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Analysis on the downside pressure and structural adjustment of the Mainland economy

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Recently, the Caixin manufacturing PMI hit a fresh new low and the industrial profits of enterprises above designated size recorded a notably decline, reiterating market concern over the slowdown of the Mainland economy. International organizations have already revised lower their forecasts on the Mainland economy for this year and the next. The OECD cited Mainland economic downturn to be a major risk factor for the global economy. The Managing Director of IMF, Ms. Lagarde, warned the emerging economies, such as Indonesia, to guard against the spillover effect from the Mainland economic slowdown. The international rating agency, Standard & Poor's, even revised the Mainland's banking sector outlook lower from stable to negative. If there is no improvement ahead, more negative actions by those international organizations are expected.

Looking at the source of downside pressure, the main cause of the economic slowdown rooted from the global financial crisis in 2008. Since then, the growth prospect of the Mainland has lowered by two major steps. The external demand shrunk rapidly after the global financial crisis, leading to a sharp contraction of Mainland's exports. The Mainland GDP growth slowed remarkably from 14.2% in 2007 to 6.1% in Q1 2009. The economy then stabilized after the authorities implemented a massive RMB 4 trillion stimulus measures, but the average annual GDP growth only reached 9.6% between 2008 and 2011. Even though the GDP growth remained at a high pace, it has already slowed from the super-high growth between 2003 and 2007 (an average annual GDP growth of 11.6%), driven by the buoyant trade activities.

After the European debt crisis in 2012, the situation of insufficient external demand became more severe. Together with the correction of its real estate market, the pace of economic growth in the Mainland slowed further to an average annual rate of 7.6% between 2012 and 2014, entering into the range of mid to high speed growth under the new normal regime. In 1H 2015, the Mainland economy slowed further to 7%, amid negative exports growth and further deteriorating fixed assets investment. The economic performance in Q3 seems to be even weaker, raising question of whether the Mainland economy could achieve this year's target of 7%.

Despite the intense downward pressure, the economic fundamentals of the Mainland remain largely intact. The series of stabilizing measures could help offset the downside risks of the Mainland economy, ensuring relatively stable growth and achieving the number one target under the new normal regime, i.e. maintaining mid to high speed growth.

1. Stable consumption growth is the major positive factor

Consumption is the main factor in determining the economic fundamental of the Mainland and also the precondition for stable growth. On one hand, consumption expenditure has long maintained relatively stable growth. It contributed an average of 4.4 percentage points, with a range of 3.6-5.6 percentage points, to the GDP growth between 2000 and 2014, obviously an important stabilizing force of economic development. In 1H 2015, consumption expenditure contributed 4.2 percentage points to GDP growth, slightly lower than the average since the beginning of this century. However, it was still somewhat higher than the 3.9 and 3.8 percentage points in 2013 and 2014 respectively, indicating the support from consumption not only did not weaken, but also strengthened further. On the other hand, consumption has outpaced investment to become the largest contributor to GDP growth. In 1H 2015, its contribution to GDP growth reached 60%, setting a new record for the past 15 years. As such, consumption becomes the number one driver and cornerstone of the Mainland economy to achieve a mid to high speed growth under the new normal regime.

However, is consumption growth sustainable? Based on the latest information, the answer is not pessimistic. For instance, Firstly, the retail sector has maintained relatively fast growth recently. The total sales of consumer goods increased 10.5% and 10.8% in July and August respectively, higher than the 10.2% in Q2. Excluding the price effect, it remained 0.2 percentage point higher, indicating the consumer goods market was slightly better than expected and the future outlook will continue a steady and modestly upward trend.

Secondly, even though the non-manufacturing business activity index has been deteriorating, the consumption-related sectors, such as air transportation, postal and logistics, accommodation, telecom and internet etc, have continued to perform well, with their business activity indices all above the boom-bust dividing line, indicating the increasing role of consumer services in stabilizing growth. The recent stock market turmoil is not likely to have huge impact on service consumption.

Third, labour income and employment condition remained robust. In 1H 2015, the nationwide average disposable income increased 7.6% in real terms, persistently higher than the real GDP growth. Moreover, unemployment rate in 31 major cities stayed at around 5.1% and 7.18 million of new urban jobs were created, exceeding the government target. This indicated that service sectors have increasingly absorbed more labour force, offsetting the negative impact of the relocation of manufacturing facilities on the labour market and providing support for the relatively fast private consumption growth.

