

The Chinese Economy Is Likely To Achieve 8% Growth Despite Adverse Conditions

– A Report From the Visit To Shanghai and Beijing –

1. Current Macro Economic Conditions and the Future Prospect

(1) Current GDP

A. Analysis of the second quarter GDP growth rate

On July 16, the National Bureau of Statistics of China released the main economic indicators for the first half of 2009. The second quarter GDP growth figure was 7.9%, which exceeded the forecast of the central government's economists responsible for macroeconomic policy. Before the figure was announced, the government had expected the growth rate for 2009 to be between 7 and 8%, but, after the announcement, it confidently expects that the rate will exceed 8%. The Chinese economy was able to achieve this high growth rate because it made up for the loss in external demand that had been caused by a decline in exports from the coastal region with an increase in the domestic demand from inland areas. As a testament to this strong domestic demand, a sizeable number of the Mingong (farmer laborers) who had returned to their inland homes have not returned to the coastal region; the coastal region has suffered from a labor shortage because the number of employees that had been laid off have not been available for rehire.

B. Trends by GDP Components

Exports: Exports in dollar terms declined by 23.5% for January to June cumulatively, and by 21.4% for the month of June alone, compared to the same periods in the previous year, thereby demonstrating the continuation of a significant decline in exports; however, domestic demand compensated for this decline. Macroeconomic data indicates continuing drastic declines in exports. According to Japanese companies in the export sector in the Jiangsu and Guangdong Provinces, however, although exports dropped sharply, by 60 to 70% from January to March of this year, compared to the same period the last year, the more recent decline is 20 to 30%.

Consumption: Total retail sales of consumer goods also have shown

steady growth – by 15% in both the first and the second quarters. There has been strong demand growth in inland areas. Even in the coastal region of Shanghai, with a high percentage of its economy in the export sector, sales of children's clothing in a high-end department store this past June exhibited a double digit increase over the same month last year, and autumn products are selling well. The restaurant business is now brisk again and, in many restaurants, customers cannot get a table without making reservations. These indications all add to the sense that "The economy is gradually recovering," according to an individual in the Japanese retail business.

Looking at consumption as a whole, automobile sales are, in particular, showing signs of strong growth (June automobile sales figure increased by 36.5% over the same month in 2008, with passenger car sales growing by 48.4%.) This growth was due to increases in income, which led to more automobile buyers. This increase in sales was, of course, prompted by a government subsidy for those buying small cars (under 1.6L), but, in general, it reflected broader car ownership occasioned by increases in income and, due to the enhanced liquidity, in corporate cash-in-hand.

Fixed Asset Investment: The January to June cumulative figure for urban area fixed asset investment increased by 33.6%, as compared to that of 2008, and the figure for the month of June alone increased by 35.3% over June 2008, thus showing continuing strong growth. The main engine for fixed asset investment is, in particular, local governments. Some experts are concerned that, in the latter half of 2010, when construction projects relating to the Shanghai Expo (May to October, 2010) and the Asian Games (November 2010 in Guangzhou) are completed, there may no longer be continued fixed asset investment. Central government officials, however, are more concerned that the current high growth of investment will continue into the latter half of 2010, leading to a greater risk of economic overheating. Thus, they are of the view that a decline in infrastructure investment in the latter half of 2010 would be desirable from the viewpoint of macroeconomic adjustment.

(2) Economic Growth Rate Forecast for 2010 and thereafter

The economic growth rate for next year will increase, as the negative impact of the decline in external demand this year abates. Some forecast that this increase will exceed 10%. The central government officials view is somewhat more cautious. Growth over 9% tends to lead to overheating of the economy, so, if the rate exceeds 9%, the government will be required to review its monetary ease policy to suppress growth. An official responsible for policy making who shares such a cautious view told me, however, "There is no doubt that China will continue its rapid growth for the next two to three years." It is worth noting that before the global financial crisis, Chinese officials responsible for macroeconomic policy were of the view that the Chinese economy needed to grow 7%, at a minimum. Even though the growth rates for both the fourth quarter of 2008 and the first quarter of 2009 were in the range of just 6%, no significant social problems emerged; this led to the current view that the growth rate can be as low as 5%. The further shake-out of firms with low business and production efficiencies means that maintaining steady employment rates will be possible even during times of lower economic growth. This may result in decreasing the minimum growth rate even further.

