2 The policy of Stabilizing Economic Growth with a Lower Limit is boosting fixed asset investment from decreasing to increasing.

From January to August, the nominal investment of fixed asset was up by 20.3%, which was 0.2% higher than the first half of the year. In particular, August itself saw an increase of 21.4%, which was 1.3% higher than the first half of the year. Since the second quarter, the State Council has issued policies and measures to promote construction of High-speed rail, railways and other infrastructure, energy conservation and emission reduction, shanty town renovation, the Broadband China strategy, etc. These favorable measures have focused on boosting the manufacturing sector and the infrastructure investment. But since the purchased land areas and the new construction areas have shrunk dramatically, and the housing prices in the third- and fourth-tier cities have been adjusting, the investment in real estate is decreasing.

1.3 The consumer demand is growing steadily.

From January to August, the total nominal retail sales of consumer goods grew by 12.8%, which was 0.1% higher than the first half the year. After deducting the price factors, the real growth was 11.4%, keeping the same level as the first half of this year and as the same period last year. Considering the current context that the central government have forbidden recreational activities using public funds, the restaurants and catering industry increased by 8.9% from January to August, with a year-on-year growth down by 4.2%, contributing to a negative share of 0.5% in the total retail growth of consumer goods. The consumption in real estate related furniture, together
with the consumption in construction and decoration material, have been growing relatively fast and keeping an upward trend.

**1.4 Export is increasing moderately.**

From January to August, the Chinese export saw a year-on-year growth of 9.2%, which was up by 1.1%. But earlier this year, the volume was propelled by the export to Hong Kong. Between January and August, the export to Hong Kong increased 31.8%, while the volume excluding export to Hong Kong only increased 5.2%. Driven by the European and American economic recovery, the export in China grew from a negative increase of 3.1% in June, to 5.1% and 7.2% in July and August, respectively. With Chinese economy stabilizing and improving, and the prices of primary commodities significantly going up, the growth rate of Chinese import increased to 10.9% and 7% in July and August, respectively.

**1.5 The trends for prices are diverging.**

With ample liquidity in domestic currency, as well as significant pressure on wages and other costs, the consumer prices have moderately increased. From January to August, the prices saw a year-on-year increase of 2.5%, which was down by 0.4%. With domestic overcapacity and oversupply, the Industrial Producer Price Index (PPI) saw a year-on-year decrease of 2.2%, which has decreased for 18 months in a row. However, in the past few months, primary commodity prices in the international market have risen, the domestic market expectation has been expected to improve, and the demand has grown. These factors led a narrowing decline and a positive month-on-month PPI growth in August. Overall, the prices are still diverging, with
consumer prices moderately increasing, industrial product prices dropping, and housing prices rising significantly.

2. Current Economic Difficulties, Problems and Risks

Currently, there is pressure on both the adjustment of the new international landscape and the downward trend of the domestic economy. There are conflicts in both the long-term structural problems and the short-term cyclical problems. There are risks to both the real economy and the financial sector. The economy is suffering the existing difficulties, as well as new problems and risks.

2.1 The economic growth still lacks motivation.

Despite the stabilization and improvement of Chinese macro economy since July, the economic growth still lacks motivation. Firstly, household income is increasing slowly, which prevents the potential of consumption growth. In the first half the year, the income growth rate of Chinese urban and rural residents dropped, making it lower than the growth rate of GDP. There also occurred the structural unemployment problem. Since state-owned enterprises were in inspection, maintenance, or on holiday, some industrial workers have not been in full employment. This will affect the recovery of consumer demand in the second half of the year. Secondly, the sources for investment in infrastructure construction and other projects are narrowing down. The central revenue and expenditure are more and more unbalanced. Government debt is under comprehensive audit by the National Audit Office, and local government financing platforms will be regulated and reduced. And as for companies, the
increasing financing cost may reduce credit demand and jeopardize their profitability, thus lead to insufficient self-owned capital and ability to repay the loans. These factors may affect the investment in later major projects and technological reform. Thirdly, the rapid appreciation of RMB in terms of real exchange rate will significantly affect the competitiveness in export.

2.2 The recovery of energy-intensive industries leads to considerable pressure on energy conservation and emission reduction.

