Chapter 1
China Economic Performance in the First Half of 2016

China's economic growth continued to slow down further. In the first half of 2016, real GDP growth[1] moderated to 6.7% YoY from 6.9% in 2015 and 7% a year earlier respectively. Of the industrial enterprises above designated size, value added decreased marginally to 6.0% from 6.1% in 2015 and 6.3% a year ago (see Fig. 1.1). China's continued economic slowdown reflects that, given subdued external demand, increasing labor cost, and end of property boom, the investment-driven and export-oriented growth model, which has served China well in the past, is now in a difficult position as returns on investment (ROI) has fallen.

As the structural transformation becomes more evident, China's growth will continue to slow down in the medium term. Due to overcapacity in manufacturing, overstock in real estate, and high corporate debt load, the total investment growth decelerated, typically, the private investment growth fell sharply. China's macroeconomic policy has to make a difficult tradeoff between near-term demand management measures and long-term supply-side structural transformation, while in the meantime addressing financial stability risks.

1.1 Structural Transformation Persisted and the Labor Market Stayed Robust

China's transition is undergoing its difficult stage while seeking new growth engines. With the changing demand structure and the accelerating supply-side structural reform, China's economic structure is being adjusted slowly. Consumption's contribution to GDP growth is rising, industrial structure is being upgraded gradually,

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[1]In this report, all the variables/indicators are taken as nominal ones, that is, they are measured at current prices, unless they are clearly indicated as "real". All the growth rates are measured year-on-year (YoY), unless they are clearly indicated as "quarter-on-quarter (QoQ)".

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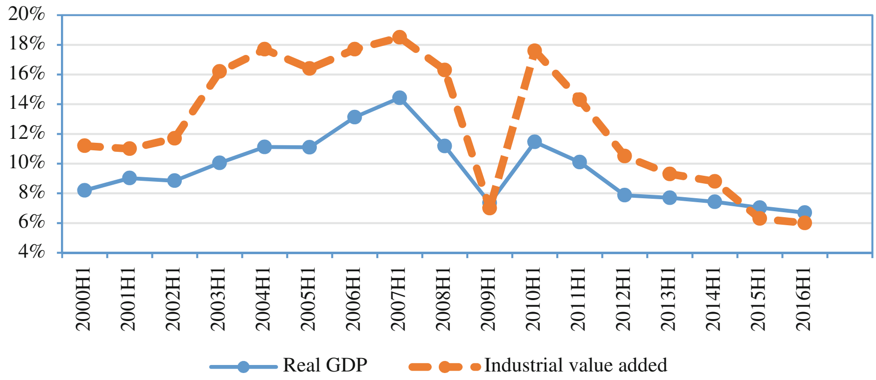

Fig. 1.1 GDP growth and industrial value added growth edged down YoY. *Source* CQMM team calculations on CEIC data

and the impact of decelerating economic growth on labor markets has been so far relatively small due to the continuous expansion of services industry.

First, given decelerating investment growth, the contribution of consumption to GDP growth rose rapidly. In the first half of 2016, total investment in fixed assets (FAI) grew by 9.0% YoY, 2.5 percentage points lower than that of the same period last year. Gross capital formation accounts for 37% of GDP growth, a decline of 0.6 percentage points over the same period last year. Though household income growth continues to edge down, consumption growth remains relatively stable. Total retail sales of consumer goods grew by 10.3%, 0.1 percentage points lower than that of the same period last year. Final consumption expenditure accounts for 73.4% of GDP growth, a drop of 13.2 percentage points over the same period last year (see Fig. 1.2).

Second, the tertiary industry keeps expanding and the industrial sector is being upgraded. Jointly supported by increasing household income and the shift of demand structure, the tertiary industry developed rapidly. In the first half of 2016, value added from the tertiary industry accounts for 54.1% of GPP, an increase of 1.8 percentage points over the same period last year, 14.7 percentage points higher than that in the secondary industry (see Fig. 1.3).

Thirdly, due to continuous expansion of the tertiary sector, which is working as the main force to absorb employment, moderating economic growth has not dragged down urban employment growth. At the end of the first and second quarter of 2016, the registered unemployment rates in urban areas are 4.04 and 4.05% respectively, staying at relatively low levels. Affected by the accelerating reform in curbing overcapacity this year, the number of unemployment insurance payments rose marginally to 2.31 million in the first quarter and 2.37 million in the second quarter, both up by 0.16 million YoY (see Fig. 1.4). Nevertheless, due to positive effects of structural adjustment, 7.17 million new urban jobs had been created in the first half of 2016, matching the level in the same period a year earlier. National requirement rates of jobs are 1.07 in the first quarter and 1.05 in the second quarter,

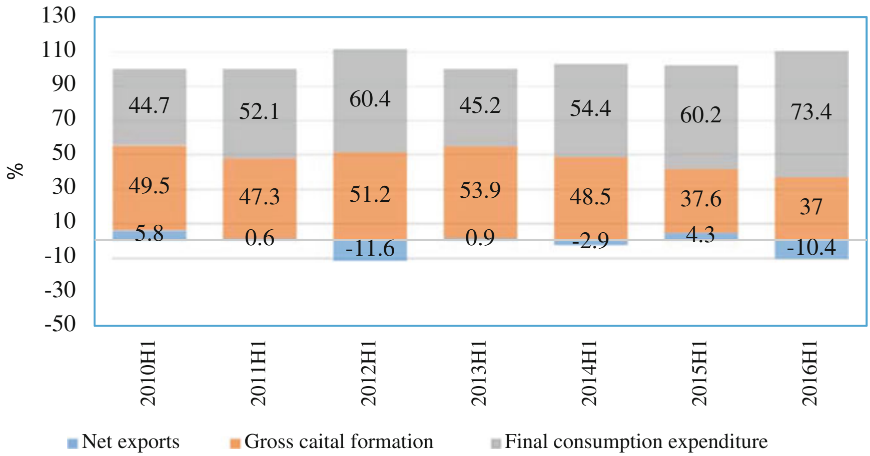

Fig. 1.2 Consumption's contribution to GDP growth increased. *Source* CQMM team calculations on CEIC data

