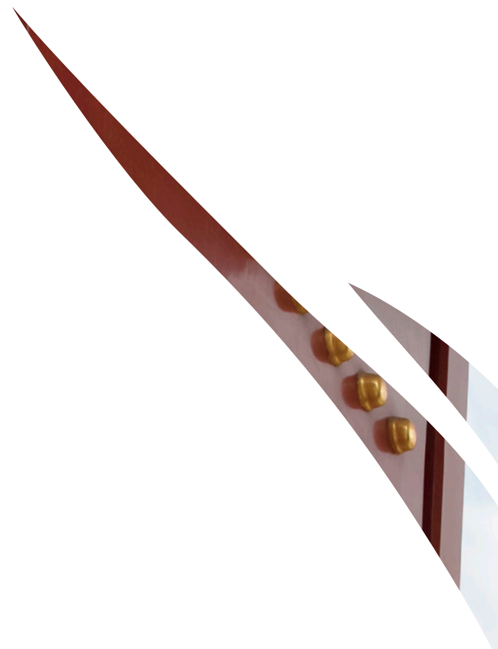


DRC

Enhancing the Sustainability of China's Economic Stabilization

— Macro-economic Situation in the 1st Quarter and outlook for 2013

Development Research Center of the State Council
Economic Situation Analysis Research Team

“Economic Situation Analysis” research team for the Development Research Center of the State Council

Advisor:

Li Wei	President and Research Fellow for the Development Research Center of the State Council

Person in charge:

Liu Shijin	Vice President and Fellow for the Development Research Center of the State Council.

Participants:

Han Jun	Vice President and Research Fellow for the Development Research Center of the State Council.
Zhang Junkuo	Vice President and Research Fellow for the Development Research Center of the State Council.
Zhang Laiming	Vice President and Research Fellow for the Development Research Center of the State Council.
Long Guoqiang	Member of CPC Leading Group and Director General of General Office and Research Fellow for the Development Research Center of the State Council.

Coordinator:

Yu Bin	Director and Research Fellow for the Macroeconomic Research Department, Development Research Center of the State Council.

Members:

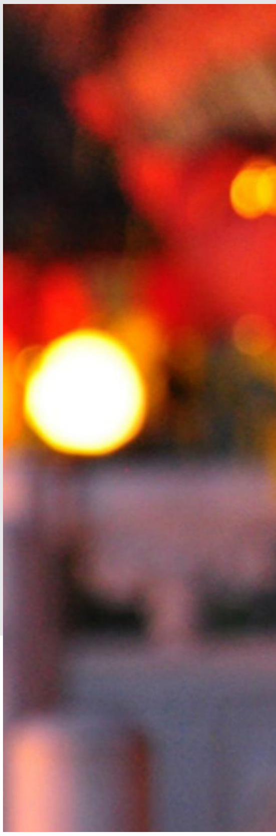
Yang Jianlong	Deputy Director and Research Fellow for the Industrial Economy Research Department, Development Research Center of the State Council.
Li Jianwei	Deputy Director and Research Fellow for the Social Development Research Department, Development Research Center of the State Council.
Deng Yusong	Deputy Director and Research Fellow for the Market Economy Research Institute, Development Research Center of the State Council.
Li Zuojun	Deputy Director and Research Fellow for the Resource and Environment Research Institute, Development Research Center of the State Council.
Zhang Liqun	Deputy Inspector and Research Fellow for the Macroeconomic Research Department, Development Research Center of the State Council.
Chen Changsheng	Director and Senior Researcher for the Macroeconomic Research Department, Development Research Center of the State Council.
Wu Zhenyu	Director and Senior Researcher for the Macroeconomic Research Department, Development Research Center of the State Council.
Liu Yunzhong	Director and Research Fellow for the Development Strategy and Regional Economic Research Department, Development Research Center of the State Council.
Qin Zhongchun	Director and Research Fellow for the Rural Economic Research Department, Development Research Center of the State Council.
Lu Gang	Director and Senior Researcher for the Foreign Economic Relations Research Department, Development Research Center of the State Council.
Chen Daofu	Director and Senior Researcher for the Financial Research Institute, Development Research Center of the State Council.
Xu Zhaoyuan	Director and Senior Researcher for the Enterprise Research Institute, Development Research Center of the State Council.
Ren Zeping	Senior Researcher for the Macroeconomic Research Department, Development Research Center of the State Council.
Dai Hui	Researcher for the Macroeconomic Research Department, Development Research Center of the State Council.
Wang Yingying	Researcher for the Macroeconomic Research Department, Development Research Center of the State Council.

Enhancing the Sustainability of China's Economic Stabilization

Macro-economic Situation in the 1st Quarter and outlook for 2013

The international economic situation in 2013 has generally been better than last year. However, China's domestic economic structural problems remain, while risk levels have increased. Two potential issues loom: a decline in medium- and long-term growth rates, and a weak short-term recovery. Future macroeconomic policy should follow established policies, and strike the right balance between stabilizing growth, controlling inflation, and avoiding risk. Sustained reform would help unlock potential growth, stabilize investment, and expand consumption. Innovative industry-specific regulation can help resolve overcapacity issues and facilitate economic restructuring. Tightening certain macroeconomic controls while relaxing others can gradually reduce fiscal and financial risks and improve the quality of economic growth, increasing the sustainability of China's ongoing economic stabilization.

I. Short-term weakness remains a reality; annual growth is expected to be just over 7.5%



Although the first quarter of 2013 saw the continuance of Q4 2012's economic recovery, macroeconomic indicators remain in flux. Market vitality has increased thanks to restocking, rebounding investment, a better international economy, and improved expectations, but the weak short-term recovery shows no signs of reversal.

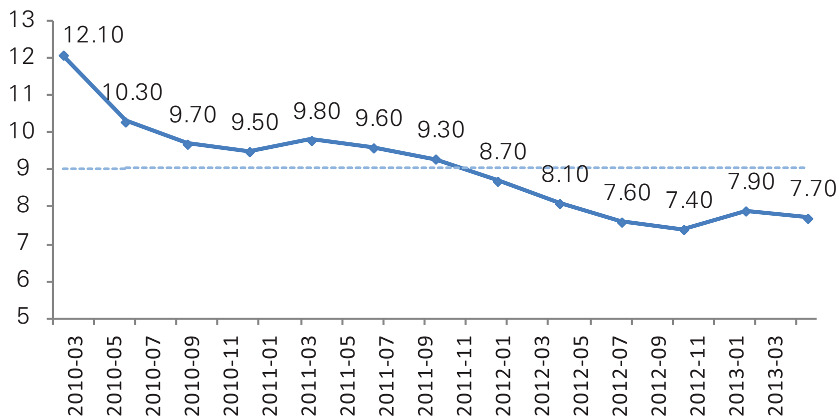
(I) Changes in demand-side indicators have emerged, along with both positive and negative factors

Positive demand-side factors include a significant recovery in export growth – 18.4% cumulative year-on-year growth in Q1 2013. Even net of some one-off increases, the actual growth rate was higher than 2012. Export growth rates rebounded significantly, apart from exports to Japan and Oceania. In addition, the upswing in infrastructure and real estate investment has continued, with growth rates exceeding 20%. Urban fixed-asset investment continued to grow steadily, while investment growth in Eastern China[1] improved compared with 2012.

At the same time, there are negative factors that cannot be ignored. First, growth in consumer demand has slowed. Compared with the same period in 2012, nominal retail sales growth in Q1 fell by 2.4 percentage points. These figures included food and beverage consumption in high-end restaurants, which grew 8.5%, down 4.8 percentage points year-on-year. Second, manufacturing investment growth has slowed. Overcapacity, a high debt-to-asset ratio, and other factors held back first-quarter manufacturing investment, which increased by 18.7%, down by 3.3 percentage points from 2012, and lower than average medium- and long-term growth rates. Manufacturing investment is the backbone of fixed asset investment; during the last five years, such investment has accounted for, on average, 34% of the fixed asset investment.

A continued decline will have a major impact on investment growth.