2. Stabilizing growth relies on investment in the short term

From the demand perspective, the substantial decline in contribution to GDP growth by investment was the real cause of economic slowdown recently. In 1H 2015, investment only contributed 2.5 percentage points to GDP growth, less than the 3.6 percentage points last year and was more than 3 percentage points lower than the annual average of 5.6 percentage points during years of vibrant growth between 2008 and 2011. This was also the main reason why the GDP growth has slowed from an average of 10.5% at that time to just 7.0% currently. In other words, stabilizing growth still relies on investment in the short term.

Therefore, the question is whether future investment can take up the task of stabilizing growth. As a general reply might not be convincing, an in-depth analysis of the investment structure could provide some insights to this question. Indeed, both the manufacturing and real estate investment have slowed notably, largely due to the decline in exports growth and real estate market activities, and were the main causes of the sharp decline of investment contribution to GDP growth. Comparing the first eight months of 2015 with the peak between 2008 and 2011, the growth of manufacturing investment slowed remarkably from 29.1% to 8.9%, accounting for 45.1% of the overall investment slowdown and 1.4 percentage points of economic slowdown. Real estate investment also slowed notably from 26.5% to just 3.5%, accounting for 38.4% of the overall investment slowdown and around 1.2 percentage points of economic slowdown. Adding up these two factors, they accounted for 83.5% of the overall investment slowdown and 2.6 percentage points of economic slowdown. As it is still in the adjustment phase after the previous massive stimulus measures and the structural transformation phase of the Mainland manufacturing industry, it is not realistic to expect manufacturing investment will turn around soon. The following three areas could help support investment growth, stabilize and even enhance investment contribution to overall growth.

Firstly, the scale of infrastructure investment is expected to expand further. In the first eight months of 2015, infrastructure investment, including investment in infrastructure (excluding electricity) and production and supply of electricity, gas and water, recorded a remarkable 18.1% growth over the previous year, contributing to 35% of overall investment growth. Investment in infrastructure (excluding electricity) increased 18.4%, somewhat faster than the first seven months this year, with an even faster growth of 19.4% in August, 4.8 percentage points faster than the previous month. Railway transportation investment also has a sufficient room for further improvement. It only completed RMB 406.1 billion worth of railway transportation projects, roughly half of the size for this year investment target. Therefore, another RMB 400 billion could be available from September to December, equivalent to twice the monthly investment amount over the previous eight months. If the railway transportation investment could achieve this year’s target, it can boost the overall fixed asset investment by 0.68 percentage point and GDP growth by 0.15 percentage point from September to December. At the same time, investment in the production and supply of electricity, gas and water is also accelerating, somewhat offsetting the negative impact from the slowdown in the investment in secondary industry.

Secondly, the sales of residential property rebounded both in terms of floor area and value, with the property prices of first-tier cities, such as Shenzhen, recovering notably. Investment in residential property projects have also been accelerating recently, with its share of overall real estate investment rose to 67.3%. At the same time, the national real estate climate index increased to 93.46 in August, up 0.43 point month-on-month. Given that the sharp deceleration in real estate investment has contributed to more than 30% of the overall investment slowdown, the improvement in residential property investment could somewhat alleviate the downward pressure.

Thirdly, investment quality is more important than quantity during the economic upgrading phase. At the beginning of this century, the amount of gross fixed capital formation counted in the GDP calculation was roughly the same as the investment in fixed assets. However, this ratio continued to decline going forward. In 2010, the gross fixed capital formation accounted for 73% of the investment in fixed assets only. This ratio then further declined to 60.3% in 2013, indicating a lot of fixed assets investment has yet to be counted as fixed capital formation, resulting in significant wastage. Going forward, investment quality is expected to be improved, following further reform measures. This should help enhance investment contribution to overall GDP growth. If the investment quality can be effectively improved, investment only needs to grow at around 10% in order to have a contribution of 2.5-3.0 percentage points to GDP growth.

Without doubt, stabilizing growth will depends on fiscal and financial policies support. Amid the current environment, the authorities are increasing support from both fiscal and monetary sides, reducing the administrative approval procedures, implementing the negative list administrative system, and lowering the share of capital requirements in investment projects, so as to stimulate investment activities ahead. At the end of last year, the State Council has already approved seven categories of large infrastructure projects, with a total investment amount of RMB 10 trillion. Currently, the authorities also approved a large number of investment projects, leading to an increase in planned investment for both projects under construction and newly started, as well as paid-in fund in the first eight months of this year, compared to 1H 2015, paving a firmer foundation for stable investment growth ahead. In June, the State Council announced 10 measures to better coordinate the use of the fiscal funding, with over RMB 1 trillion of fiscal funding to be better utilized and the implementation of RMB 3 trillion of local government debt swap programme. Both moves could lower the heavy debt and fiscal burden of local governments and enhance their investment capability. At the same time, monetary policy is also likely to be relaxed, with further reduction of reserve requirement ratio till likely to improve liquidity, support investment, consumption and economic growth.