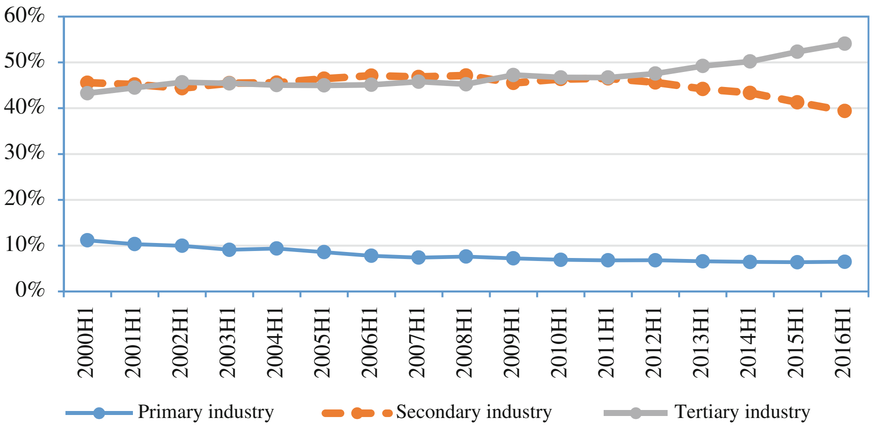

Fig. 1.3 The services industry kept growing YoY. *Source* CQMM team calculations on CEIC data

down by 0.05 and 0.01 over a year-ago period respectively, suggesting some more bitter job competition (Fig. 1.5).

Fourthly, the achievement of supply-side structural reform is being reflected in uptick of corporate returns. In the first half of 2016, among those industries with rampant overcapacity, coal production dropped by 9.0% YoY, crude steel production declined by 2.5%, electrolytic aluminum production fell by 1.8%, plate

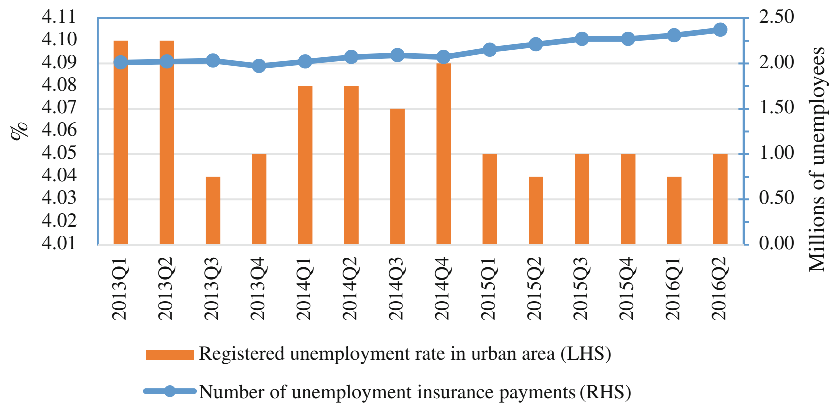

Fig. 1.4 Unemployment rate in urban areas remained stable. *Source* CQMM team calculations on Wind Info data

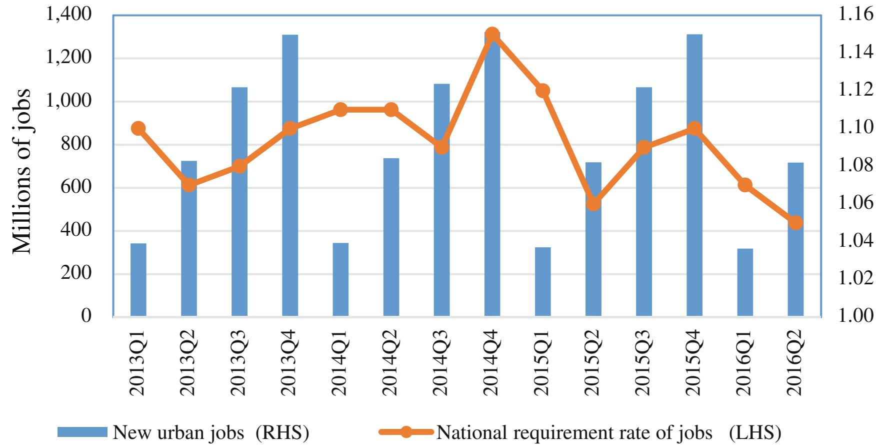

Fig. 1.5 Labor market robustness still in evident. *Source* CQMM team calculations on Wind Info data

glass production was down by 3.6%, while only cement production expanded by 3.0% (see Fig. 1.6). By contrast, production of overall industrial sectors rose by an impressive 6.1%. These figures suggest that measures to cut excess capacity in manufacturing sector has come into force.

In the meantime, supported by measures to reduce businesses cost burden, industrial production picked up slightly, and the financial performance of enterprises improved. In the first half of 2016, of the industrial enterprises above designated size, real industrial value added in real term expanded by 6.0% YoY, 0.2

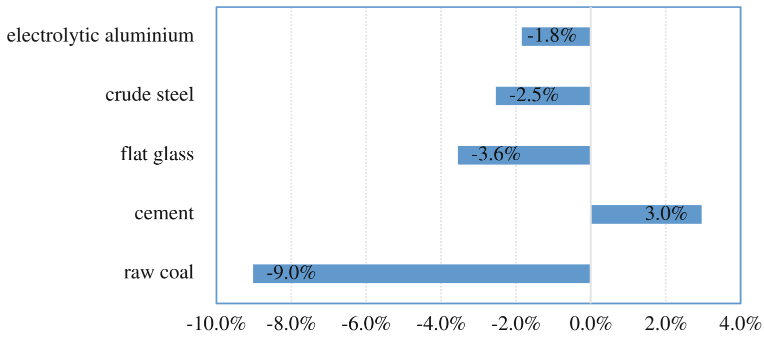

Fig. 1.6 Measures to curb overcapacity came into force YoY. *Source* CQMM team calculations on CEIC data

