How to interpret China's current slowdown

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Signs of slowing down going into 2012

China's gross domestic product (GDP) growth cooled again in the second quarter of 2012, growing at a rate of 7.6 percent versus 8.1 percent in the first quarter. Growth for the first half of 2012 averaged 7.8 percent, which is the lowest growth rate in many years. A few days after the official data was released by the National Bureau of Statistics of China, the International Monetary Fund (IMF) lowered its estimate of China's GDP growth for 2012, from 8.2 percent to 8.0 percent, warning that a hard landing in the medium term is a possibility.

Other major economic data also indicate a cooling down effect in China. Exports and imports for the first six months grew by a mere 9.2 percent and 6.7 percent year on year, compared to 24 percent and 27.6 percent for the same period a year ago. Foreign direct investment shrunk by 3 percent over the last year. Forward looking indicators were also showing signs of slower growth: The PMI index continued its downward trend, reporting a reading of 49.2 in August, down from 50.1, 50.2, 50.4 and 53.3 in July, June, May and April respectively, and indicating a contraction of manufacturing activities. [1]

What caused the slowdown?

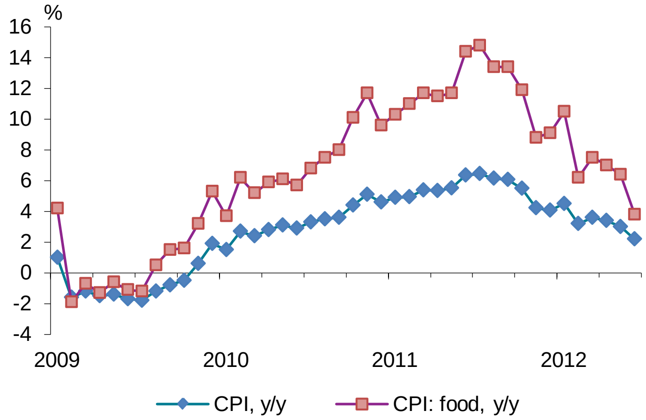
One can ponder the question: "What are the major factors that influenced this slowdown?"

The slowdown has been predominantly influenced by cyclical factors, i.e., a decrease in liquidity and a weaker external demand. At the same time, it has also been the result of deliberate policy adjustments.

At the end of 2008 to deal with the impact of the Global Financial Crisis, the Chinese government rolled out a RMB 4 trillion stimulus package. This package worked well in extricating the economy from the crisis, but it also created a series of asset bubbles. The inflation rate started to rise,