Overall, even though the downward pressure on the Mainland economy is relatively strong, its economic fundamentals remain solid, with a relatively low risk of further notable slowdown. It is expected that the Q3 GDP growth will likely to be slightly lower than 7%, and the Q4 growth is expected to recover to around 7%, with good chance of achieving the 7% growth target this year.

3. Structural rationalization enhances growth momentum

In the long run, stabilizing growth will rely on structural rationalization and skill upgrading. This will help achieve the number two target under the new normal regime, i.e. structurally moving towards higher quality. After a few years of efforts, there has been some initial success in the structural adjustment and the related growth momentum is now surfacing.

Firstly, the tertiary industry is now the main pillar and driver of the economy. In the past few years, a number of new service industries have been developing rapidly. Internet, broadband, cloud computing, big data, logistics and courier services etc., are now creating the new servicing space. For instance, following the rapid growth over the past two years, the national online retail sales of goods and services increased 35.6% in the first eight months this year. Other service items, including new service activities, like information transmission, software and information technology services, leasing and commercial services etc., recorded a rapid growth of 8.9% in 1H 2015, contributing to 37% of total service sector growth and becoming the largest growth driver in the service industry. Currently, the new start-ups encouraged by the government are also mainly related to this type of service industry, which should have enormous room for development ahead.

Following the rapid development of new service activities, the share of tertiary industry to GDP ratio also increased continuously. In 2013, the tertiary industry share of total economy reached 46.1%, outpacing the secondary industry the first time and becoming the main pillar of the economy. In 1H 2015, the tertiary industry share further increased to roughly half of the total economy.

Meanwhile, services industry contribution to GDP growth has been increasing continuously as well, with its contribution was only below 40% five years ago. It then exceeded that of secondary industry in 2013 and reached over 50% last year. The service sector contribution then increased further to nearly 60% in 1H 2015, indicating the Mainland economy has already entered into a service-oriented era.

Secondly, there were also breakthrough in structural adjustment between consumption and investment. This was partly because consumption has long been a stabilizing force, and even more due to the sharp slowdown in investment activities. Nevertheless, consumption has replaced investment to be the main growth driver of the Mainland economy, suggesting the Mainland economy has entered into a consumption-led era. As the Mainland economy is still in the progress of structural upgrading, it is appropriate to maintain the proportion between consumption and investment to the GDP growth at around 60% and 40%. With the current consumption contribution to GDP growth has already reached around 60%, the structural adjustment should be largely completed. However, the share of consumption to the total economy was just around 50%, indicating there is further room of improvement. It will take roughly 15 years for the consumption share of total economy to reach 60% if its share to GDP growth remains at 60%.

Thirdly, structural adjustment of manufacturing industry is accelerating. Since the beginning of this year, structural adjustment has entered into a critical phase, with the production of those lower value-added manufacturing activities, especially those "three high and one low" activities (high energy consumption, high pollution, high cost and low efficiency), was declining. In the first eight months of 2015, the production of steel, cement, glass, coal, and alkaline declined 1.4% to 8.0% from the previous year. In August, the extraction of petroleum and natural gas, petroleum process, ore mining, smelting and pressing of ferrous metals, and the mining and washing of coal etc., all recorded producer prices decline between 15.6% and 37.9%. Meanwhile, the highly-skilled manufacturing production surged 10.5%, 4.4 percentage points higher than the overall industrial growth, with the manufacture of medicines, computer, communication and electronic equipment, and chemical products recording 10.3% to 12.6% growth. Nonetheless, the share of those highly-skilled manufacturing remained relatively small, with its faster growth still not sufficient to offset the overall downtrend in the manufacturing industry.

Fourthly, the share of general trade activities also increased. The processing trade activities started contracting in 2013 and declined another 8.4% in the first eight months this year, while those higher value-added general trade activities recorded double-digit growth in the past two years. Given the sluggish external environment, general trade activities still recorded a small 2.8% growth since the beginning of this year. Even though it could not offset the negative impact from the weak processing trade activities, the share of general trade activities increased to 54.3% in the first eight months this year, 2.9 percentage points higher than last year. However, the share of processing trade activities declined further to 34.4%, 3.3 percentage points lower than the previous year, with the volatility was much larger than the past few years. Based on this trend, the share of general trade activities could reach two-thirds in 2020, while the share of processing trade might decline to less than 20%. The trade structure of the Mainland will return to a more normal stage. Going forward, if the external trade performance would return to normal in the future, this more balanced trade structure will be more beneficial to the Mainland economic growth.