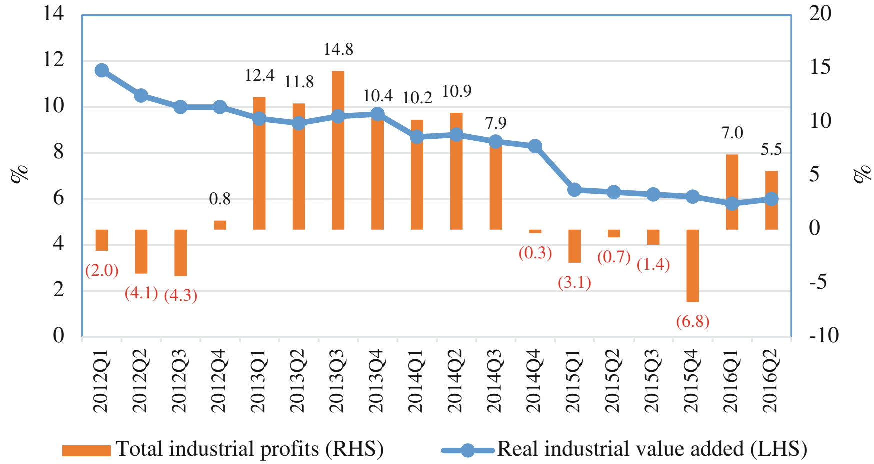

Fig. 1.7 The industry sector gained momentum YoY. *Source* CQMM team calculations on CEIC data

percentage points higher than that in the first quarter. In addition, total profit rose by 5.5%, reversing the continued decline last year (see Fig. 1.7).[2]

Furthermore, manufacturing composition carried on continuous improvement, and growth rates of profit maintained stable. In the first half of 2016, the industrial value added of general-purpose machinery manufacturing sectors increased by 1 percentage points over the same period last year, the growth rate of export delivery value rose by 6.24 percentage points, the growth rate of revenue from principal

[2]The growth rate of profit of industrial enterprises above designated size was down by 6.18% in 2015.

business climbed by 1.05 percentage points, and the growth rate of profit expanded by 1.12 percentage points. The growth rate of industrial value added of special-purpose machinery manufacturing sectors increased by 2.2 percentage points over the same period last year, the growth rate of export delivery value increased by 10 percentage points, the growth rate of revenue from principal business went up by 2.26 percentage points, and the growth rate of profit picked by 10.22 percentage points. The industrial value added of electrical machinery and equipment manufacturing sectors increased by 1.7 percentage points over the same period last year, the growth rate of export delivery value rose by 7.39 percentage points, the growth rate of revenue from principal business climbed by 2.86 percentage points, and the growth rate of profit expanded by 11.98 percentage points.

The transformation and upgrading of industrial structure accelerated, and the newly-emerging strategic industries grew rapidly. In the first half of 2016, the value added for newly-emerging strategic industries, such as energy saving and environmental protection, new generation information technology, bioindustry, high-end equipment manufacturing, new energy, new materials, and new energy vehicles, increased by 11% YoY, 5 percentage points higher than that for overall industrial sectors.

1.2 Total Investment Growth Edged Down While Private Investment Growth Dropped Dramatically

In the first half of 2016, the FAI (excluding rural households) increased by 9.0%, a decline of 2.5 percentage points over the same period last year. Of which, the FAI in the primary industry fell by 6.7 percentage points, the FAI in the secondary industry declined by 4.9 percentage points, and the FAI in the tertiary industry dropped by 0.7 percentage points. Of the FAI in the secondary industry, for mining markedly fell by 12 percentage points over the same period last year, for manufacturing contracted by 6.4 percentage points. Of the FAI in the tertiary industry, for transport, storage and post was down by 8.9 percentage points, for financial sector decreased by 9.2 percentage points, while for real estate picked up by 1.5 percentage points.

In terms of investment composition, the FAI in manufacturing grew by 3.3% YoY, a decrease of 6.4 percentage points over a year earlier. The FAI in real estate development increased by 7.2%, 1.5 percentage points higher than that in the same period last year. The FAI in infrastructure picked up by 20.9%, an increase of 1.1 percentage points over a year ago.

The rapid growth of infrastructure investment and the steady growth of real estate buffered the decelerated growth of overall investment. Of the FAI in the first half of 2016, the share of manufacturing investment is 31.8%, down by 6.4 percentage points over a year earlier, the share of property investment is 23.8%, up by 1.4 percentage points, and the share of infrastructure investment is 24.7%, up by 1.1 percentage points (see Fig. 1.8).

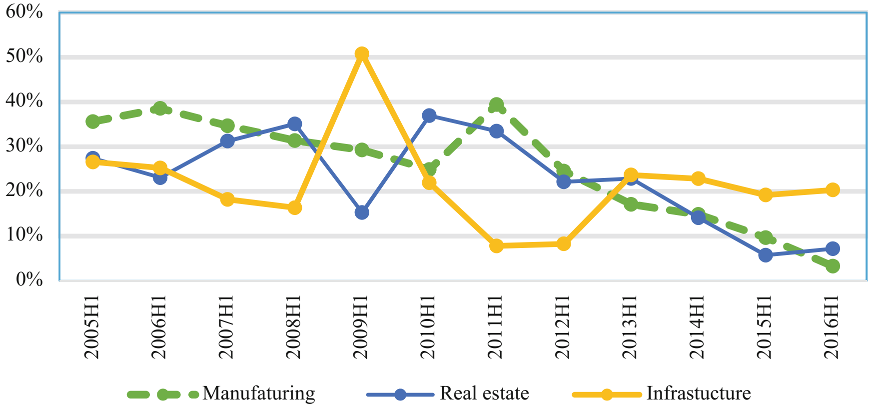

Fig. 1.8 Manufacturing investment slowed down YoY. *Source* CQMM team calculations on CEIC data

The first half of 2016 saw the dramatic drop in private investment growth, which was one of significant characteristics of China's investment growth. In 2015, the private FAI went up by 10.0% YoY, almost matching the 10.1% growth rate of the total FAI. Nevertheless, the gap between the private investment growth and the total investment growth has been widened since early 2016. In the first half of 2016, the private investment growth decelerated by 2.8%, 6.2 percentage points lower than that of the total FAI over the same period last year (see Fig. 1.9).[3]

In addition, the continued slowdown of China's investment growth is not only due to the decelerating private investment growth, but own to a mix of other various factors as follows.