Fig. 1: Changes in China's quarterly GDP growth during 2010-2013.3 (%)

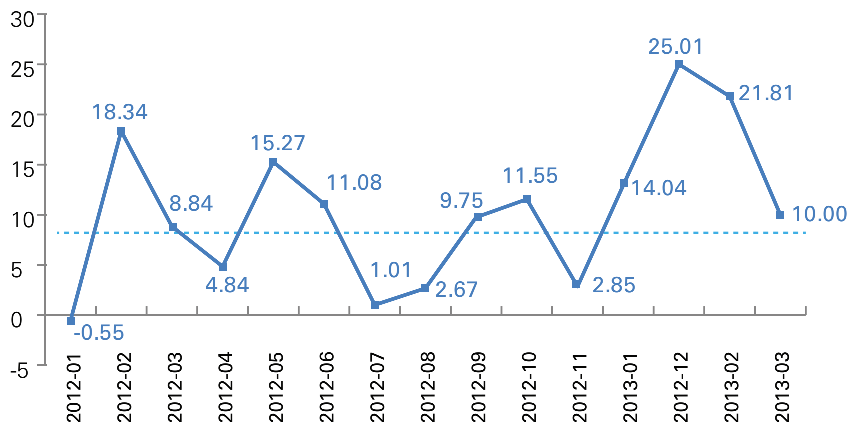


Data source: State Statistics Bureau

Note: Blue dotted line means the quarterly GDP growth average between the first quarter of 2010 and the first quarter of 2013 which is 9.05%. The quarterly GDP growth since the fourth quarter of 2011 has been lower than the average.

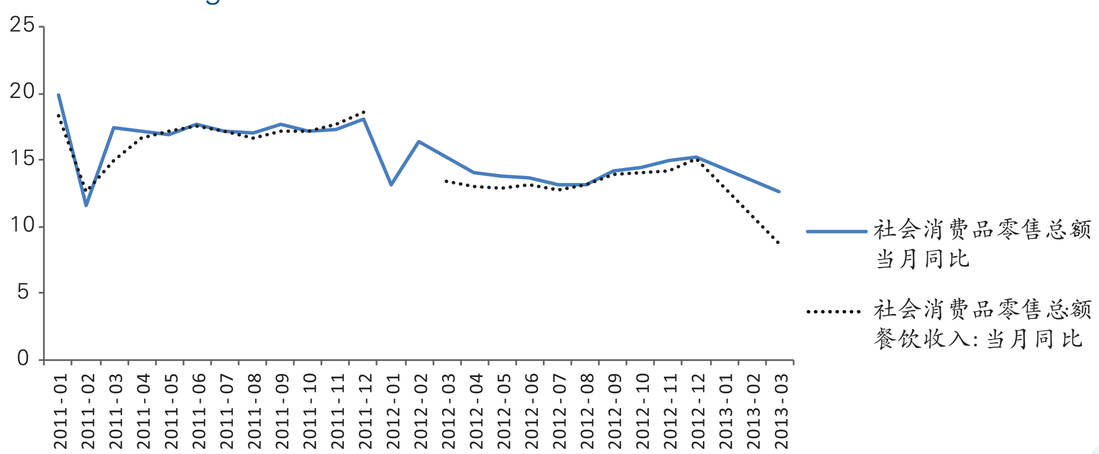
1 Eastern China includes the 11 provinces or municipalities of Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, and Hainan.

Fig. 2: Change in China's total export nominal growth during 2012-2013.3 (%)



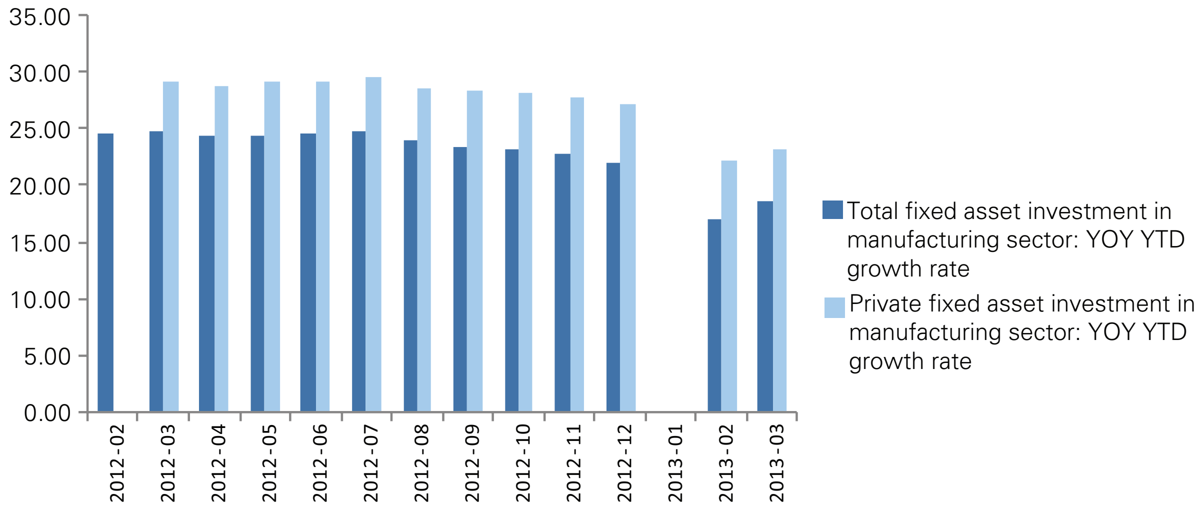
Data source: Ministry of Commerce
Note: Blue dotted line means the 2012 China's export growth average which is 8.31%.

Fig. 3: Change in total retail sales of consumer goods and catering service revenue in China during 2011-2013.3



Data source: State Statistics Bureau

Fig. 4: Total investment in manufacturing sector during 2012-2013.3: YOY YTD growth rate (%)