Fifthly, income structure is also improving. On one hand, the nationwide average real disposable income increased 7.6% in real terms in 1H 2015, 0.6 percentage point higher than the real GDP growth, indicating the share of national income continues to skew towards the household sector, with resident income accounting for a larger share. On the other hand, the average real disposable income for the rural residents increased 8.3%, faster than the 6.7% growth for urban residents, with the income dispersion between rural and urban area narrowing further. With better allocation of income, it is likely to enhance the purchasing power and ultimately growth outlook of the economy.

Overall, even though the Mainland economy is now facing intense downward pressure, the consumption activities remain largely stable, together with the stabilizing growth measures by the government, they are likely offsetting some downside risks of the economy. In order to achieve mid to high speed growth, it is needed to rely on investment in the short term and rationalize its economic structure and skill upgrading in the long term. As structural adjustment itself could enhance growth momentum, the move toward higher quality growth will also support mid to high speed growth ahead, leading to a decade of 6% to 7% growth in the future. As a result, a mid to high speed growth and higher quality Mainland economy under the new normal regime will likely to be the largest growth engine for the global economy ahead.

主要經濟指標 (Key Economic Indicators)

一. 本地生產總值 GDP	**2013**	**2014**	**2015/Q1**	**2015/Q2**
總量(億元) GDP($100 Million)	20,961	21,446	5,736	5,662
升幅(%) Change(%)	2.9	2.3	2.4	2.8
二. 對外貿易 External Trade	**2013**	**2014**	**2015/8**	**2015/1-8**
外貿總值(億元) Total trade($100 Million)				
港產品出口 Domestic exports	544	553	42	323
轉口 Re-exports	35,053	36,175	3,031	23,139
總出口 Total exports	35,597	36,728	3,073	23,462
進口 Total imports	40,607	42,190	3,323	26,420
貿易差額 Trade balance	-5,010	-5,463	-251	-2,958
年增長率(%) YOY Growth(%)				
港產品出口 Domestic exports	-7.6	1.7	-21.3	-15
轉口 Re-exports	3.8	3.2	-5.9	-0.8
總出口 Total exports	3.6	3.2	-6.1	-1.0
進口 Imports	3.8	3.9	-7.4	-2.4
三. 消費物價 Consumer Price				
綜合消費物價升幅(%) Change in Composite CPI(%)	4.3	4.4	2.4	3.4
四. 樓宇買賣 Sale & Purchase of Building Units				
合約宗數(宗) No. of agreements	70,503	81,489	5,197	56,171
年升幅(%) Change(%)	-29.9	15.6	-34.2	9.1
五. 勞動就業 Employment			**2015/5-2015/7**	**2015/6-2015/8**
失業人數(萬人) Unemployed(ten thousands)	11.84	14.95	13.4	13.7
失業率(%) Unemployment rate(%)	3.4	3.2	3.3	3.3
就業不足率(%) Underemployment rate(%)	1.5	1.5	1.4	1.4
六. 零售市場 Retail Market			**2015/8**	**2015/1-8**
零售額升幅(%) Change in value of total sales(%)	11.0	-0.2	-5.4	-2.2
零售量升幅(%) Change in volume of total sales(%)	10.6	0.6	-0.2	1.5
七. 訪港遊客 Visitors			**2015/8**	**2015/1-8**
總人數(萬人次) arrivals (ten thousands)	5,430	6,077	561	3,987
年升幅(%) Change(%)	11.7	11.9	-6.6	-0.1
八. 金融市場 Financial Market			**2015/7**	**2015/8**
港幣匯價(US$100=HK$) H.K. Dollar Exchange Rate (US$100 = HK$)	775.4	775.6	775.2	775.1
貨幣供應量升幅(%) change in Money Supply(%)				
M1	9.7	13	11.2	17.6
M2	12.3	9.5	5.1	6.0
M3	12.4	9.6	5.0	5.9
存款升幅(%) Change in deposits(%)				
總存款 Total deposits	10.6	9.7	7.0	8.2
港元存款 In HK$	5.1	9.3	9.8	10.8
外幣存款 In foreign currency	16.2	10.1	4.3	5.7
放款升幅(%) in loans & advances(%)				
總放款 Total loans & advances	16.0	12.7	6.9	6.4
當地放款 use in HK	13.8	12.1	3.2	4.0
海外放款 use outside HK	21.4	14.2	15.9	12.2
貿易有關放款 Trade financing	43.8	-1.4	-16.6	-16.9
最優惠貸款利率(%) Best lending rate (%)	5.0000	5.0000	5.0000	5.0000
恆生指數 Hang Seng index	23,306	23,605	24,636	21,671