First, in the first half of 2015 and 2016, the total FAI in China reached 23.71 trillion yuan and 25.8 trillion yuan respectively. The huge base reigned the rapid growth of new investment.

Second, mining, in which the coal industry plays an important role, is one of main sectors that the government determined to cut overcapacity. In the first half of 2016, the investment in mining fell by 19.7% YoY, a decrease of 12 percentage points over the same period last year.

Thirdly, China's outward foreign direct investment (OFDI) grew rapidly. In the first half of 2016, the non-financial OFDI reached 88.86 billion dollars, exceeding the FDI for the first time by 19.44 billion dollars on a similar comparison. The non-financial OFDI increased by 58.7% YoY, a significant increase of 29.5 percentage points over a year earlier. Of this, the non-financial OFDI of the first and second quarter picked up by 55.4 and 61.4% respectively, far exceeding the average growth rate of the last five years. Nonetheless, growth of OFDI all dropped

[3]The dramatic drop in private investment growth has raised much concerns. Chapter 3 is to analyses its causes and simulate its macroeconomic effects. Chapter 4 makes corresponding policy suggestions.

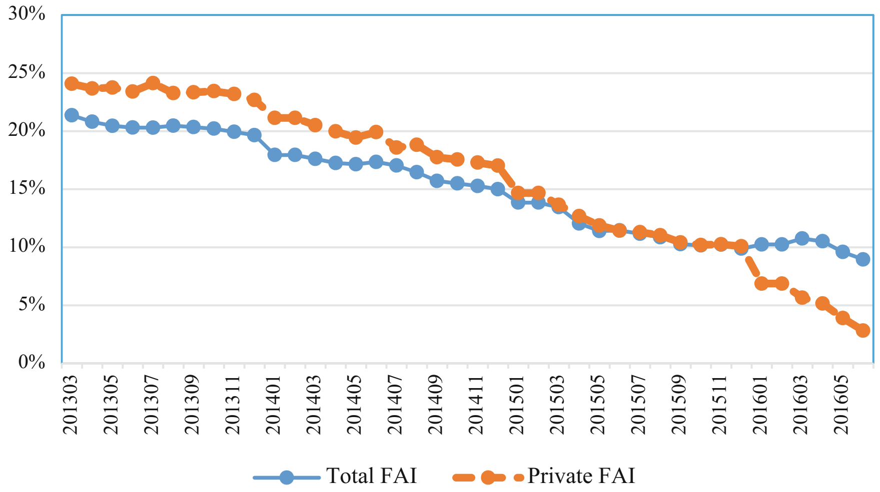

Fig. 1.9 Private investment growth dropped dramatically YoY. *Source* CQMM team calculations on CEIC data

dramatically in the second half of the years since 2012, except 2014 (see Fig. 1.10). Furthermore, although the private outward investment growth accelerated in the first half of 2016, the large and medium state-owned enterprises were still the main forces of China's OFDI, while not private enterprises.[4] So it is hard to tell that there is necessary connection between the rapid growth of OFDI and the sharp drop in private investment growth.

Fourthly, in terms of region, the slowdown of total investment growth was mostly affected by the sharp fall in investment growth in the northeast region.[5] In the first half of 2016, the northeast region, which once was China's most important

[4]According to the *Statistical Communiqué of the People's Republic of China on the 2014 National Outward Foreign Direct Investment* released by the Department of Outward Investment and Economic Cooperation, the OFDI by China central enterprises almost accounted for 48.9% of the total non-financial OFDI. Taking into account the OFDI by local SOEs, the OFDI by SOEs would be the main body of total OFDI. Take Shanghai, in which private investment is relatively concentrated on. The OFDI by SOEs in 2014 reached 5.28 billion dollars, accounting for 42.93% of total investment. In addition, in terms of volume of projects, for SOEs are commonly greater than those for private enterprises. Source: Shanghai Municipality Commission, Annual Report on Shanghai OFDI Cooperation and Development 2015.

[5]The eastern region covers ten provinces or municipalities: Beijing, Tianjin, Hebei, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, and Hainan. The central region covers six provinces: Shanxi, Anhui, Jiangxi, Henan, Hubei, and Hunan. The western region covers twelve provinces, municipalities, or autonomous region: Inner Mongolia, Guangxi, Chongqing, Sichuan, Guizhou, Yunnan, Tibet, Shaanxi, Gansu, Qinghai, Ningxia, and Xinjiang. The northeastern region covers three provinces: Liaoning, Jilin, and Heilongjiang. In December, 2015, the FAI in the three provinces in the northeastern region was first listed independently by the National Bureau of Statistics (NBS).

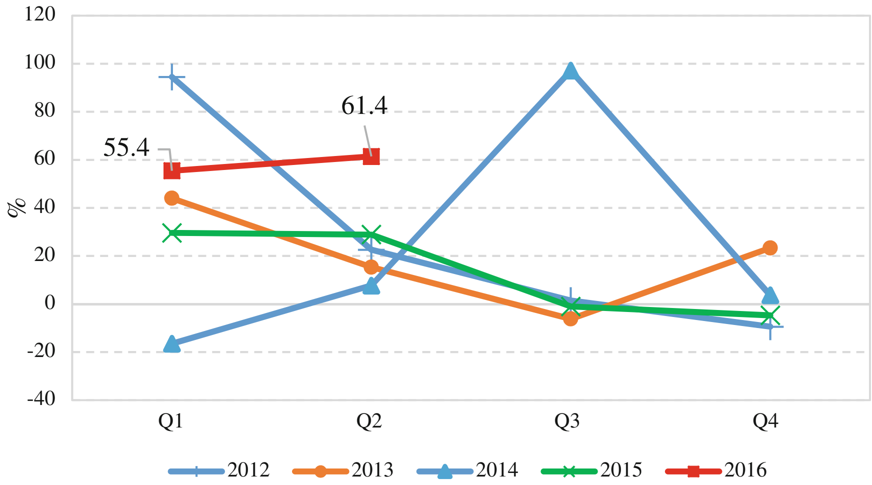

Fig. 1.10 Growth rates of non-financial OFDI QoQ. *Source* CQMM team calculations on CEIC data

manufacturing base, has been significantly affected by measures to eliminate backward production capacity. The FAI growth in northeast region declined by 32% YoY, a decrease of 20.8 percentage points over a year earlier. In contrast, the investment growth in other regions maintained relatively stable. Of the FAI growth, the eastern region climbed by 11% YoY, the central region rose by 12.8%, and the western region went up by 13.5% (see Fig. 1.11). After excluding the northeast region, in the first half of 2016, China would see a 12.3% growth rate of investment, only dropped by 0.4 percentage points over the same period last year.[6]