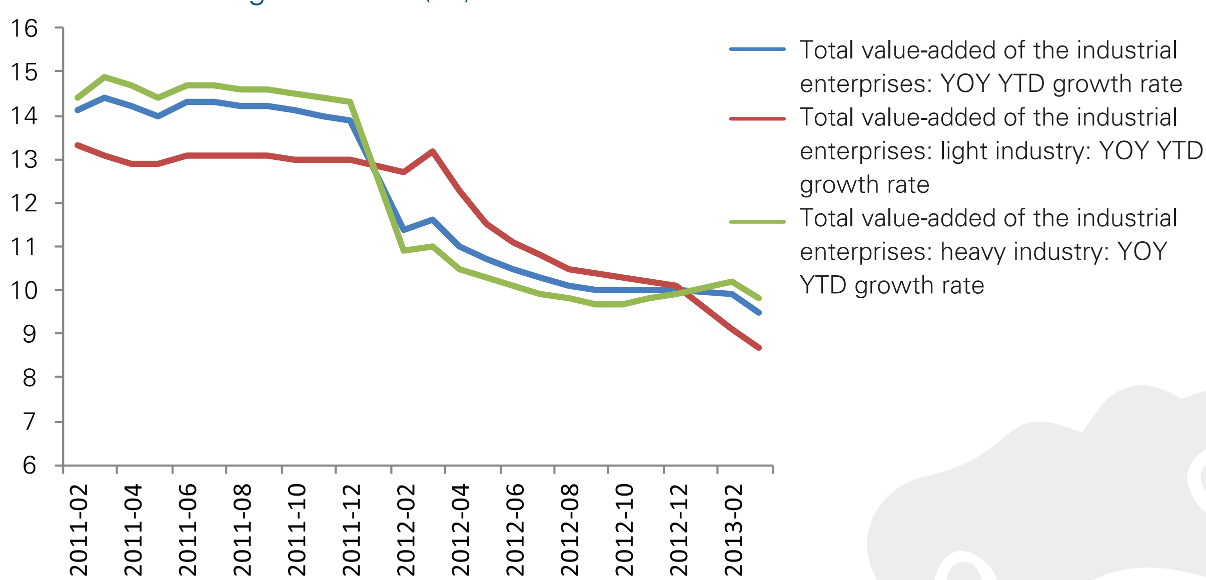


Data source: State Statistics Bureau

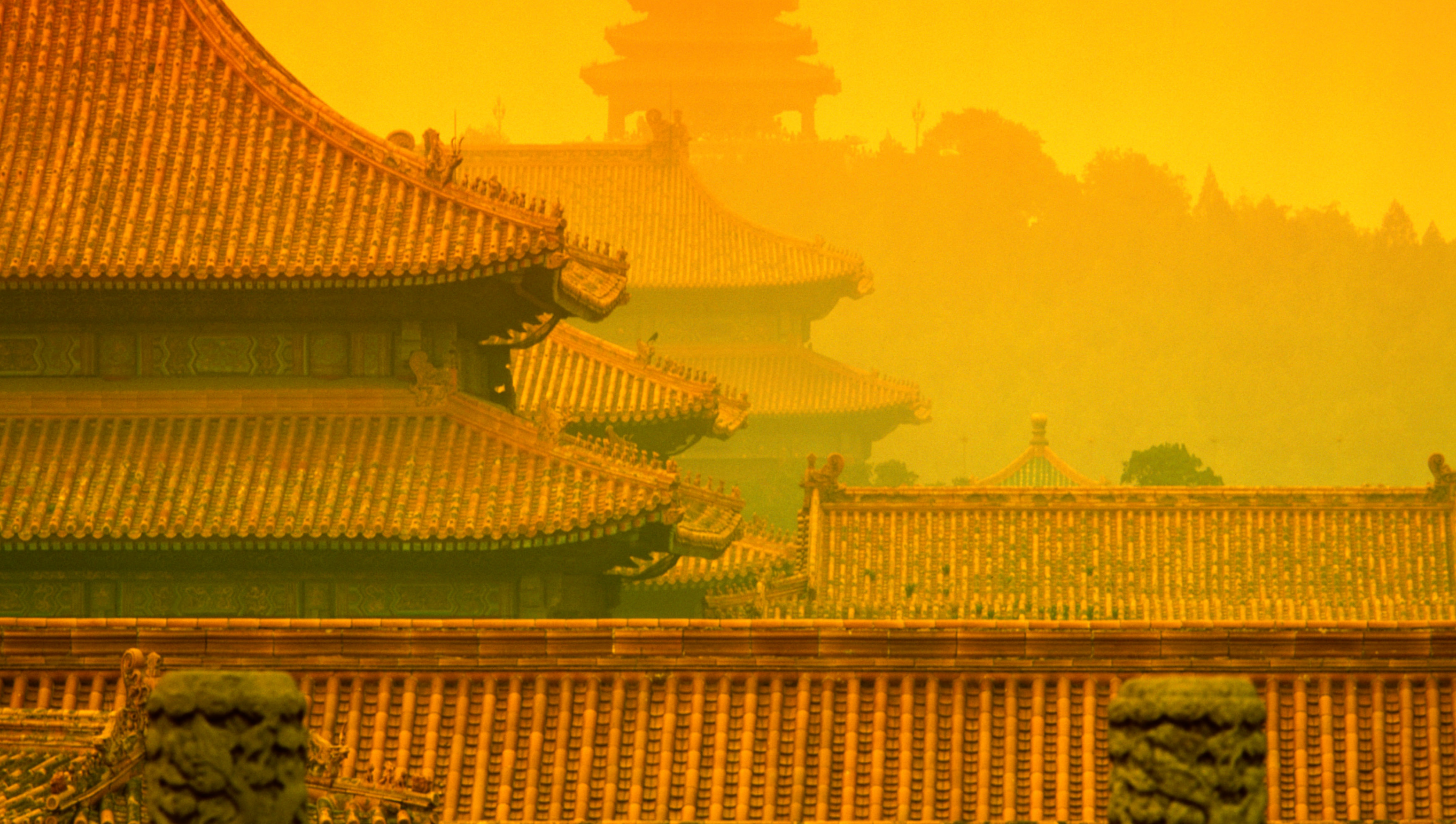
(II) Supply is relatively stable, and the capacity utilization rate in some sectors is low

Compared to the dynamic demand situation, supply was basically stable. Year-on-year growth in total industrial value-added remained steady at 10% from September to December of 2012, and decreased 0.5 percentage points in the first three months of 2013. The growth rates for important industrial products such as automobiles, steel, cement, integrated circuits, power generation equipment, and communications equipment have experienced a modest recovery, apart from the growth rate in the power generation sector has not. The industrial value-added growth rate is expected to improve slightly in the second quarter of this year.

Fig. 5: Change in total value-added of the industrial enterprises during 2010-2013.3: YOY YTD growth rate (%)



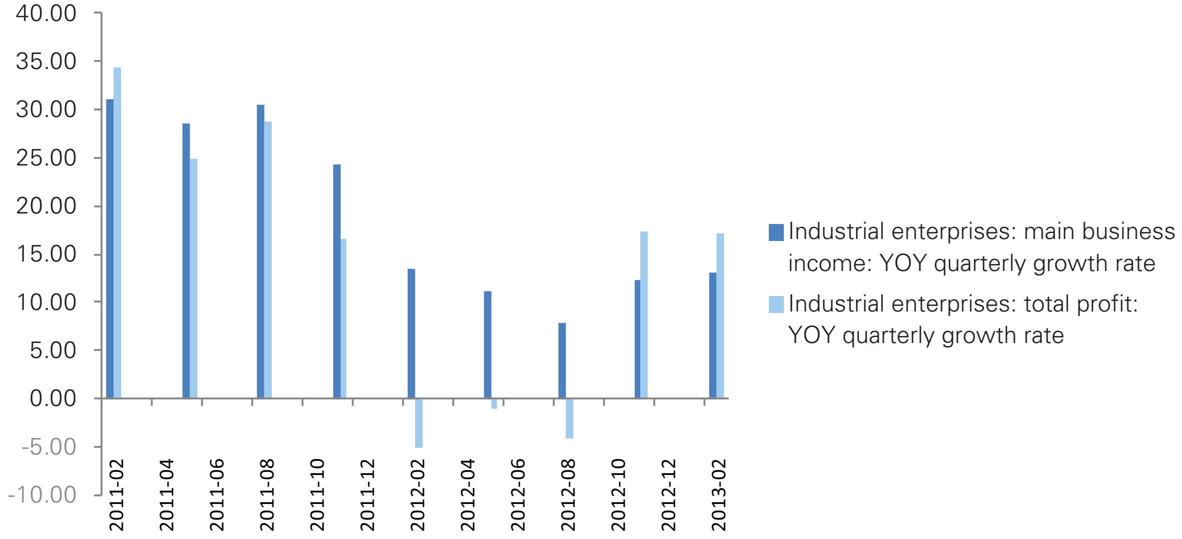
Data source: State Statistics Bureau



Historically, the Chinese economy has seen a lag in the interaction between supply and demand, which depends primarily on adjustments in commercial inventory. When demand rallies, inventories are rapidly drawn down. With reduced inventories and improved expectations, companies replenish their inventory by increasing their purchases or output. If demand continues to im prove, companies are likely to choose to expand investment and increase output.

Under normal circumstances, the sustainability of such as inventory recovery depends on the strength of the recovery in demand, and expectations for future growth. If the recovery in output and capacity utilization rates closely tracks inventory replenishment, then this is an important signal of further economic improvement.

Fig. 6: Main business income and total profit of industrial enterprises (%)