(3) Employment

One of the most serious risks to the Chinese economy caused by the global economic downturn triggered by last year's Lehman Shock was thought to be social unrest caused by increases in unemployment. Recent years saw the serious problem of new college graduates being unable to find employment. After April and May of this year, however, those fresh out of college are finding jobs without problem and the problem of unemployment is now rapidly abating. The reasons for this abatement generally are seen as follows. Both central and local governments have been engaged in increasing their efforts to find employment for new graduates. In the face of the worsening global recession, many students no longer were so selective and, instead, they chose jobs that they would not have taken previously. In addition, the economic recovery since April has led to a

decline in unemployment. Furthermore, the People's Liberation Army increased its hiring, and the number of students who elected to go to graduate schools has also increased. All of these factors contributed to a decline in unemployment.

There are some who caution that the unemployment statistics are, to a degree, manipulated by the education departments, which are responsible for compiling the raw data for unemployment of new graduates, in order to emphasize the success of their efforts to cope with the unemployment of new graduates.

(4) Regional Trends

Overall, the Chinese economy is well on its way to recovery, however, regionally, inland areas are continuing to experience a strong recovery, while the coastal regions are still confronting the adverse effects of the global economic downturn, which has resulted in a decline in exports. In my meetings with Japanese banks operating in China, I was informed that the most seriously affected areas in the coastal regions are Dalian, Shanghai, Suzhou, and Shenzhen. Though they, too, are coastal, the areas of Tianjin and Guangzhou have fared better in the face of the drop in external demand due to infrastructure investment and automobile industry.

(5) Real Estate and Stock Market

A. China Overall Is Recovering

In the months since December 2008, price indices for real estate in seventy large- and medium-sized cities declined as compared with the same periods of the previous year. In June, for the first time in six months, price indices exceeded the same month in 2008 by 0.2%. The figure for June grew by 0.8% over May, almost reaching 10% on an annual basis, demonstrating rapid recovery in the real estate market. Spurring this quick recovery is the rapid increase in bank lending, which led to a rise in corporate short-term liquidity, some of which, in turn, began to flow into the real estate market. A central government official responsible for macroeconomic policy noted that, "The real estate market is, in reality, showing faster price increase than the statistics are showing," and is alarmed by a possible asset bubble

brought on by the policy of easing liquidity.

B. Rise in Vacancy Rate in Office Buildings and hotels in Beijing and Shanghai

As stated above, the overall real estate market is showing a quick recovery due to strong demand from consumer housing purchases¹; however, vacancy rates are over 50% for many grade A upscale office buildings for foreign corporations and over 70 to 80% for five star hotels. Given this adverse environment, construction projects of skyscrapers for grade A office buildings and luxury hotels are being delayed substantially. Some shopping centers neighboring luxury hotels have been abandoned without a single tenant. It was symbolic that a restaurant on the top floor of the HSBC Tower (Mori Building), the star of upscale office buildings in Shanghai, had to close at the end of July. It is now common practice for five star hotels in Beijing and Shanghai to offer half-price discounts for their rooms.

C. Stock Market

Those concerned with the stock market were of the view that the Shanghai Stock Exchange Composite Index should be about 2800 to 3000, given the current profitability of Chinese corporations. In July, the Index easily surpassed 3000 and some IPO issuers have P/E ratios of 37 to 40. This is viewed as a market bubble and the likelihood of market adjustment is increasing.

(6) Policy Management

In addition to the 4 trillion yuan economic stimulus package, monetary ease this year has led to increased lending, promoting strong domestic demand, as described above.