Nonetheless, while China's total investment growth edged down, its structure was improved. In terms of industrial sector, the increasing share of investment in high-tech industry will help the industrial sector move forward to medium-end and high-end industries. In the first half of 2016, high-tech industry investment grew by 13.1% YoY, 4.1 percentage points higher than the total FAI growth rates. The ratio of high-tech industry investment to total FAI is 6%, 0.2 percentage points higher than that in the same period last year. Of investment in services sectors, investment in high-tech services sectors accelerated. In the first half of 2016, high-tech services investment expanded by 16.4% YoY, 4.7 percentage points higher than that in services investment. In addition, the investment in some sectors related to people's livelihood also grew rapidly. For examples, the investment in management of water conservancy, environment and public facilities increased by 26.7% YoY, and the investment in science, education, culture, and health rose 18.1%, 13.4 and 5 percentage points higher than that in total services investment respectively.

[6]CQMM team calculations on CEIC data.

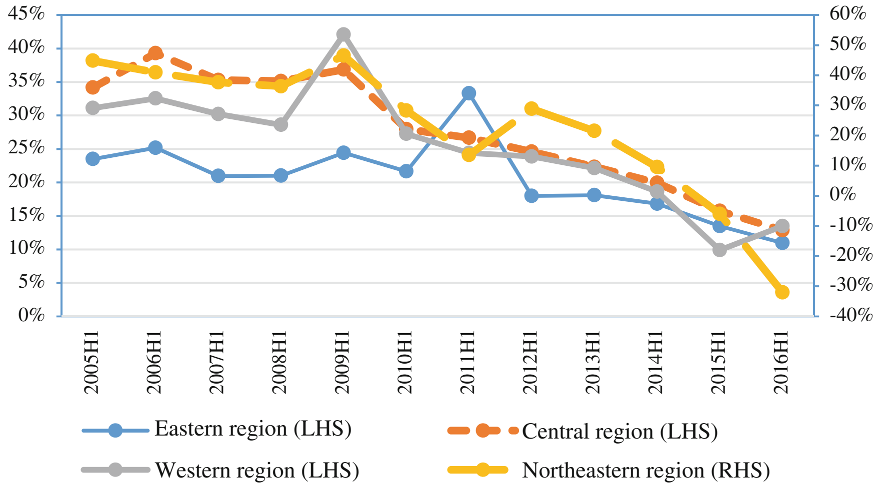

Fig. 1.11 The FAI in the northeastern region fell sharply YoY. *Source* CQMM team calculations on CEIC data

It is noteworthy that the accelerating infrastructure investment was mostly financed by public funds. Besides, given that the real estate is undergoing destocking in many cities, it might be a temporary choice to support the total investment growth by property investment. Taking into account China's high governmental and corporate leverage, it would be difficult to maintain the total investment by boosting infrastructure and property investment. The growth of investment in the second half of 2016 is expected to decelerate.

1.3 Consumption Growth Remained Steady Despite Household Income Growth Decelerated

Coinciding with the economy's downward trend, the household income subdued. In the first half of 2016, China's per capita real disposable income of households increased by 6.5% YoY, 1.1 percentage points lower than that in the same period last year. Quarterly, it rose 6.5% both in the first and second quarter, 0.2 percentage points lower than the GDP growth rate on a similar comparison, which occurred for the first time in recent years (see Fig. 1.12).

In the first half of 2016, sales of consumer goods at domestic market increased steadily. Total retail sales of consumer goods picked up by 10.3% YoY, matching its growth rate in the first half of 2015. Given weak foreign trade and subdued investment growth, the steadily rapid growth of household consumption increased the contribution of consumption to GDP growth. In the first half of 2016, the contribution of final consumption expenditure accounts for 73.4% of GDP growth,

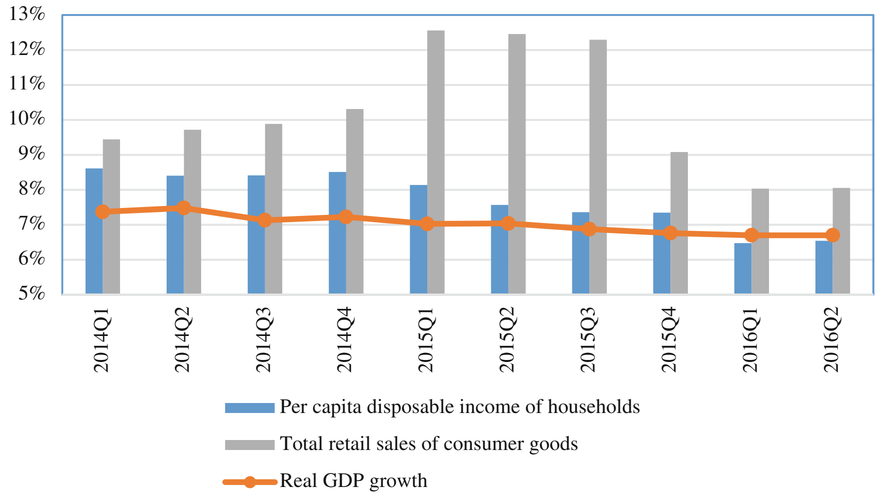

Fig. 1.12 Consumption growth stayed robust YoY. *Source* CQMM team calculations on CEIC data

an increase of 13.2 percentage points over the same period a year ago and 13.5 percentage points over 2015 respectively.