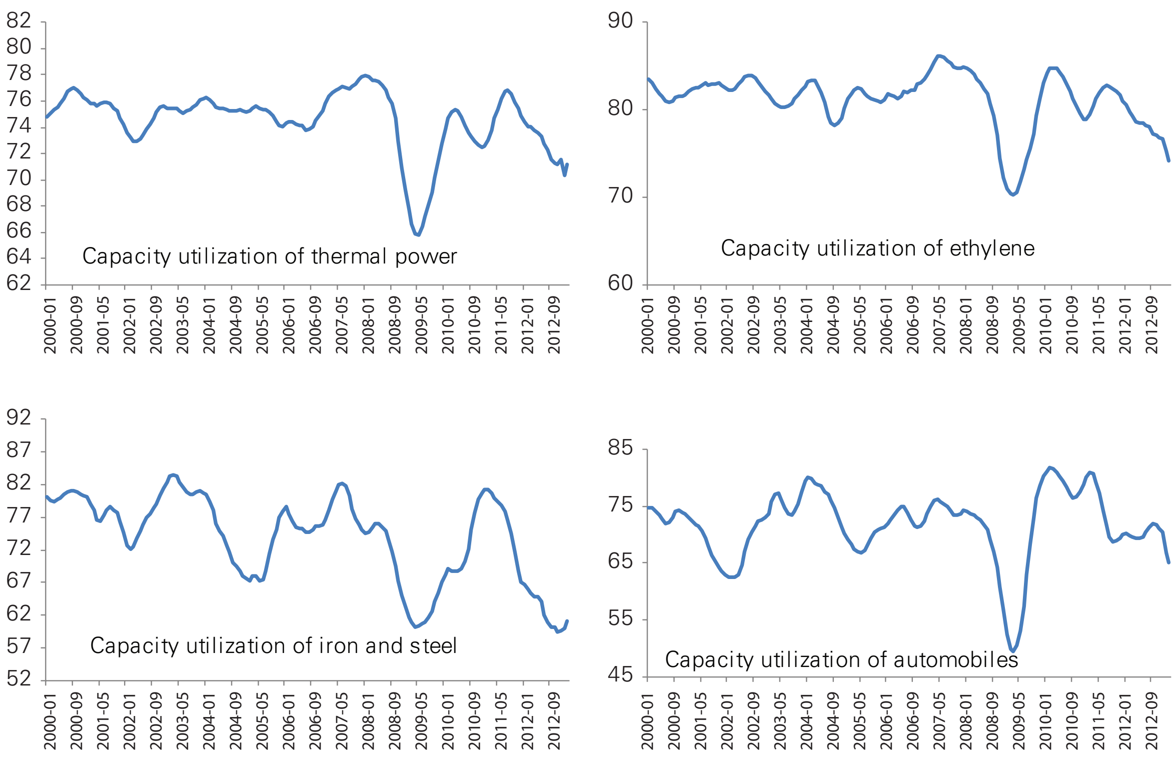


Data source: State Statistics Bureau

After a long period of destocking, restocking in Chinese enterprises began in the fourth quarter of 2012. Output in many industries also rose, but there has been no significant improvement in the capacity utilization rate. For example, the capacity utilization rate of steel, automobiles, cement, non-ferrous metals, textiles, thermal power, and ethylene was rather low. This shows that the recovery in demand and output has not been strong enough to overcome China's serious overcapacity problem.

It is worth noting that the continued increase in infrastructure and real estate investment—which remains an important driver of demand—was constrained by accumulated fiscal and financial risks; however, if demand grows too fast, it may stimulate investment growth in industries with excess capacity, which will in turn exacerbate existing problems. The prudent option is to maintain moderate demand growth and to somewhat improve capacity utilization. In this scenario, capacity reduction and structural adjustments in sectors with overcapacity can take place, without a significant investment stimulus.

Fig. 7: Capacity utilization rate of some important industrial products (%)



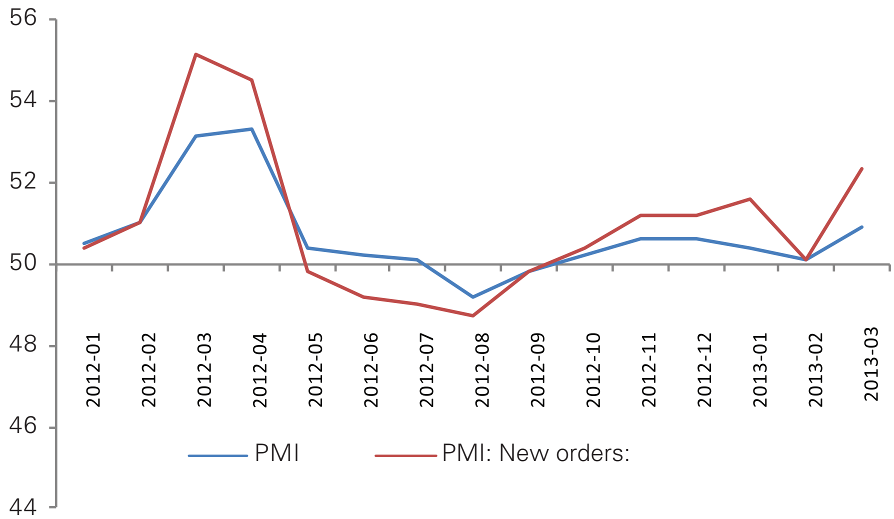
Data source: DRC of the State Council

(III) Economic growth is expected to rise and then stabilize, with expected annual growth of just over 7.5%

The international economic situation in the first quarter of 2013 was generally better than in the previous year. The American economy continues to recover. The shale gas revolution in the US has triggered systematic cost reductions. The US service and manufacturing industries expanded and capacity utilization reached a 62-month high. The real estate recovery has also continued, with existing home sales hitting a 39-month high. Employment reached pre-crisis levels as the unemployment rate fell to 7.6%. Corporate R&D investment increased and the strength of the real economy improved. The European economy will stabilize amidst adjustment. Due to the situations in Cyprus, Italy and elsewhere, the Eurozone's service and manufacturing PMI, economic sentiment index, and investment confidence index all declined in March, interrupting a recovery that began in the third quarter of 2012. Nevertheless, Eurozone countries' bond yields have dropped significantly, and the German economy continues to strengthen. The Eurozone economy is expected to stabilize in the first half of the year and recover in the second half. The Japanese economy showed initial signs of improvement. Thanks to the expanded monetary and fiscal stimulus of Prime Minister Shinzo Abe's government, the February consumer confidence index rose to 44.3, a level last seen in June 2007. The economic observer outlook index also rose to its highest value since the index was created in 2000. Emerging markets continue to recover. Growth began to accelerate in the Brazilian and Indian economies in the third and the fourth quarters of 2012, respectively. PMI was over 50 in each of the BRIC countries in February, reflecting continued recovery in these emerging economies. Driven by the improved international situation, Chinese exports in 2013 are expected to grow by about 10%.

Factors pointing to a moderate economic recovery in China have continued to accumulate. The restocking process is likely to continue for the foreseeable future, tipping its impact on economic growth from negative to positive. Other leading indicators have continued to improve. The PMI and new orders indices have increased for the last six months. As PPI recovers, companies' prospects are expected to improve, which will lead to a gradual increase in raw material purchases.

Fig. 8: PMI Index



Data source: State Statistics Bureau

Although high-end consumption has declined significantly in China, it accounts for less than 30% of all consumption. Actual retail sales growth in the first quarter declined by only 0.1 percentage points.

Due to overcapacity, it is unlikely that manufacturing investment will reach previous levels over the short term, but improving corporate profits, and exports, will provide some support for manufacturing investment.

According to surveys performed by the Economic Situation Analysis Research Team at the Development Research Center of the State Council, its index of coincident macro-economic indicators continued to rise, as did the confidence and volume indices for 48 industries, even though all three indices remain lower than their long-term averages.

According to a survey of 1,353 enterprises conducted through the Entrepreneur Survey System of the Development Research Center of the State Council, orders have recovered and business has improved slightly. The proportion of companies describing their operations as "normal" increased by 4 percentage points from the previous year, and the number of companies reducing their production (or services) decreased 10.6%.

Table 1 Forecast of business operators on China's macro-economic situation in the first quarter of 2013 (%)