[1] The National Bureau of Statistics of China

Figure 1- Inflation Rate 2009-2012

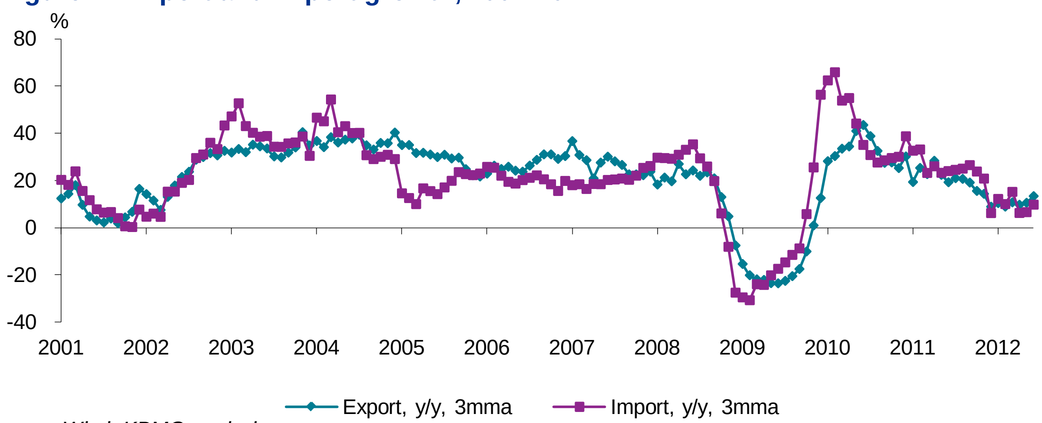


Sources: Wind, KPMG analysis

reaching a high of 6.45 percent in July 2011 (see Figure 1), and the prices of real estate also soared. The index on real estate price of China's 100 major cities published by China Index Academy showed that in August 2011, when the property market hit its record high, the average real estate price of China's major cities was RMB 8,880 per square metre, an increase of 6.92 percent year-on-year. To curb inflation and to quash the speculative bubbles in the property market, the government introduced a series of tightening measures. For instance, the central government increased the deposit reserve ratio six consecutive times in 2010, which caused a drop in the accumulated fixed asset investment growth rate to 24.5 percent by the end of 2010 (6 percentage points lower than the previous year). The government also enacted policies to restrict purchases in real estate, which caused the investment growth rate in real estate to decrease by 3.9 percentage points in 2011. These tightening policies were inevitably effective in reducing domestic investment.[2]

External factors also undoubtedly played a significant role in the cooling of China's economy. The sovereign debt crisis in Europe and the sluggish performances of other advanced economies have taken their toll on China. The U.S. and Europe are two of China's biggest trading partners. Their weak economic conditions correlate to sluggish exports that have dragged down China's growth rate. The slower growth rate in foreign trade for the first half of the year clearly illustrates this situation (see Figure 2).

Figure 2 - Export and import growth, 2001-2012



Sources: Wind, KPMG analysis

[2] Soshoo: http://www.soshoo.com/DataList.do?method=DataView&id=1115143&dblist=TJ&view=no&str=FFF56fa;FFF5b9a;FFF8d44;FFF4ea7;FFF6295;FFF8d44;,,;2;0;1;1;

Besides the cyclical factors, adjustments in economic policy also played a role in the current slowdown. The Chinese government has reiterated that it will change the mode of economic growth from an over-reliance on investment and exports, to a balanced model of investment, exports, and domestic consumption. This is a policy objective that focuses on sustainable growth. To achieve this objective, the government lowered its 2012 GDP growth target, for the first time in eight years, to 7.5 percent (the target had been set at 8 percent since 2005). As a consequence to this new policy orientation, growth in investment spending for the first half of 2012 was 5.2 percentage points lower than the same period a year ago. [3] From this perspective, one can say that there was a 'planned' slowdown in growth, though not yet as slow as the original target had 'planned'.

Will there be a hard landing?

The question that remains to be answered is whether the Chinese economy will spiral downward or stabilise at a sustainable growth percentage. In other words, will China be able to keep the growth rate in the vicinity of 7-8 percent, as the policymakers designed? Or, will China be heading towards a hard landing?

The immediate answer is that the prospect for a hard landing (or economic collapse) is slim. Despite the array of borderline indicators, signs of strength still remain. For example, growth in domestic consumption has been strong; retail sales in the first half of 2012 increased by 14.4 percent from a year ago. Liquidity has also been on the rise; new bank lending rose by 16 percent in June versus May, and M2 grew by 2.78 percent (equivalent to RMB 2.5 trillion, or USD 392.5 billion) for the same period. Moreover, after reaching its peak in July 2011, CPI has been well contained, reading at a mere 2.2, 1.8 and 2.0 percent for June, July and August respectively.[4] A low inflation level gives the policy makers large room for introducing monetary policy initiatives if necessary.

What's more, some pre-emptive measures have been taken by the government to prevent a rapid fall in growth. For example, The People's Bank of China (PBoC) cut interest rates twice within a month, The National Development and Reform Commission (NDRC) has fast-tracked the approval of infrastructure projects, and a series of new export tax rebate measures have also been unveiled in June to support small and medium businesses. The combined effects of these measures are likely to provide fuel to the economy.