While sales of consumer goods expanded, new commercial forms grew rapidly. In the first half of 2016, the online retail sales[7] of physical goods increased by 26.6%, accounting for 11.6% of the total retail sales of consumer goods, up by 0.8 percentage points than that in 2015. Furthermore, sales of quality consumer goods maintained rapid growth, suggesting that the consumption structure be upgraded distinctively, In the first half of 2016, of retail sales by enterprises above designated size, for sports and recreation articles went up by 16.9% YoY, for communication equipment grew by 14.9%, for camera increased by 22%, all above the growth rate of total retail sales of consumer goods, suggesting that the demand for consumer goods is being upgraded.

Consumption in rural areas grew faster than that in urban areas. In the first quarter and the second quarter, the real retail sales of consumer goods in rural area were up by 8.8 and 8.6%, 0.9 and 0.7 percentage points higher than those in urban areas respectively, maintaining the state of growing faster than that in urban areas since 2013. The narrowing gap between the urban-rural consumption growth is coinciding with figures for the urban-rural income gap. In the first and second quarter, the per capita real disposable income of rural residents went up by 7.0 and

[7]Online Retail Sales: refers to the sales of goods and services got through public online trading platform (including self-built websites and third-party platform). Goods and services include physical goods and non-physical goods (such as virtual product, services). The total retail sales of consumer goods include online retail sales of physical goods, excludes online retail sales of non-physical goods.

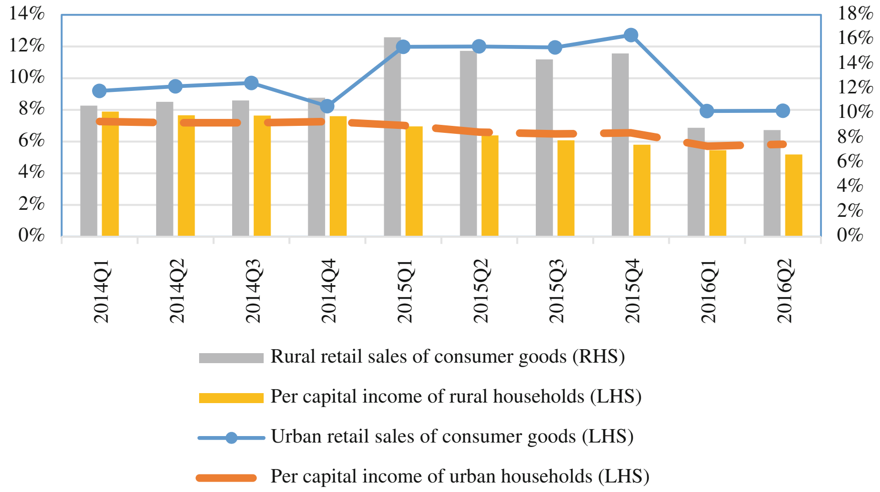

Fig. 1.13 Consumption in rural areas grew faster than than in urban areas YoY. *Source* CQMM team calculations on CEIC data

6.7% respectively. By contrast, the per capita real disposable income of urban households picked up by 5.7 and 5.8% respectively (see Fig. 1.13). Helped by the internet platform, the consumption market in rural areas has been extended, and the consumption environment has been improved. Compared with urban areas, the market structure of consumer goods in rural areas has larger development room.

1.4 Foreign Trade Growth Remained Sluggish

Global trade remains very subdued in the first half of 2016. According to the update forecast released by the International Monetary Funds (IMF) on July 19, 2016, the growth rate of global trade in goods and services is expected to be 2.7%, only slightly up by 0.1 percentage points over last year. Owing to the weak external demand and outward transfer of industries, China's export remained sluggish. In the first half of 2016, the total value of exports in dollar terms dropped by 7.7% YoY, down by 8.6 percentage points over the same period last year (see Fig. 1.14). By country and region, the decline of exports is closely related to that of exports to the US and the ASEAN. In the first half of 2016, the value of exports to the US and the ASEAN dropped by 9.9 and 8.4% respectively, while the value of exports to these two regions accounts for 30.1% of total value. In terms of type of trade, the processing trade exports fell by 9.9% YoY, while the general trade exports decreased by 7.7%.

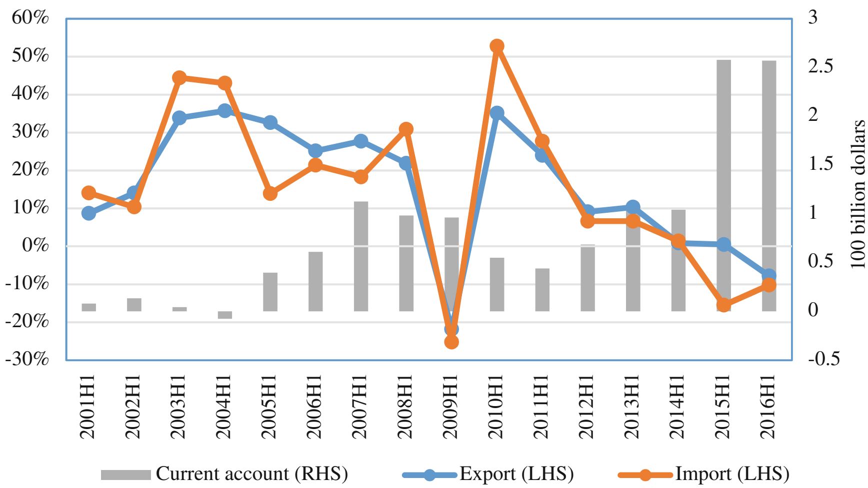

Fig. 1.14 Foreign trade growth remained weak YoY. *Source* CQMM team calculations on CEIC data

In the near term, the external demand will remain weak. Such great events as Brexit, the South China Sea event, and the pickup of international trade protectionism, are expected to put pressures on exports. Though the continued RMB depreciation is expected to support exports, generally speaking, it is hard to be optimistic about China's export prospects.