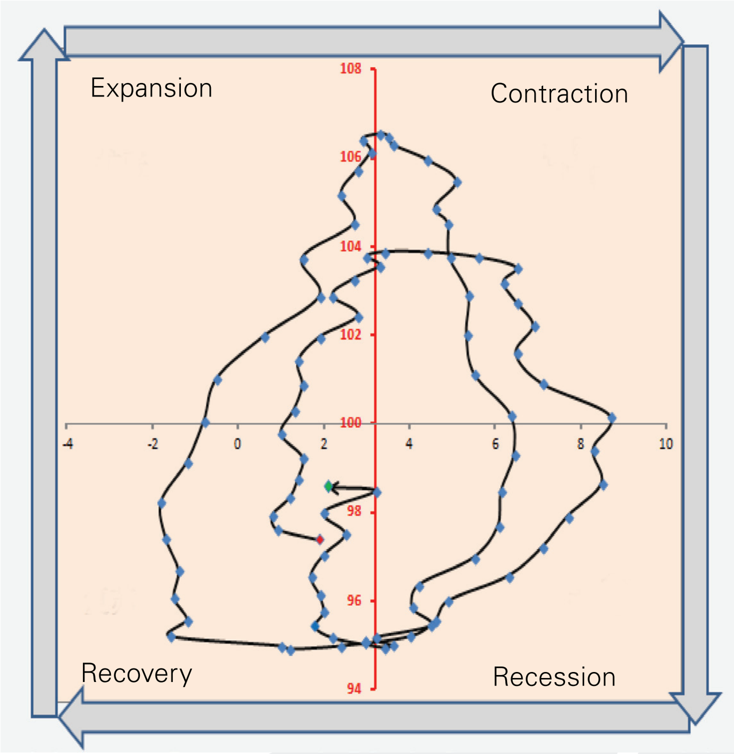
		Very good	Good	Moderate	Bad	Very bad
Overall	First quarter of 2013	1.9	27.2	53.4	16.3	1.2
	First quarter of 2012	1.7	19.2	49.7	25.2	4.2
	2012	1.3	13.3	38.1	37.4	9.9
	2011	2.4	28.9	43.9	21.0	3.8
Enterprises in Eastern China		1.5	24.8	55.5	16.8	1.4
Enterprises in Central China		4.1	32.8	46.9	15.5	0.7
Enterprises in Western China			32.3	51.9	15.0	0.8
Large-sized enterprises		1.1	24.4	55.6	18.9	
Medium-sized enterprises		1.2	26.6	52.4	18.4	1.4
Small-sized enterprises		2.3	27.7	53.8	15.0	1.2
State-owned enterprises			34.8	54.3	10.9	
Non-state-owned enterprises		2.2	27.0	53.4	16.3	1.1
Foreign-owned enterprises			22.9	54.2	19.8	3.1

Source: DRC Enterprise Survey System

Overall, the short-term economic recovery is fragile, but the trend towards recovery has not changed, as the positive forces remain slightly stronger than the negative ones. There is an emerging consensus that further reform would generate additional benefits. Continued reform would be likely to gradually unlock long-suppressed forces for growth.

GDP growth in the second quarter is expected to show a recovery, while GDP growth for the year is expected to be just over 7.5%. At the same time, inflationary pressures cannot be ignored. There are many factors: rising costs, easing liquidity and input factors, and greater volatility in the supply and demand of pork, poultry, and other agricultural products. However, price increases for the year should remain within their targeted ranges.

Fig. 9: The DRC Chinese economy clock (March 2013)



Data source: DRC of the State Council

Note: Referencing the DRC China Economic Clock, the vertical axis is the DRC synchronized cyclical index, the horizontal axis is CPI, and the intersection point is the historical equilibrium point. The figure shows that, since January 2006, China's economic growth and inflation together paint a picture of cyclical economic trends.

II. Focusing on major problems to guard against the impact of cumulative effects

While pressure on China's economy has eased, numerous dilemmas persist in the economy. In the short term, some conflicts may emerge: between rising housing prices and stable real estate investment; and between the "Eight Provisions"[2] policy and stable consumer demand. Conflicts may also exist between increases in infrastructure investment and concern over local government debt risk, as well as between reductions in production capacity, structural adjustments, and stable economic growth. To properly manage these issues, we must consider both short-term stability and long-term development, and resolve these conflicts gradually, while guarding against cumulative effects and avoiding systemic risk.

2 On December 4, 2012, the meeting of the Political Bureau of the Central Committee of the Communist Party of China deliberated and adopted the Eight Provisions on "improving working methods and closely connecting with the masses." The Eight Provisions are: improving investigation and study, simplifying meetings, simplifying briefings, standardizing visit activities, improving security and guard practices, improving news coverage, strictly regulating presentation publishing, and strictly enforcing frugality.

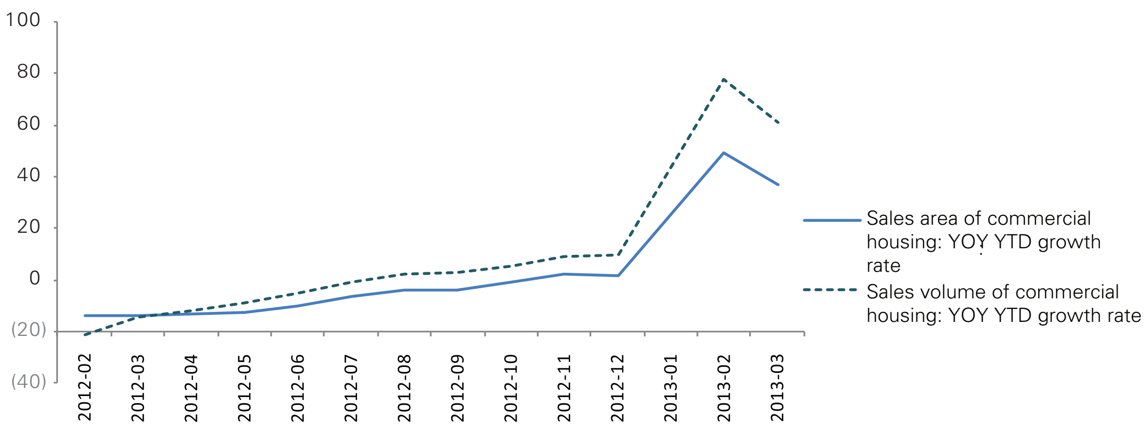
(I) Risks triggered by real estate market volatility

The real estate market is greatly influenced by policy changes. Policy and administrative measures related to financing, land, and taxes will have a direct impact on supply and demand in the real estate market, causing short term volatility. In the first quarter of 2013, national real estate sales by construction area grew by 37.1% year-on-year, up 35.3 percent from 2012 as a whole. Breaking the figures down further, residential sales by area grew 41.2% and sale values grew 69.0%. In line with the growth in sales volumes and values, the number of cities with rising housing prices has increased significantly. The capital position of real estate companies improved and investment growth recovered.

However, the 22% drop in land area acquired by real estate developers in the first quarter is noteworthy, indicating that developers are maintaining a cautious attitude towards the real estate market. Following the introduction of a new round of real estate regulations, tax policy adjustments are likely to also impact transaction volumes. We should therefore pay close attention to real estate sales growth over the next two quarters.

If sales growth cannot be sustained, real estate investment will slow, and growth in land sales is unlikely to continue. Land transfer revenues will decline, further increasing pressure on local government revenue and expenditure, as well as financing platform risks. Volatility in short-term transaction volumes may lead to substantial fluctuations in the prices of real estate and other assets, which is not conducive to the stability of the economy as a whole.

Fig. 10: China sales area and volume of commercial housing: YOY YTD growth rate (%)



Data source: State Statistics Bureau

Table 1: Year-on-Year Changes in Primary Indicators of the Chinese Real Estate Market (%)

	2010		2011		2012		2013
Real Estate Development Investment	33.2	32.9	27.9	23.5	16.6	16.2	20.2
New Housing Construction Area	40.7	23.6	16.2	0.3	-7.1	-7.3	-2.7
Housing Construction Area	26.6	31.6	25.3	25	17.2	13.2	17.0
Commercialized Housing Sales Area	10.1	12.9	4.9	-13.6	-10.0	1.8	37.1
Commercialized Housing Sales Value	18.3	24.1	12.1	-14.6	-5.2	10.0	61.3
Real Estate Developers' Paid-In Capital This Year	25.4	21.6	14.1	8.2	5.7	12.7	29.3
Land Acquisition Area	28.4	18.4	2.6	-3.9	-19.9	-19.5	-22.0

Data Source: National Bureau of Statistics

(II) Risks related to overcapacity and the adjustment process

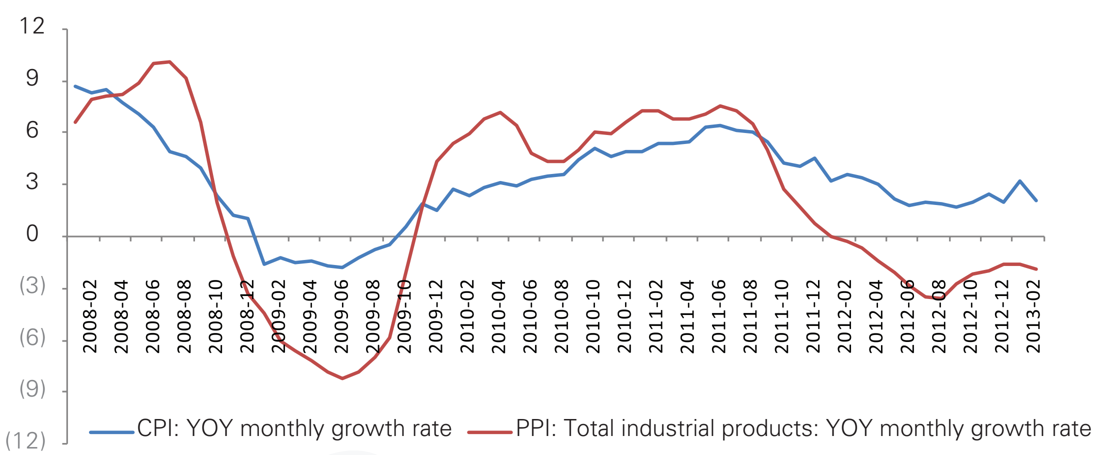
China's current industrial overcapacity covers a wide range of sectors, with a high level of excess capacity over a sustained period of time. In traditional industries, there is overcapacity in sectors ranging from iron and steel, to electrolytic aluminum, cement, automobiles, coke, calcium carbide, ferroalloys, copper smelting, textiles, and petrochemicals. In emerging industries, there is also obvious overcapacity in carbon fibers, wind power equipment, LEDs, lithium batteries, and solar panels, the result of various local policies.

