CHINA'S STEADY ECONOMIC DEVELOPMENT

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THE Chinese economy has a mixed blessing. On the downside, short-term corrections and mid- to long-term cyclical factors since the beginning of 2014 are encroaching on its growth potential. On the upside, restructuring efforts and reforms are paying off, improving both corporate bottom-lines and government revenues.

This mandates a prudent, yet proactive approach to coordinate efforts to stabilize growth, promote reforms, restructure the economy, improve people's livelihoods and prevent aggravated risks. While implementing a proactive fiscal policy and a prudent monetary policy, China will press ahead with reforms in selected sectors. It will thus seek to further unleash growth potentials, whilst addressing risks of overcapacity, local government debts, and volatility in the real estate market. And with a focus on the quality of growth, China's economy will keep experiencing a smooth transition to a new normalcy.

Reachable Growth Targets

In the first half of this year, China's GDP grew by 7.4 percent over the same period last year, a slowdown of 0.2 percentage points from previous annual growth numbers. The added value of industrial companies above the designated scale was up by 8.8 percent, a decline of 0.5 percentage points. With a warm-up in overseas markets, a strong rebound in exports is expected in the second half of the year. At the same time, consumption held up, claiming a bigger share in economic growth. Policies to channel funds for railway construction and shanty town renovation are boosting the once saggy growth of investment. Generally, impacts on the demand side are moderate and controllable. A number of growth indicators have shown signs of pick-up, stabilization, or narrowed decline. If investment continues to be stabilized, along with restructuring and institutional transformation, the Chinese economy is expected to reach the target range of growth.

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Another encouraging sign is that the climate for exports is improving. The world economy is recovering from the crisis. In June 2014, the U.S. unemployment rate dropped to 6.1 percent—the lowest since September 2008. In the Eurozone, the Purchasing Managers Index (PMI) remained above 50, which suggests the manufacturing and services sectors are continuing to expand. In Japan, however, the stimulus package is losing allure and the hype of consumption tax threatens to derail its recovery. Recovery in the U.S. and European markets will increase their demand for export to emerging economies, stimulating their economic growth, while the relative slowdown of the latter will be maintained. From an overall point of view, the world economy will grow slightly faster this year than it did in 2013. China will thus see moderately improved external markets and greater demand. Calculated by composite effective exchange rate, RMB appreciated by 7 percent last year, dealing a blow to the export sector. But Chinese exporters have seen a chance to lower their costs and improve their competitiveness since the beginning of 2014, thanks partly to the increasing flexibility of RMB from one-way appreciation to move in both directions, and to the declining Purchasing Power Index (PPI). In the first six months of this year, China's exports rose by 0.9 percent, but with eye-catching gains of 7 percent in May and 7.2 percent in June. The annual growth of exports is thus estimated to be 6 percent.

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Consumption will achieve a slightly higher increase. In the first half of this year, revenues of the catering industry surged by 10.1 percent, which is 1.4 percentage points more than in the same period last year. In the wake of China's anti-extravagance campaign, adaptable restaurants have survived and thrived. Highlights like information, culture, education, and healthcare hold their glory, making China's consumption mix more rational and resilient. In the first half of this year, online retail sales of companies above the designated scale surged by 56.3 percent. With a large number of new homes to be completed this year, derivative consumer spending on internal renovation, building materials, household appliances, and furniture is likely to soar in the second half of 2014. Growth of per capita income in urban and rural areas bottomed out in the second half of 2013, laying the foundation for stronger consumption this year. Total retail sales of consumer goods this year will some-what outperform the last, making up an increased share in China's overall economic growth.

We can also see that investment is facing downward pressure. In the first half of this year, capital investment grew by 17.3 percent over the same period last year—a drop of 2.8 percentage points. Flat investment growth is facing major downward pressure.

Statistics tell us that 34 percent of China's investment ends up in the manufacturing sector. Property industry claims another 21 percent, services 14 percent, agriculture and mining around 6 percent. Compounded by weak demand from end users, overcapacity, swelling cost and shrinking profit, investment in the manufacturing sector—the heavy and chemical industries in particular—may continue to plunge. The real estate market is witnessing polarized performance, with tier-two and smaller cities suffering from oversupply and bulging inventory. In the first half of this year, commercial house sales dropped by 6.0 percent in volume and 6.7 percent in value, while the investment growth in property development faltered by 6.2 percentage points, and new construction starts went down by 16.4 percent. Local governments are struggling with heavily indebted financing vehicles, shrinking tax revenues, and declining income from land transfers. With a large amount of debts scheduled to mature this year, local authorities are less tempted to invest, hindering needed investment growth in infrastructure. In compensation, private capital is courted through streamlined administration and a lowered threshold. But much more remains to be done to step up reform, redefine the role of the government, and remove institutional barriers.