Owing to economic slowdown and no significant improvement in domestic demand, imports continued to hover low. In the first half of 2016, the total value of imports in dollar term dropped by 10.2% YoY, the rate of decline slowed by 5.4 percentage points over the same period last year (see Fig. 1.14). As bulk commodities account for a large proportion of China's imported commodities, with the decline in prices for imported bulk commodities slowed, the fall in total value of imports eased correspondingly. In the first half of 2016, of the average import prices, the rate of decline in iron ore slowed by 23.3 percentage points over 2015, in crude oil slowed by 13.4 percentage points, in coal slowed by 1.7 percentage points, and in copper slowed by 1.7 percentage points. The increase in both volumes and prices of imported bulk commodities eased falls in the total value of imports.

In terms of merchandise, mechanical and electrical products and traditional labor-intensive products are still the main categories of exports, though the growth rates of them decreased simultaneously. In the first half of 2016, the value of exports in dollar term for mechanical and electrical products fell by 8.0% YoY, accounting for 57.2% of the total value of exports. Of this total, for integrated circuit increased by 2.9%, for solar batteries export expanded by 1.9%. The value of exports for traditional labor-intensive products dropped by 5.1%, accounting for 21% of the total value of export. Of this total, for toys grew by 8.9%, while for textile, wearing apparel, and plastics only fell slightly, suggesting that some traditional products still maintained their competitiveness.

1.5 The CPI Sustained Stable While the Decline in PPI Slowed

In the first half of 2016, the consumer price index (CPI) rose by 2.1% YoY, meaning mild consumer price inflation. Even though the rapid growth of bank credit and money supply heightened the pressure on consumer price inflation, after the second quarter of 2016, the vegetable prices dropped much more than expected, and the growth of pork prices slowed down, the inflation pressure shown up in the first quarter started to ease. No-food price index maintained stable, its growth rates has steadily stayed in the range of 0.9–1.2% in the past sixteen months. In addition, the core CPI performed stable too, its growth rates slightly fluctuate between 1.3 and 1.6% in the last 17 months (see Fig. 1.15).

Since early 2016, due to the property boom in upper-tier cities and the accelerating implementation of programmed infrastructure projects, prices of bulk commodities had a sharp rebound. Falls in the producer price index (PPI) have been eased from down by 5.9% in August, 2015, to down by 2.6% in June, 2016. Over the same period, the rate of decline in the PPI for means of production has slowed from down by 7.7 to 3.5%, and that in the PPI for consumer goods has slowed from down by 0.3–0.1% (see Fig. 1.16).

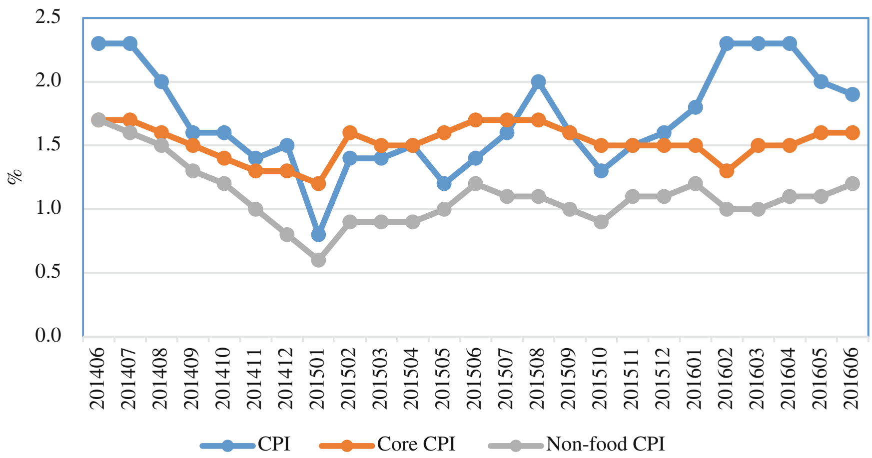

Fig. 1.15 Inflation pressure subdued YoY. *Source* CQMM team calculations on CEIC data

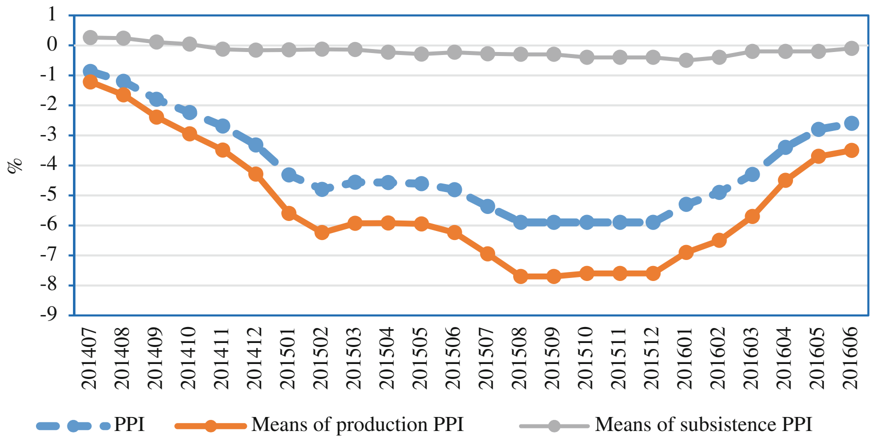

Fig. 1.16 Decline in PPI eased YoY. *Source* CQMM team calculations on CEIC data

1.6 Bank Credit Rose Rapidly While the Gap Between M1 and M2 Growth Widened

In the first half of 2016, the new loan amounted to 7.53 trillion yuan, about 1 trillion yuan more than that in the same period last year. Of this total, growth of loans of non-financial enterprises and loans of government department and organizations maintained steady compared to a year earlier. The additional 1 trillion yuan loans were all from household sector. Of new loans from household, the medium and long-term loans increased by 2.62 trillion yuan, 1.28 trillion yuan higher, or an increase of 95.52%, over the same period last year. As the medium and long-term household loans mainly consists of mortgage, the likely explanation is that, in the first half of 2016, the property boom in upper-tier cities brought a surge in bank credit, and then the surge in bank credit spurred the housing market in turn, resulting in the property boom.

