

China's Slowing Growth Rates: Testing Beijing's Tolerance for Slow Growth

China's Q2 2013 growth is expected to slow down to 7.5%. World's second largest economy is rapidly slowing. The slow down in the Chinese economy seems to be accelerated with the recent credit crunch in the aftermath of FED president Bernanke's announcements. FED's announcements led to capital outflows in emerging markets around the world. This sudden capital outflow also affected the China's financial markets even though the capital flows are restricted in China. In particular, property developments projects have been attracting foreign capital inflows for long time via partnerships between foreign and local investors.

Just a few days after Bernanke's announcements, Shanghai Interbank Offer Rates (SHIBOR) skyrocketed to historical highs. This sudden rise in inter-bank interest rates was due to the unwillingness of large banks to fund other institutions in a panic environment of capital outflows. Within one day this caused local banks to face tight liquidity conditions in a highly liquid economy. The Chinese Central Bank realized the severity of the problem and put aside its tight monetary stance for the short term.

Chinese Central Bank is in favor of lower M2 growth rates since two years, which was not much supported during the Presidency of Hu Jintao. Tighter monetary policy in the Chinese economy implies higher appreciation of the Yuan. However, with the new leadership which is seemingly more reformist, Central Bank has gained more support for its tighter monetary policy stance. Recently, Chinese Central Bank is following its relatively tighter monetary policy. However, Federal Reserve's recent move changed the framework which Chinese authorities designed their policies. This regime shift in the US economy forces the Chinese economy to develop its policies under a new framework.

According to this new framework we believe that the Chinese Central Bank should adjust its M2 growth rates upwards. On the fiscal side, due to increased risks in the local government debts and its possible effects on non-performing loans, fiscal reforms should create alternative sources of revenues for local governments. The main problem of local government debt is related to the land and property markets. Many less industrialized provinces are highly dependent on land sales as their most important source of local revenue. The revenues obtained from these sales are used to promote high growth in these provinces. Provincial taxes are not sufficient to sustain high infrastructure investments and urbanization of the Chinese cities. By a transfer of some of the central governments' revenues to the local governments, the fiscal situation of many provinces can be improved. Furthermore, this reform provides a good match with the new change of provincial success criteria. In the new appraisal system provincial authorities are not only judged by the GDP growth of their provinces but on a broader measure of success. In the previous system, local authorities had significant incentives for higher GDP through investment and property projects, which resulted in an unsustainable growth model.

Central government has been implementing various monetary and unorthodox policies to cool down the property market, however without breaking the dependence of local governments on rising land prices, there is not much of a chance for success. The root of

the problem should be tackled and reforms should change the decomposition of local revenues.

China's GDP grew 7.7% in Q1 2013, and Beijing hopes 2013 growth could hit 7.5 percent - impressive by world standards but the slowest in 23 years for China. The gross domestic product report, due on July 15, will be preceded by trade and inflation data, with the latter, on Tuesday, likely to show weak domestic demand and continued low levels of inflation. Inflation is not likely to be a problem for the Chinese economy in the near future, leaving room to balance the economy within the target range of GDP growth.

Consumer inflation is expected to quicken to 2.5 percent in June, well below the central bank's 3.5 percent target for 2013, and also below benchmark one-year deposit rates of 3 percent. Inflation had ran at 2.1 percent in May. In a sign of the tough times ahead for firms, producer prices are forecast to drop for the 16th consecutive month, falling 2.7 percent in June, compared with May's 2.9 percent drop. China's factories have been hammered in the past year by poor demand and excess capacity, especially among solar makers, ship builders and steel makers. Analysts say some have resorted to cutting prices to raise sales, but with little success. Trade data, due on Wednesday, is forecast to show an improvement in both imports and exports compared with May, but in a feeble rebound not expected to herald a solid revival. Exports are projected to have grown 4.0 percent in June from a year earlier, while imports are seen rising 8.0 percent.

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