Furthermore, financial reforms continue to progress. Moves toward greater financial liberalisation, such as loosening controls over interest and exchange rates, have been introduced. Letting the market play a larger role will help correct the distorted allocation of resources, and create a level playing field for all market participants. The capital market is also undergoing reforms aimed at creating a favourable environment for well-managed companies to access capital, and providing incentives for companies to generate profitable returns for investors. For example, China Securities Regulatory Commission (CSRC) has announced measures to bring transparency to the IPO pricing mechanism, give more

[3] The National Bureau of Statistics of China
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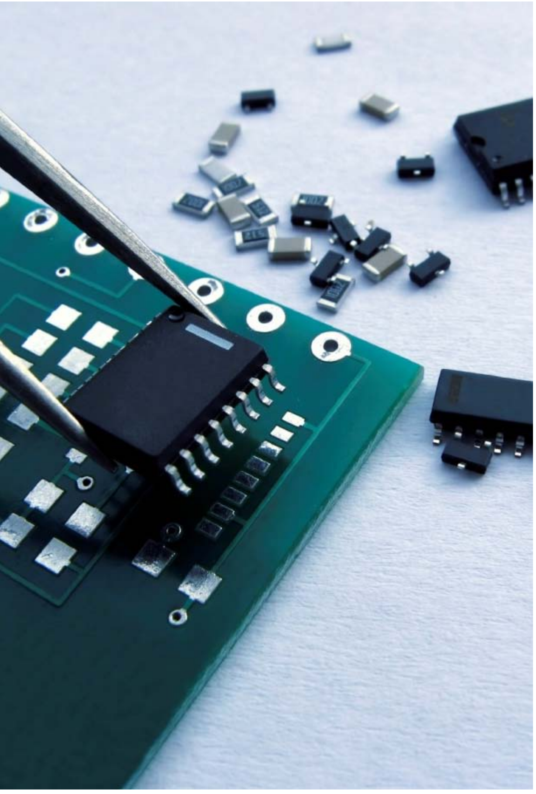
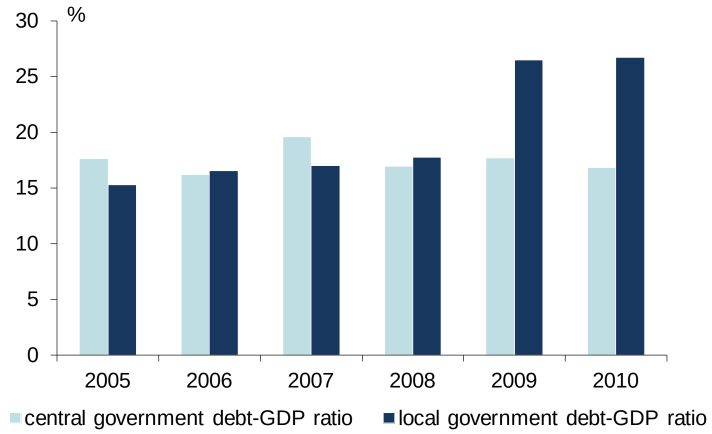


power and greater responsibility to companies, investors and underwriters, and implement a more strict and effective delisting process. To further open the market and increase cross-border capital flow, CSRC is planning to establish Exchange Traded Funds (ETFs) in the domestic market based on overseas indexes, and ETFs traded in Hong Kong based on domestic indexes. On the same note, recently, CSRC has granted Qualified Foreign Institutional Investor (QFII) status to more overseas entities and raised the cap of their investment.

Further reforms are needed

Although hard landing is a remote prospect, China still needs to be cautious when steering its economy. A soft landing and long-term sustainable growth require continuous economic reform and well-informed policy adjustments.