In July and August, industry, investment, consumption and export in China begun to rebound, particularly with industry growing from 8.9% in June to 10.4% in August. The rebound should be analyzed from the perspectives of its structure. In terms of manufacturing, steel, choke, plate glass and other heavy industrial products are increasing significantly. In terms of investment, the investment in infrastructure continues to accelerate, with the industrial manufacturing and investment of the state-owned enterprises contributing to the trend. The economic structure is showing similar characteristics again, where the heavy industry is motivating, government investment is dominating and the state-owned enterprises are taking the lead. Since this year, the secondary industry in China has consumed a higher level of electricity than the same period of last year. Recently, the six major energy-intensive industries have a higher growth rate in energy consumption. And with steal, non-ferrous metal and other heavy chemical industries accelerating, energy conservation and emission reduction will then be under significant pressure.

2.3 The overcapacity problems accumulate and restrict the manufacturing
development and economic recovery.

2013 is at the peak of overcapacity due to earlier investment. With earlier overcapacity still in existence and new capacity accumulating, the current problems exist in various industries at a high level of absolute excess that will last for a long time. The problems will restrict such core issues as economic growth, restructuring and upgrading. Now the overcapacity problems in China are structural rather than cyclical, which means they cannot be solved by stimulating demand.

2.4 Financial risks are increasing, partly because companies prefer virtual economy instead of real economy and banking systems choose the “shadow” to channel demand.

In the context of an excessive money supply, an easing monetary environment, and an increasing debt of the financing platforms, the National Audit Office is investigating the local government debt. As is estimated by IMF, the Chinese government debt, in a broad sense, accounts for 50% of its GDP. Most of the debt is repaid by the sale of land. In order to continue financing for infrastructure construction and profiting of enterprises, commercial banks and other financial agencies expand shadow banking business on a large scale. By the end of June, the shadow bank balances amounted to over 20 trillion yuan. Considering the overcapacity problems, and the local financing platforms which borrow money to repay loans, social capital shows a weak propensity to invest in real economy. Then the virtual economy is operating with real economy in absence. In the meantime, domestic enterprises merge, more companies bankrupt, and some financial products suffer the increasing risks of
credit default. These factors can accumulate and lead to mounting financial risks.

2.5 Soaring prices, regional distinction and other problems in the real estate market become acute.

Housing prices in first- and second-tier cities continue to rise significantly, becoming apparently unaffordable to the households, and jeopardizing the sound development of urbanization. On the one hand, the soaring housing prices boost the overall housing price level, resulting a favourable attitude towards real estate investment among households and enterprises. This has squeezed the real economy and the room for an easing monetary policy to a large extent. The high prices are becoming a significant bottleneck to the macro control in the current stage. On the other hand, although land supply and real estate investment are expanding in the third- and fourth-tier cities, the industrial upgrade and employment opportunities there cannot keep up with the pace of the expansion. The unbalance between living and investing in houses leads to severe overcapacity, especially Ghost Towns. It is the current land system and the local governments’ over reliance on land finance that lead to a vicious circle of the real estate problem.

3. Economic Forecast of the Fourth Quarter and the Year

In the fourth quarter, the policy of Stabilizing Economic Growth with a Lower Limit, the moderate replenishment of the inventory among companies, the stable foreign demand and other factors will continue to fuel the stabilizing and improving Chinese economy. However, the narrowing infrastructure investment sources, the
dramatic decrease of new construction areas and purchased land areas, the overcapacity that restricts manufacturing recovery, the high base effect from last year, and other factors will prevent the economic recovery. Overall, the fourth quarter will see a stabilizing and mildly increasing economy. According to preliminary estimate, GDP in the fourth quarter and the year will grow by about 7.6%, with a moderately increasing inflation rate and a stable unemployment rate.