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Thanks to government macro control measures in the first half of the year, investment in manufacturing and infrastructure show sign of stabilizing. And the service sector continues to receive more investment. The poor performance of the real estate market has been a leading factor for flagging investment. If the cash-flow of developers dries up, it could expose major risks, the fallout of which on land-transfer income and infrastructure investment deserves close monitoring.

Headway on Structural Readjustment

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Since the beginning of this year, in response to growing downward pressures and local risks, China has made structural readjustments. What follows is some of what has been accomplished.

First, the service sector remains healthy. In 2013, the share of added value of the tertiary industry to GDP and its contribution to growth overtook those of the secondary industry. In the first six months of this year, added value of the tertiary sector rose by 8.0 percent, which is 0.6 percentage points more than the secondary industry. It now accounts for 46.6 percent of China's GDP, a margin of 0.6 percentage points over the secondary industry. The emergence of services as the most robust sector and new growth engine underlines historical changes to China's economic structure. The boom is attributed to accelerating urbanization, upgrading household consumption and the transformation of manufacturing, which have created phenomenal demand for producer and consumer services.

Second, consumption has increased its remarkable contribution to economic growth. Last year's growth was more investment-driven, with the share of final consumption in GDP growth going down by 5 percentage points, and that of capital formation going up by 7.3 percentage points. This trend has been reversed since the beginning of 2014. As export and investment decline drastically, consumption keeps growing at last year's pace, claiming an evidently larger share in GDP growth. From January to June, the contribution by final consumption to GDP growth bounced to 54.4 percent—5.9 percentage points higher than that of capital formation. The proportion of final consumption expenditure in GDP reached 52.4 percent, notching up by 0.2 percentage points over the same period last year.

Third, the labor market is more resilient to moderate growth. The number of China's working population started to decline from its peak in 2012, easing the pressure on job creation. Meanwhile, the continued increase in economic scale and the share of the service sector has enabled economic growth to generate more jobs. In 2013, with 7.7 percent of GDP growth, China created 13.1 million new jobs—or 1.7 million jobs for each percent of growth. Within this statistical caliber, the annual target of creating 10 million new jobs can be achieved with 7 percent growth—not counting openings created by industrial restructuring.

Fourth, the transformation and upgrading of the manufacturing sector is gaining momentum. Challenged by rising factor prices and weak traditional markets, manufacturers are cutting costs and improving economic benefits through industrial upgrading, labor-substituting technology, intensive land and space management, and e-commerce. In the first five months of this year, the profits of manufacturers above the designated scale went up by 13.8 percent, 4 percentage points higher than the average level of industrial sectors. As China streamlines its government administration, introduces pro-SME tax concessions, and facilitates industrial and commercial registration, newly registered companies are mushrooming, representing vitalized innovation and entrepreneurship possibilities.

Lastly, urban and rural residents enjoy faster income growth and a narrower income gap. In recent years, farmers have benefited from successive years of bumper harvests and a moderate rise in the price of agricultural produce. Furthermore, they enjoy more opportunity to work in cities. Therefore, rural residents' income has grown faster than that of urban dwellers, continuously narrowing the urban-rural income gap. In the first half of 2014, growth of rural per capita income and urban per capita disposable income was 9.8 percent and 7.1 percent respectively—both up by 0.6 percentage points over the same period in 2013.

Understanding the Speed of China's Growth

For 30 months in a row, China's growth has fallen below the benchmark of 8 percent—7.4 percent in the first half of this year, after 7.7 percent on average in both 2012 and 2013. This has become a source of international concern. Some even argue that it is a sign of a hard landing of the Chinese economy, and a burden on the recovering world economy. The author believes otherwise. The current speed of economic growth in China should be observed properly.

The economic history of the world testifies to the fact that no country can enjoy hyper growth forever. In the post-war era, Japan and West Germany celebrated their economic miracles, which only lasted for about two decades, followed by marked decline. After the beginning of its reform and opening-up, China enjoyed over three decades of close to double-digit growth—the spectacular China Miracle. Such white-hot growth is no longer sustainable, for multiple reasons. Demographic change has sent up labor costs, thus depriving China of its traditional competitive strength. As more and more Chinese sectors approach or acquire technical leadership in the world market, the latecomer's advantage and space for catching up are being worn out.

The legacy growth model featuring high investment, strong resource consumption and heavy pollution is increasingly a restraint on resources, the environment, and the eco-system. The economic volume underlying each percentage of GDP growth is much bigger than before, making it more difficult to keep pace. Moreover, the world economic landscape and international division of labor are shifting, taking a toll on the traditional competence and growth potential of developing countries. In this context, it is inevitable for China to accommodate a moderate growth rate. This is also consistent with the general pattern of world economic development.