Figure 3 - China's central and local government debt relative to GDP



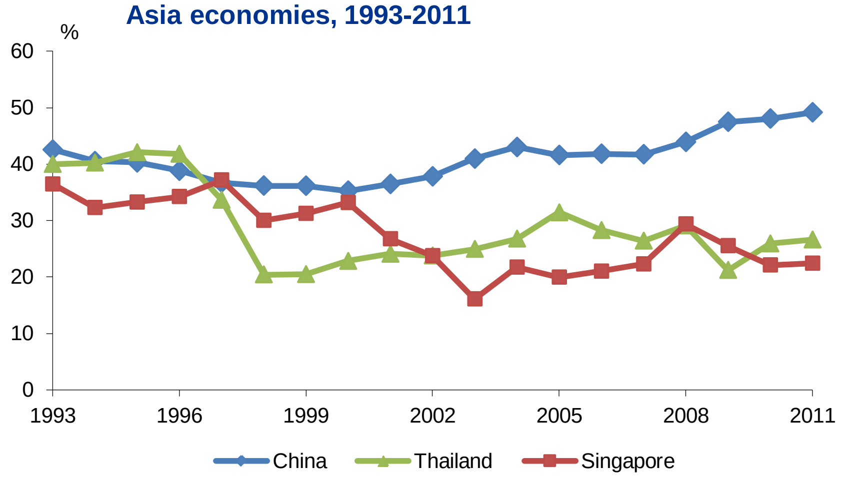
Source: Bu, Tang, and Wang (2012)

Firstly, in spite of the relatively healthy balance sheet of the central government, local government debt has increased drastically in recent years [5] (see Figure 3).From 2008 to 2010, the local government debt to GDP ratio increased from 17.3 percent to 26.7 percent, making the total outstanding debt ratio reach 43.5 percent, which may pose default risks for local governments. To manage the risk, China should use caution when adopting expansionary fiscal policies in the future.

Secondly, China has invested excessively in the past, even compared with the high-investment economies in East Asia (see Figure 4). In 2011, the investment share of GDP was as high as 49 percent. Investment is one of the key drivers of economic growth as it facilitates capital stock accumulation and technological progress. Too much investment, however, could be problematic for growth as it creates overcapacity, affects efficiency, and drags consumption. As Figure 4 demonstrates, Thailand and Singapore also used to support high levels of investment. Yet both countries had to dramatically cut their investment spending in late 1990s and early 2000s. To avoid such a disruption, China should rid itself of overreliance on capital investment.

[5] According to the calculation by Bu, Tang, and Wang (2012) "Government debt, monetary finance and fiscal sustainability: an application to China", the People's Bank of China Working Paper Series.

Figure 4 - Investment share of GDP across Asia economies, 1993-2011



Sources: Wind, KPMG analysis

Thirdly, China's exports are not going to recover any time soon. The continued deterioration of the external environment signifies that demand for China's export goods will remain weak for a protracted period of time. In addition, wage increases (see Figure 5) are raising the costs of Chinese goods. The export-led firms are forced to absorb higher costs and slash their productions. To cope with this difficulty, the Chinese government needs to introduce more structural changes to stimulate domestic consumption, find a way to help affected enterprises move up the value chain and increase their competiveness, as well as cope with the issue of rising costs by, among other measures, reallocating some factories from the coastal areas to the inland regions.

Finally, the country should move forward with financial reform in a controlled manner. Financial liberalisation, which will definitely befit the Chinese economy in the long run, could endanger the stability of China's financial system in the short run, if the process is not handled properly. The most noticeable issues lie in the openness of the capital account. The partially controlled capital account is often recognised as the main reason China kept a relatively healthy status throughout the global financial crisis. Without a proper procedure of opening up the capital account, short-term capital flow would be allowed to enter and exit, prompting speculation and arbitrage opportunities against the Chinese currency. This in turn, would leave China susceptible to economic/currency shocks, which would prevent the financial system from functioning normally and efficiently.

In conclusion, we believe that the current slowdown probably suggests that China is transitioning to a lower, more sustainable growth trajectory. With strong indicators from primary economic aspects and large room for policy manoeuvring, the economy is likely to advance at a relatively slower pace, but without major disruption. Nevertheless, the Chinese government needs to move forward with further in-depth economic reforms while keeping an eye on several key issues when steering the economy. Otherwise, substantial risks may emerge and the road to sustainable growth could be quite bumpy.

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