Moreover, industries tend to exhibit more pronounced overcapacity when they are highly valued by the government or when they are subject to a strict examination and approval process. For example, capital-intensive heavy industry, chemical production, and emerging industries encouraged by the state are often targeted by local governments pursuing GDP growth and tax revenue. For these industries, overcapacity is particularly serious. Competitive sectors with low entry and exit barriers also have overcapacity, but most of these areas hover around normal levels, and reflect cyclical surpluses.

The bankruptcy of Suntech Power Holdings Co., Ltd. reveals the role of institutional and policy factors in excess capacity, as Suntech was not an isolated incident.

Declining growth over the medium- to long-term will further exacerbate overcapacity and its resultant downward pressure on economic growth. The slowdown in market demand is likely to result in low profits, or even losses, across the whole industry, the increased risk of large-scale bankruptcy may cause financial and fiscal risks. Meanwhile, overcapacity will lead to fierce competition at the lower end of the value chain, which lowers profit margins in the sector and prevents good companies from rising above the rest. This can make it difficult to harness the beneficial effects of competition to take the industry up the value chain.

Fig. 11: Changes in PPI and CPI



Data source: State Statistics Bureau

(III) Increased local fiscal revenue, expenditure pressures, and default risks

In recent years, the financing activities and debts of local government financing platforms have expanded rapidly. Some financing platforms have overstated or false assets or inadequate capital, are overly dependant on the expectation that land prices will continue to appreciate, or are seeing the withdrawal of quality assets. Since 2010, banks have exercised some control over new loans to local government financing platforms, forcing these platforms to turn to financing via the "shadow banking" system. The scale of these "off-balance sheet" financial management products and trust products has gradually expanded, accelerating financial disintermediation. New RMB loans, which accounted for more than 70% of total commercial loans in the past few years, fell to 52% in 2012.

There are numerous problems with financing via shadow banking, including unclear legal relationships, serious maturity mismatches, severe disparities between funding pool products and investment targets, and inadequate regulation. Newly announced non-standard debt regulations will further narrow the range of funding sources for local governments. Slower economic growth will also lead to slow tax revenue growth, while fluctuations in the real estate market will affect revenues from land sales. Expenditures however will remain relatively inflexible, while gaps between local fiscal revenue and expenditures will become more obvious. Some local financing platforms may break down, increasing the likelihood of debt risk contagion in some areas. If the risk spreads, many construction projects would be forced to shut down and be left uncompleted. The banks' non-performing assets would increase, and financial institutions with high proportions of financing platform loans would encounter significant difficulties. This issue will also affect the stability of the bond market and spread to funds, trusts, banks, and other institutional investors.

(IV) Consumption growth faces downward pressure

A variety of factors has led to the slowdown of overall consumption growth in the first quarter of 2013. Sales volumes of some consumer goods have dropped significantly.

The first factor is the direct impact of food safety incidents. Alcohol blending, the use of plasticizer, and other events have had an effect on liquor consumption; the exposure of fake shark fin and fake bird's nest has had a significant impact on the demand for related consumer goods.

Second, strict measures to limit consumption using public funds have been put in place to curb extravagance and waste and foster clean government, an effort that requires a long-term commitment. However, this campaign also has an impact on domestic consumption. We now understand that this commitment has impacted a range of businesses including hotels, restaurants, exhibitions, flower shops, tourism, and other service industries. The China Hotel Association estimates that operating income in more than 90% of hotels has decreased 10-50%; high-end food and beverage companies have seen operating income decline by 50-60%.

Third, due to the impact of unusual factors such as epidemics (avian flu), the prices of pork, milk, chicken, and baby chicks have fallen sharply.

---

3 The phrase "off-balance sheet activities (OBS)" refers to a commercial bank's operating activities that are not listed on a balance sheet according to the general accounting standards. These activities do not affect the bank's assets, but do affect the current profits and losses of the bank and the bank's return on assets. Off-balance sheet financial management products and trust products are off-balance sheet activities.

4 Disintermediation is a direct transaction between supply and demand parties that bypasses all intermediaries. Disintermediation in the financial sector is "financial disintermediation," because depositors can seek higher returns from investment funds and securities, while corporate borrowers sell bonds through institutional investors at a low funding cost, weakening banks' role as a financial intermediary.

5 Funding pool products come from a large funding pool operated and managed as a whole by the issuer (usually a bank), who has gathered clients' financial management funds into the pool. Inbound capital is an inflow, while mature capital paid out or redeemed is an outflow. Liquidity management is carried out in a continuously reciprocal cycle.

6 Non-standard bond assets are debt assets traded on the interbank market or a securities exchange, including but not limited to, credit assets, trust loans, entrusted claims, acceptance bills, letters of credit, accounts receivable, various beneficial interests (rights to earnings), and equity financing with terms of repurchase.

Fourth, environmental factors such as smog have impacted consumption. In the first two months of 2013, total visitors to China declined by 2.8%, while the number of visitors to mainland China (excluding visitors to Hong Kong, Macao and Taiwan) dropped by 6.4%. The hotel occupancy rate was only 48.9%, down 7 percentage points year-on-year.

Consumption is a stabilizing force in China's economy. In the past five years, GDP growth driven by consumption represented an average 4.7 percentage points. If consumption continues to fall, the resulting drop in demand and increased unemployment will require close attention.

(V) Problems of structural unemployment may gradually emerge

From total emp loyment, we can see that changes in the population structure and the peak in the working-age population should serve to ease overall medium-term employment pressure. On the other hand, structural adjustments and upgrading may cause the gradual emergence of structural unemployment pressures.

First, due to rising labor costs and high social welfare requirements, many manufacturing companies in Eastern China have replaced workers with machines, causing many low-end workers to change jobs.

Second, the hospitality sector, tourism, and other service industries have absorbed many workers. As revenues decline in these industries and adjustment becomes inevitable, agriculture and livestock sectors will be impacted, and some workers may be made redundant.

Third, in the process of overcapacity adjustments, some companies may halt production, and this reduced capacity will cause unemployment issues.

These adjustments are a necessary part of optimizing China's economic structure; the resulting unemployment is an unavoidable cost of China's economic restructuring. To facilitate healthy and stable mid- to long-term development and avoid social unrest, social security, skills training, and employment services must be handled properly.

(VI) A further increase in inflationary pressure

In 2013, inflationary pressure has increased, so attention must be paid to its effects on macro-policy adjustments.

First, massive currency stocks have made CPI more sensitive to changes in demand. After PPI entered negative territory, the gap between PPI and CPI has remained the same for 12 consecutive months. Negative PPI places upward pressure on CPI, a phenomenon that has not been seen in China for 20 years. Overall liquidity is rather high, and the demand elasticity of commodity prices remains high (meaning that slight increases in demand can cause rising prices).

Second, mounting corporate debt ratios, shrinking profits, and a decreased ability to absorb costs have widened the direct downstream transmission range. In 2012, total social financing grew by nearly 16%, while economic growth was only 7.8%. The real economy did not see significant inflows of liquidity; these funds were simply used to pay interest. Compared with an environment in which corporate profits are improving, rising cost pressures are currently transmitted to end products faster than ever before.