3.1 The growth rate of fixed asset investment will slightly decline.

The investment growth has certain positive effects. Firstly, the investment policy of strengthening weak links will gradually reap benefit. Since the second quarter, the government has issued investment-boosting policies and measures, covering energy conservation and environment protection, shanty town renovation, infrastructure in urban areas, railways in central and western China, etc. These policies will gradually play a positive role in the fourth quarter. Secondly, the State Council have released policies and measures to increase investment sources, such as mobilizing the stock of financial assets, liberalizing loan interest rate, mobilizing the stock of fiscal revenue, etc. These measures can help to fuel investment growth. Thirdly, structural tax reduction policies, such as tax reduction in small and micro enterprises, as well as the pilot program to replace the business tax with a value-added tax, will be expanded nationwide. The policies and measures can help to ease the tax burden for companies and encourage their investment in fixed assets and machinery equipment. However, there is still severe overcapacity in industry, and the basic difficulty to attract investment to manufacturing still remains. All levels of the government will see
increasing unbalance between revenue and expenditure, while local government debt management and risk control will become standardized, and the budget for local infrastructure will narrow. The real estate market will show a diverging trend, with the housing prices in the first- and second-tier cities soaring, yet housing prices in most of the third- and fourth-tier cities stagnating. The market will see a slowing investment trend. In addition, high base effect will influence the investment growth in the fourth quarter. According to preliminary estimate, fixed asset investment in the fourth quarter and the year will grow by 19.8% and 20.1%, respectively.

3.2 Household income growth will slow down, holding back the consumption growth.

Consumption will steadily increase. Firstly, cultivating new growth areas will boost consumption growth. The government will promote the Broadband China strategy, making information consumption a new growth area after real estate and automobiles. The government will also promote the environment protection industry as a new pillar industry of the national economy and a new engine for consumption and investment. Secondly, with over 20 cities raising the minimum wage level by about 20%, the consumption level of the low-income households can be increased. Thirdly, since cities are suffering from problems such as traffic congestion and air pollution, many cities are planning to carry out curbs on new vehicle purchases. The plan may bring many households to buy cars before the curbs, leading to an estimated booming automobile consumption in the fourth quarter.

However, consumption may lack subsequent motivation. Since this year, the
income growth of urban and rural residents is apparently slowing down, affecting their real consumption capacity. In the first half the year, the urban disposable income per capita grew by 6.5% in real term, while the rural cash income per capita grew by 9.2% in real term, which was 3.2% less than the growth rate last year. In addition, while the total retail sales of consumer goods grew rapidly in the fourth quarter last year, the base effect will influence the consumption growth this year. According to preliminary estimate, the total retail sales of consumer goods in the fourth quarter and the year will grow by about 13% and 12.9%, respectively.

3.3 Export will maintain a steady increase.

Firstly, the world economy will keep the moderate increasing trend, with developed economies recovering relatively significant. Secondly, China is promoting the free trade zones, establishing favorable international and domestic environment for import and export. Thirdly, since the second half of the year, the government has issued series of support policies for trade to facilitate trade and expand export. So the fourth quarter will see the benefit of the previous policies. However, the real effective exchange rate of RMB has increased dramatically since this year, affecting the competitiveness of exporting companies significantly. In addition, the composite index of leading indicator, known as the Baltic Dry Index (BDI), is currently fluctuating and remaining at the bottom despite an unstable increase in the short term. According to preliminary estimate, the export in the fourth quarter and the year will grow by about 7.5% and 8.5%, respectively. The trade surplus of the year will be over 260 billion USD, with a 16% year-on-year increase.
### 3.4 Consumer price will be steadily increasing.

Firstly, the high temperature nationwide and the floods in main producing areas in the North will affect crop yield in the autumn, thus affecting the stability of crop prices. Secondly, the government purchase and reserve will delay the pork cycle. Thirdly, cost-driven pressures, such as labor cost, will remain. However, the pressure of imported inflation is easing, since the commodity prices in the international market are dropping and the real exchange rate of RMB is rising. In addition, the carryover effect in the fourth quarter is becoming significantly mild. In terms of the industrial product prices, the stabilizing and improving industrial productivity will lead a mild decrease of ex-factory price, with the carryover effect in the fourth quarter contributing negatively to less than 0.1%. But the general oversupply condition will not change. According to preliminary estimate, CPI in the fourth quarter and the year will grow by about 3.1% and 2.7%, respectively, with an estimated monthly peak of 3.2% and an average much lower than the target upper limit of 3.5%. PPI will drop by 1.6% and 2% respectively.
## Forecast of Major Chinese Macro-economic Indicators

<table>
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<tr>
<th>Indicator</th>
<th>Actual First Half of 2013</th>
<th>Forecast Quarter III</th>
<th>Forecast Quarter IV</th>
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<th>Forecast 2014</th>
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<td>GDP</td>
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<td>Total Retail Sales of Consumer Goods</td>
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<td>Export (100 Million USD)</td>
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