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But China's outlook remains positive. Economic reform promises to release new growth potential. Other favorable conditions are still in place, such as accelerating urbanization and upgrading household consumption, along with the fact that the fundamentals of China's competitive advantages remain unshaken and that globalization is yielding new opportunities. Since last year, the government has made a determined response to the slowdown. Innovative macro adjustments have been implemented, with a focus on redefining the growth model, restructuring the economy, enhancing the quality and effectiveness of economic operations, and defusing the risks. These efforts will ensure China's lasting and stable growth.

It is expected that, in the coming decade, China will continue to register mid- to high-speed growth of about 7 percent a year on average. Assuming an average annual growth of 6.7 percent between 2014 and 2020, China will double its economy on the basis of its 2010 numbers. Although the high-speed growth miracle has come to an end, China has entered a more challenging and exciting stage of economic development, unveiling the process of accomplishing the transition from mid- to late-industrialization and realizing the goal of becoming a high-income country and an overall well-off society.

In 2013, China's GDP reached 56.9 trillion RMB, or $ 9.18 trillion, up by $ 1 trillion over 2012. That was more than 12 percent of the world economy. Its growth rate has dropped below 8 percent, but the total scale continues to expand, contributing to around 20 percent of world economic growth. China remains a powerhouse of world economic growth, and a pilot of the world's recovery.

Cultivating New Growth Engines

Faltering investment poses a major pressure. To realize annual targets, it is imperative for China to stabilize investment growth. To that end, two balances should be achieved. One is between growth maintenance, risk control, and structural readjustments; the other is between demand management and deepening reform.

In the first trio, one extreme scenario is to set aggressive targets despite shrinking growth potential. That can fuel credit inflation, local government debts, and asset bubbles, spelling fiscal and financial disasters. On the other extreme, if growth suddenly grinds to a halt, it can exacerbate overcapacity, build up the Non-performing Loan (NPL) ratio of banks, and trigger systemic risk. For the sake of risk control, the growth rate has to be stabilized within a narrow but normal range.

In the second combination, demand management policies are desirable to promote consumption and iron out short-term fluctuations—especially the major ones. However, without institutional and structural reforms, such policies could worsen structural imbalances and make it even more difficult to phase out the old growth pattern.

The key to successful reform is to enable the market to play a decisive role in resource allocation, while allowing the government to play an improved role. How to realize the first part is now the major challenge. Reform measures address the supply side or the demand side, and the time taken for them to take effect varies. Therefore, while promoting major reforms that take longer, the imminent task is to prioritize demand side reforms so that quick results can be achieved in terms of expanding demand, stabilizing growth and seeking synergy with other pro-demand policies. This approach will buy time for institutional and structural reforms to cultivate drivers for mid- to long-term growth.

China's New Normalcy

China is still engaged in catching up with developed economies. It hosts many projects with sound economic and social benefits. Investment opportunities abound. The manufacturing sector is at a critical juncture of transformation and upgrading, generating huge demand for equipment updating. Burgeoning sectors, such as hi-end manufacturing, emerging strategic industries, and a modern service industry, are inviting destinations for huge investment.

Major investment is also needed in renovating the urban underground pipelines and other public works, in order to upgrade the overall quality of urban infrastructure, as well as in the central and western regions and the rural areas, where development is falling behind in relative terms. Improving the per capita level of asset possession will be one of the main contributors to mid- to long-term growth, as well as the key direction for short-term economic activities. To address problems and challenges facing the Chinese economy, it is necessary to highlight the importance of reform, investment and risk control, whilst seeking a balance between the three.

Immediate focus is to readjust investment structure, raise investment growth rate, and control financial risks. Priorities for reform include redefining the role of government, revitalizing the market, regulating Local Government Financing Vehicles (LGFVs), encouraging best practices in local government financing, enabling policy-oriented financial institutions to support housing and infrastructure constructions, and freeing up assets through securitization. In addition, supporting initiatives should be addressed, such as public opinion guidance, risk isolation, and social security. Accelerated depreciation should be promoted amid structural tax cuts. And efforts should be made to solve the problem of overcapacity to speed up industrial restructuring.

In the mid- to long-term, priority should be given to major reforms to boost growth, restructuring and transformation. Industrial reform should focus on removing administrative monopolies and encouraging competition to improve the efficiency of non-trade sectors. Measures should also be implemented in the dimension of land, financial services, wholesale and retail, as well as the protection of intellectual property rights, so as to help companies cut costs, boost profitability, and accelerate their transformation and upgrading. The service sector should be further opened to domestic and foreign investors. With implicit barriers removed, a market system of equal access and fair competition should be up and running. The central government should moderately raise its ceiling of debt-to-GDP ratios and annual deficit targets. A bigger balance sheet at the central level can better finance public services, while facilitating and reducing the debt burden of local governments and the corporate sector.

All in all, China's economy will continue to experience a smooth transition to a new normalcy.