¹ The average monthly income for Chinese is less than 10,000 Yuan for a single, less than 20,000 for a working couple. It is common for a couple earning about 20,000 Yuan a year to purchase a 1 to 1.5 million Yuan house. In Japan, if a mortgage is greater than five times a person's income, other living expenses would have to be cut. In China, this is not the case due to financial assistance from parents and corporate expense accounts ("public funds"), on which they can rely, which are in proportion to their positions in the company (mainly for sales activities). It is common for Chinese to use these expense accounts for personal use, such as meals with friends, transportation, travel, and gifts. As a result, even if mortgage payments take up a large portion of personal income, they can maintain their living standards.

The central government continues to watch closely, and with alarm, the details of the investments, mostly in infrastructure, implemented by the 4 trillion yuan stimulus package. It is reported that in some areas, there have been cases of overinvestment, resulting in inefficiency, and reckless investment with environmental destruction and wasteful energy consumption. Overall, however, the situation has improved due to stricter control and oversight of investment than previously.

Although the monetary ease policy has promoted infrastructure investment, it also has resulted in an extraordinarily high level of bank lending and increased liquidity, some of which has flowed into the stock market, as well as the real estate market, causing a property bubble. An increasing number of central government officials and those in the financial market are now concerned about excessive monetary ease resulting ultimately in an increase of non-performing loans.

At the end of April, when January-March cumulative increased bank lending figures and major economic indices were released, some officials responsible for macroeconomic policy recognized such problems. Even then, their concern was not “How to get out of economic stagnation” or “How to achieve 8% growth,” but “How to suppress the side effects of the economic stimulus package.” (See my column dated June 8, 2009) Some, however, were more concerned about the economic recovery losing its steam and hitting the bottom again. Thus, views inside the government were split in half and, during the second quarter, the basic policy of monetary ease was not adjusted.

In July, after confirming a strong economic recovery – with the second quarter’s economic growth rate reaching 7.9%, and observing a bubble in the stock and real estate markets – agreement was reached on the need for a minor adjustment in the monetary ease policy. The adjustment was to shift to a gradual and appropriate level of monetary ease, rather than to suddenly end excessive monetary ease. The Chinese government is of the view that bank lending is an important financial source for local infrastructure investment and, therefore, to continue construction projects, the government cannot

suddenly stop the policy. It is, instead, placing more emphasis on stronger monitoring of lending and financial institutions by the China Banking Regulatory Commission; this oversight is expected to control the flow of liquidity into the stock and real estate markets, as well as to control the increase in inefficient investment.

2. Regional Characteristics

(1) Formation of Industrial Clusters

Many cities in the coastal region are suffering from a decline in economic growth due to a drastic drop in export. Some cities, however, in order to stimulate the economy, are promoting the development of new industrial clusters by investing in infrastructure, such as highways, etc.. If there is an increase in highly productive firms in these new industrial clusters and these firms can provide goods and services that satisfy domestic demand, then the coastal regions will become less dependent on exports; the regions will be able to hasten the conversion of their industrial structures to focus on domestic demand. Some examples of such new industrial clusters in the coastal regions are as follows.

A. Coastal Economic Belt in Jiangsu

The north coastal area in Jiangsu Province is promoting the construction of an industrial area that connects the three cities of Lianyungang, Yancheng, and Nantong. This area is called Subei, with vast land area on tideland formed by the Huai River. Formerly, there was no transportation from Subei to Shanghai due to the Yangtze River, which limited the development of a physical distribution network. This resulted in Subei being excluded from the economic development enjoyed by Shanghai in the south and the Shandong peninsula to the north. In June 2008, with the opening of the Sutong Bridge, Subei is now directly connected to Shanghai, the center of the Yangtze River Delta. This has prompted a fresh look at this vast area, with its cheap labor, thereby enhancing its economic development.

B. Coastal Economic Belt in Liaoning

In the Bohai coastal area in south Liaoning Province, construction is underway for an industrial area that connects Dandong, Yingkou, Panjin, Jinzhou, Huludao, with Dalian at its center. The current development level is low but, as is the case with the coastal economic belt in the Jiangsu Province, because it is blessed with a large land area and cheap labor, it has great potential for future development.