Third, commodity price reform, an absolute decline in the labor supply, and other factors continue to promote rising prices.

Fourth, judging from current pork prices and breeding stocks, pork prices are likely to rise in the second half of the year and the pig cycle may become prominent once again. In addition, since the beginning of the year, real estate prices have increased rapidly and monetary easing globally may drive higher commodity prices, which are likely to further increase inflationary pressure in China.

III. Stabilizing development, adjusting capacity, and protecting the bottom line to maintain a stable economic recovery

A transformation in China's macroeconomic growth model is underway. With it has come the search for a new equilibrium. For the remainder of 2013, central government policies should be implemented with the goal of seeking progress amidst stability. By promoting stability, stabilizing demand, adjusting capacity, and protecting the bottom line, stable economic and social development can be preserved.

When implementing a proactive fiscal policy and prudent monetary policy, the relevant parties should focus on using reform to unlock potential growth, stabilize investment, and expand consumption; innovative industry-specific regulations should emphasize the increased use of market-oriented methods to resolve overcapacity problems. A simultaneous relaxation and control strategy should be used and the overall goal of preventing systemic risk must be maintained, thereby gradually alleviating financial risk and gaining time and space for the Chinese economy to progress in a relatively stable fashion.

(I) Promoting stability by using reform measures to stabilize investment demand

The Chinese economy has experienced a weak recovery, but the recovery of external demand has been limited, domestic consumption growth is weak, the factors impacting real estate and infrastructure investment growth are erratic, and increases in end-user demand are insufficient. According to the original law of economic cycles, expansion of intermediate demand resulting from blind increases in production-oriented investment may trigger a new round of overcapacity and aggravate existing issues. Concerned parties must identify a workable combination of reform and growth, prioritize reform in a variety of fields, and unlock suppressed demand potential. The focus should remain on final investment demand. This will stabilize investment without increasing overcapacity.

For example, there is potential for increased investment in the railway sector, but the China Railway Corporation has a high debt ratio and limited ability to raise financing; the company should therefore accelerate its planning processes and work to introduce investors from other sectors. There is similar potential in other sectors, such as electric power, petroleum, natural gas, infrastructure, and services. The relationship between electricity, coal, and transport must be clarified to expedite pricing reform. Further promoting the development of services will create room for growth in the service sector and improve efficiency.

(II) Stabilizing the consumer market and fostering new areas for consumption

The measures undertaken to control the "Three Public Consumption" (shorthand for the spending of public funds on overseas trips, vehicle purchases, and official receptions) must be implemented. The decline in spending on high-end hotels, restaurants, and other services will have a short-term impact on consumption growth, but these measures are conducive to reasonable and sound consumption growth over the medium and long term. Unemployment issues for workers in these industries should be noted, to improve the provision of job transfer training, employment information, and other services. High growth in consumption of information and data services suggests the replacement and updating of electronic and home appliances should be encouraged, which would in turn promote increased household information consumption. The consumer environment should be enhanced through the establishment of a producer tracking system and the promotion of food and drug safety, to give consumers a stronger sense of security and safety. While strengthening disease prevention and control, concerned parties should formulate policies to protect and support animal husbandry, paying equal attention to the public supervision and guidance needed to enhance consumer confidence and stabilize the market for livestock products.

(III) Rely more on market-oriented methods to adjust overcapacity

Using a system of centralized approval to control the development of competitive industries makes it difficult to truly curb overcapacity. Innovative new industry-specific regulations should be created, to foster stable, transparent, and predictable policies and institutional systems that accord with technical standards on energy consumption, environmental protection, and quality. A market environment that promotes fair competition must be created; this will require constraining local governments' ability to stimulate investment through the use of excessively low land prices, low environmental standards, inappropriate tax incentives or financial subsidies.

To adjust excess capacity, concerned parties should pay attention to both market entry and market exit mechanisms, effectively reduce administrative interference and explore the establishment and improvement of a corporate exit policy system. Capacity adjustment requires a shift from protecting enterprises to protecting employees; social welfare continuity, job transfer and re-training, and employment services for the jobless should be provided. Policies regulating bankruptcy and liquidation will improve risk response planning. We should support companies that use technology to transform themselves, as well as companies that increase their core competitiveness through innovation.

(IV) Implement region-based real estate policies to better target regulation

Concerned parties should "encourage real demand and curb speculative investment demand," to further improve real estate market regulation. Regional differences in the real estate market must be respected, as measures suitable for Beijing might reduce the relevance and effectiveness of regulations if they were adopted nationwide. A clear system of nationwide standards and indicators for reasonable housing price levels is required to determine regulatory targets for different regions. This would give local governments the power to select a package of policies for land and real estate regulation, policies that may include local tax policy adjustments and housing guarantees, enabling local governments to meet regulation targets based on local conditions and regulate real estate in their regions effectively.

First-tier cities should stabilize expectations by paying more attention to regulating supply; such measures may include increasing the land supply, adjusting ways of supplying affordable housing, and increasing the proportion of affordable housing for sale. Concerned parties should accelerate real estate registration and networking, levy property taxes at the right time, increase the cost of holding multiple homes or luxury homes, and promote the effective use of existing housing, to return housing to the status of a consumer good and to meet basic housing needs.

(V) Actively guard against and defuse local government debt risks

The legal relationships between the central government, local governments, investment and financing platforms (companies), and banks must be clarified. Central government conditions and disciplinary measures for rescuing local governments, including assessments of officials, budget constraints, and investment restrictions must be made explicit to prevent moral hazard. The approval systems for urban investment bonds and local government bonds require reform. A clear boundary must be established between local governments and investment and financing platforms; asset management markets for banks' wealth management products should also be standardized. An appropriate increase in treasury bond issuance could replace some existing local government debts. If the fund usage and cash flows of existing local financing platform meet certain conditions, maturity extensions may be permitted, to bring investment into better alignment with financing terms for local investment projects. Concerned parties should accelerate financing platforms' corporate governance reform. Contingency plans should be formulated for platforms with unsustainable funding chains. The government should accelerate the formulation of a complete government balance sheet, laying a foundation for the independent issuance of municipal bonds by local governments using market-oriented methods.

(VI) Regulating the price of pigs and other agricultural products to reduce inflationary pressure

Supply and demand imbalances are not the main causes of rising food prices, as prices often increase in the presence of sufficient supply. When overall demand grows or monetary conditions ease, food and other products with slowly improving labor productivity often experience liquidity inflows, which can lead to significant price fluctuations. At present, the price indices for agricultural products are generally declining, and pig, piglet, and pork prices are falling. The pig-corn pricing ratio (Price of live pig at sale vs. Wholesale price of corn) has dropped from 7.3:1 at the beginning of the year to 5.3:1. In the short term, pork prices may also decline slightly, but based on the pig cycle, prices are expected to rise after the middle of this year, beginning the rising part of the cycle. Despite the slight inflationary pressure this year, this may have a major impact on price increases next year if adjustments are not made in advance.

We recommend increasing pork purchases and reserves in the near term to stabilize pork prices, and prevent producers from significantly reducing existing stock and accelerating the addition of piglets. The policies governing the development of the pig farming industry require further improvement; this should include the establishment of adjustment mechanisms for lower price periods and the promotion of basic stability in the pig farming sector. Moreover, low prices should be seen as an opportunity to encourage qualified enterprises to lock in medium- and long-term feed prices in soybean meal, soybean oil, corn, and other agricultural futures, to control future market risk.

Editors: Liu Shijin, Yu Bin and Chen Changsheng

Changes in major indices of Chinese macroeconomy (2012.3 —2013.3)

Type	Title / comparison		2012										2013		
			3	4	5	6	7	8	9	10	11	12	1	2	3
% Speed indicator %	GDP	YOY quarterly growth rate	8.1			7.6			7.4			7.9			7.7
		YOY YTD growth rate	8.1			7.8			7.7			7.8			7.7
	—Primary sector	YOY YTD growth rate	3.8			4.3			4.2			4.5			3.4
	—Secondary sector	YOY YTD growth rate	9.1			8.3			8.1			8.1			7.8
	—Tertiary sector	YOY YTD growth rate	7.5			7.8			7.9			8.1			8.3
	Total value-added of the industrial enterprises above designated size	YOY monthly growth rate	11.9	9.3	9.6	9.5	9.2	8.9	9.2	9.6	10.1	10.3	-	-	8.9
		YOY YTD growth rate	11.6	11.0	10.7	10.5	10.3	10.1	10.0	10.0	10.0	10.0	-	9.9	9.5
	—Light industry	YOY monthly growth rate	13.9	10.3	9.1	9.0	10.1	8.6	9.0	9.1	9.2	9.6	-	-	8.2
		YOY YTD growth rate	13.2	12.3	11.5	11.1	10.8	10.5	10.4	10.3	10.2	10.1	-	9.1	8.7
	—Heavy industry	YOY monthly growth rate	11.2	8.9	9.8	9.6	8.8	9.0	9.3	9.7	10.5	10.6	-	-	9.1
		YOY YTD growth rate	11.0	10.5	10.3	10.1	9.9	9.8	9.7	9.7	9.8	9.9	-	10.2	9.8
	Total fixed asset investments	YOY YTD growth rate	20.9	20.2	20.1	20.4	20.4	20.2	20.5	20.7	20.7	20.6	-	21.2	20.9
	—Primary sector	YOY YTD growth rate	35.8	40.7	37.2	28.6	28.8	31.5	32.2	32.3	30.5	32.19	-	37.4	31.4
	—Secondary sector	YOY YTD growth rate	24.6	24.2	23.9	23.8	23.4	22.6	22.4	21.9	21.1	20.15	-	15.6	16.2
	—Tertiary sector	YOY YTD growth rate	17.6	16.4	16.4	17.4	17.7	17.8	19.4	20.1	20.4	20.57	-	25.0	24.5
	—Central government investments	YOY YTD growth rate	-9.7	-4.1	-7.7	-4.1	-3.0	0.2	2.3	5.1	6.1	5.89	-	4.4	11.6
	—Local government investments	YOY YTD growth rate	23.1	22.0	22.1	22.1	22.0	21.6	21.8	21.8	21.7	21.72	-	22.3	21.4
	—Real estate investments	YOY YTD growth rate	23.5	18.7	18.5	16.6	15.4	15.6	15.4	15.4	16.7	16.2	-	22.8	20.2
	Total retail sales of consumer goods	YOY monthly growth rate	15.2	14.0	13.7	13.7	13.1	13.2	14.1	14.1	14.9	15.2	-	-	12.6
	—Urban	YOY monthly growth rate	15.2	14.0	13.7	13.7	13.1	13.1	14.2	14.5	15.0	15.2	-	-	12.2
	—Rural	YOY monthly growth rate	14.6	14.5	14.3	14.0	13.6	14.3	14.7	14.8	14.6	15.1	-	-	15.0
	Urban resident per capita disposable income	YOY YTD growth rate (inflation adjusted)	9.8			9.7			9.8			9.6	-	-	6.7
	Rural resident per capita net income	YOY YTD growth rate (inflation adjusted)	12.7			12.4			12.3			-	-	-	9.3
	Total export	YOY monthly growth rate	8.9	4.9	15.3	11.3	1.0	2.7	9.8	11.6	2.9	14.1	25.0	21.8	10.0
		YOY YTD growth rate	7.6	6.9	8.7	9.2	7.8	7.1	7.4	7.8	7.3	7.9	25.0	23.6	18.4
	Total import	YOY monthly growth rate	5.3	0.3	12.7	6.3	4.7	-2.6	2.4	2.3	0.02	6.0	28.8	-15.2	14.1
		YOY YTD growth rate	6.9	5.1	6.7	6.7	6.4	5.1	4.8	4.6	4.1	4.3	28.8	5.0	8.4
	Trade surplus	YOY monthly growth rate	2825.8	65.3	40.6	42.6	-16.1	48.0	88.5	87.2	33.2	89.4	6.7	147.6	-117.1
	Actual utilization of FDI	YOY monthly growth rate	-6.1	-0.74	0.05	-6.88	-8.65	-1.43	-6.81	-0.24	-5.4	-4.47	-7.27	6.32	5.65
	CPI	YOY monthly growth rate	3.6	3.4	3.0	2.2	1.8	2.0	1.9	1.7	2.0	2.5	2.0	3.2	2.1
		Month on Month growth rate	0.2	-0.1	-0.3	-0.6	0.1	0.6		0.3	-0.1	0.1	0.8	1.1	-0.9
	RPI	YOY monthly growth rate	3.5	3.1	2.5	1.4	0.8	1.0	0.9	0.9	1.1	1.5	1.3	2.1	0.8
		Month on Month growth rate	0.3	-0.1	-0.5	-0.8	-0.3	0.6	0.4	-0.1	0.2	0.7	0.9	0.8	-0.9
	PPI	YOY monthly growth rate	-0.32	-0.7	-1.4	-2.08	-2.87	-3.5	-3.6	-2.8	-2.2	-1.94	-1.64	-1.63	-1.92
		Month on Month growth rate	0.27	0.16	-0.37	-0.7	-0.8	-0.5	-0.06	0.16	-0.12	-0.06	0.24	0.15	0
	Fiscal income	YOY monthly growth rate	18.7	6.9	13.1	9.8	8.2	4.2	11.9	13.7	21.9	29.17	5.8	9.55	6.1
	—Tax income	YOY monthly growth rate	12.4	2.6	13.7	12.0	4.6	7.2	5.8	12.5	21.1	56.53	4.6	8.13	6.1
	—Non tax income	YOY monthly growth rate	56.48	51.37	9.03	0.3	34.7	-9.4	52.8	25.5	27.0	-	15.6	19.5	-
	Fiscal expense	YOY monthly growth rate	34.7	8.0	10.8	17.7	37.1	11.7	16.6	6.7	6.7	4.22	19.1	12.18	7.2
	M0	YOY monthly growth rate	10.6	10.4	10.0	10.8	10.0	9.7	13.3	10.5	10.7	7.7	4.4	17.2	12.4
	M1	YOY monthly growth rate	4.4	3.1	3.5	4.7	4.6	4.5	7.3	6.1	5.5	6.5	15.3	9.5	11.9
	M2	YOY monthly growth rate	13.4	12.8	13.2	13.6	13.9	13.5	14.8	14.1	13.9	13.8	15.9	15.2	15.7
Total volume indicator	Urban employee average wage RMB		10866			21314			32262			-			-
	Total social financing hundred mil RMB		18704	9637	11432	17802	10522	12475	16462	12906	11225	16282	25420	10659	25443
	Foreign exchange reserves hundred mil USD		33050	32989	32061	32400	32400	32729	32851	32874	32977	33116	34400	34400	34400
Index indicator	PMI		53.1	53.3	50.4	50.2	50.1	49.2	49.8	50.2	50.6	50.6	50.4	50.1	50.9
	Consumer confidence index		100	103	104.2	99.3	98.2	99.4	100.8	106.1	105.1	103.7	104.5	108.2	102.6
	RMB effective exchange rate index		108.4	108.1	108.7	108.7	108.7	108.3	107.5	107.9	109.6	110.1	111.9	113.7	114.0

Data source State Statistics Bureau, People's Bank of China, and Ministry of Commerce, etc.

Brief introduction to the Development and Research Center of the State Council, and the Macroeconomic Research Department

The Development and Research Center of the State Council (DRC) is a policy research and advisory institution directly affiliated with the State Council. Its main responsibilities are to research the global-mindedness, comprehensiveness, strategic planning, longevity, and foresight of China's social and economic development, to address current issues and difficult problems, and to provide policy advice and consultancy. The DRC possesses a high caliber team of experts, who have closely followed the State Council's work through the different periods since China's Reform and Opening. It has conducted in-depth research and studies and tendered large amounts of high quality research and practical policy advice, directly contributing to the development of China's economy and society.

The Macroeconomic Research Department is affiliated with the Development Research Center of the State Council. For many years, the department has specialized in research and analysis specific to China's macroeconomic situation, analyzed financial and/or fiscal policies, and provided advice to help maintain the continuing, rapid, and healthy development of the national economy. Furthermore, the department has participated in research that has directly contributed to many of China's significant economic and reform measures, as well as research, discussion, and drafting of relevant key documents; it has also handled many major specific research projects and topics for the Party and the State Council, generating research that has held great social and policy significance.

25