C. Hongqiao New District

In the Hongqiao district in Shanghai, there are both a central airport for domestic airlines (with extra international service to Haneda and Gimpo, Seoul) and highways that connect major cities in the Yangtze River Delta, such as Suzhou, Wuxi, Nanjing, Hangzhou, and Hefei, with Shanghai as its center, as well as industrial areas outside the Yangtze River Delta. In order to further strengthen its strategic transportation capabilities, a terminal will be constructed next to the Hongqiao Airport for bullet train service between Beijing and Shanghai, and there is a plan to connect the Hongqiao Airport and the Pudong International Airport by linear motor cars, a trip that currently takes one and a half to two hours by car. With the strengthening of Hongqiao district's as a domestic and international transportation hub, the Yangtze River Delta and its surrounding area will see increased development of industrial clusters. In addition, industrial areas in the Hongqiao district may become a strategic center for national distribution networks. This area has the Japanese Consulate in Shanghai, as well as a concentration of Japanese firms, with Japanese-owned office buildings. Accordingly, these Japanese businesses will benefit from the development of the Hongqiao New District.

D. Other Major Industrial Clusters

Major industrial clusters in China are the Pearl River Delta (center: Guangzhou and Shenzhen), the Yangtze River Delta (center: Shanghai), the Bohai Economic Rim (center: Tianjin), and the West Delta (center: Chongqing, Chengdu). Among these, each of the Pearl River Delta and the Yangtze River Delta constitute a single industrial cluster. The Bohai Economic Rim, however, is an amalgamation of

three clusters consisting of a) Beijing, Tianjin, and Hebei Provinces, b) the central and the south areas of the Liaoning Province, and c) the Shandong Peninsula; however, each of these three clusters is developing independently of the others. The West Delta consists of two clusters, a) Chengdu, Chongqing, etc. and b) Xian, Xianyang, etc. In addition, there is also the mid-point of the Yangtze River (center: Wuhan), Zhongyuan (center: Zhengzhou), west coast of the strait (Fuzhou, Xiamen, Quanzhou, etc.), totaling ten industrial clusters. Seven of eight comprehensive reform test fields are located in these industrial clusters. The seven fields are Pudong, Binhai, Wuhan, Chengdu, Chongqing, Shenzhen, and Zhongguancun. The exception is Changsha-Zhuzhou-Xiangtan. These comprehensive reform test fields perform central functions for the industrial clusters, where infrastructure investment is concentrated. This is especially notable in Pudong (Shanghai) and Binhai (Tianjin) because the designated fields are small and infrastructure investment is especially concentrated.

In addition, the Guangxi north-bay economic development area, ratified by the State Council in 2008, is currently underdeveloped but is expected to develop and grow into an industrial area that will be the center of a heavy-chemical industry cluster and a window for trade and investment with the ASEAN countries.

(2) Economic Effect of Infrastructure Investment for Farmers

According to Mr. Takamoto Suzuki of the Mizuho Research Institute, who recently visited inland China, shopping centers are the most noticeable infrastructure investment in farm villages. The rise in farmers' income provides the foundation for the demand for these shopping centers. In a village visited by Mr. Suzuki that is three hours' drive from Xian, he saw an asparagus processing plant recently bought by Spanish. Thanks to this plant, the prices paid for asparagus in the area rose and the canning workers are able to earn 800 to 1,000 yuan per month. At its production peak, the plant would hire 1,000 in three months. The average annual income for a farming family is 3,000 yuan. So, one person working for three months at this plant can earn enough for the whole year. Such plant

business would not have been previously possible; however, with improvements in the distribution system, such as investment in highways, etc., the plant can ship products in one day to Lianyungang, a port in the north Jiangsu Province, thereby making the business viable. This example illustrates the fact that improvements in the distribution system are having a huge impact on inland farming villages.