By the end of June, 2016, the narrow money (M1) went up by 24.6% YoY, and the broad money (M2) picked up by 11.8%, meaning that the growth rate of M1 is 12.8 percentage points higher than that of M2. Actually, the growth of M1 started to exceed that of M2 in October, 2015. Since then, the scissors difference between them has been widened continuously. The difference increased to 12.8 percentage points at the end of June, 2016, from 0.5 percentage points at the end of October, 2015 (see Fig. 1.17).

The M2 growth slowed down for the following reasons:

- Balance of M2 has been great.
- The sharp drop in the bank acceptance bill brought about a significant fall in corporate margin deposits.

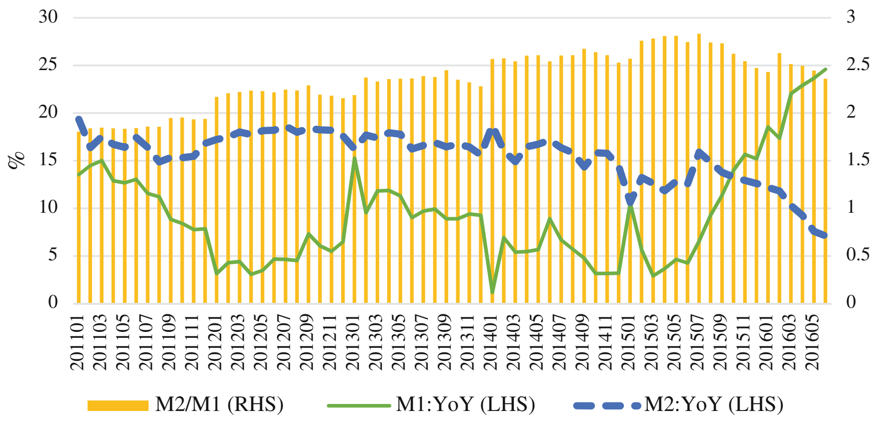

Fig. 1.17 The scissors difference between M1 and M2 growth widened. *Source* CQMM team calculations on CEIC data

- Composition for foreign exchanges purchase declined continuously, making derived deposits fall.
- Large amount of local government bonds issued drained much bank fund and crowded out bank loans to certain degree, weakening the ability of banking system to create money.

As to the increasingly rapid growth of M1, one cause is that the corporate demand deposits expanded significantly. To be specific, first, the interest rate differential between time deposits and demand deposits narrowed, the opportunity cost of holding demand deposit declined. Second, many companies tend to hold money, waiting for investment opportunities. And thirdly, hot property sales led the household deposits and the housing mortgage loans to real estate enterprises demand deposits.

The other cause is that, due to the large number of local government replacement bonds issued in the first half of 2016, some funds from local government replacement bonds and newly issued bonds retained temporarily were put in the bank accounts of government departments and organizations (most of them are local government financing vehicles accounts), which increased significantly the demand deposits by government departments and organizations.

According to the plan by China's central government, 11.4 trillion RMB yuan worth of local government bonds is to be replaced in 2016 and 2017, suggesting that the annual average is 5.7 trillion yuan. In the first half of 2016, the replacement bonds publicly issued and directional issue amounted to 2.65 trillion yuan in total, suggesting that the send half of 2016 will see 3.05 trillion yuan of replacement bonds newly issued. Thus, the gap between M1 and M2 growth rate is expected to be widened.

The above analysis shows that, the sharp increase of bank credit and the divergence between M1 and M2 in the first half of 2016, closely related to the property boom. And the property investment growth, spurred by the property boom, has played an important role in supporting China's economic growth. However, on a fundamental basis, assets prices cannot be divorced from the real economy, otherwise financial risks would be accumulated constantly. In addition, if assets prices go up rapidly, then prices of other materials, or even the price indices, would be stimulated, which would put the implementation of monetary policy in a dilemma.

As for as real estate, the goals of its policy in the second half of 2016 should constrain too rapid growth in upper-tier cities on one side, and to destock the overstocking houses in lower-tier cities on the other side. That implies that there is a tradeoff between controlled the overhung property prices and destocking. Extending this idea to the aggregate economy, the monetary policy in the second half of 2016 should also make tradeoff between stabilizing decelerating economic growth and promote structural transformation, while addressing the financial stability risks.

1.7 Fiscal Revenues Saw Fast Growth and Fiscal Expenditures Expanded Dramatically

In the first half of 2016, the property boom in upper-tier cities brought about the pickup of fiscal revenues. The national general public budget revenues amounted to 8.55 trillion yuan, up by 7.1% YoY (6.8% in real term). Of this total, the central general public budget revenues reached 3.72 trillion yuan, up by 3.3%, and the local general public budget revenues reached 4.84 trillion yuan, up by 10.1%.

Of the national general public budget revenues, the total tax revenues increased by 8.6% (8.0% in real term) YoY, exceeding the GDP growth rate of 7.2% (6.7% in real term), reversing the situation that tax growth lagged GDP growth in 2015 (see Fig. 1.18). The main reason is that the surge of property prices in the upper-tier cities led to the increase of those taxes directly related to real estate. For instance, contract tax went up by 14.8% YoY, the land VAT picked up by 13.1%, and housing property tax rose 8.5%. The property boom also spurred the expansion of those taxes indirectly connected to real estate, say, corporate income tax, VAT, business tax, personal income tax, and so on. For instance, corporate income tax from real estate increased by 17.3%, and income tax from transfer of property grew by 23.9%.

Property boom in upper-tier cities spurred the land market, driving the land concession fee grow rapidly. In the first half of 2016, the local government land concession fee reached 1.43 trillion yuan, up by 9.7% YoY, a sharp increase of 48.0 percentage points over the same period last year. As the land concession fee accounts for over 75% of local government funds revenues, the latter, which works as the second largest Source of local government revenues, picked up by 5.7%, a significant increase of 38.9 percentage points over the same period last year (see Fig. 1.19).

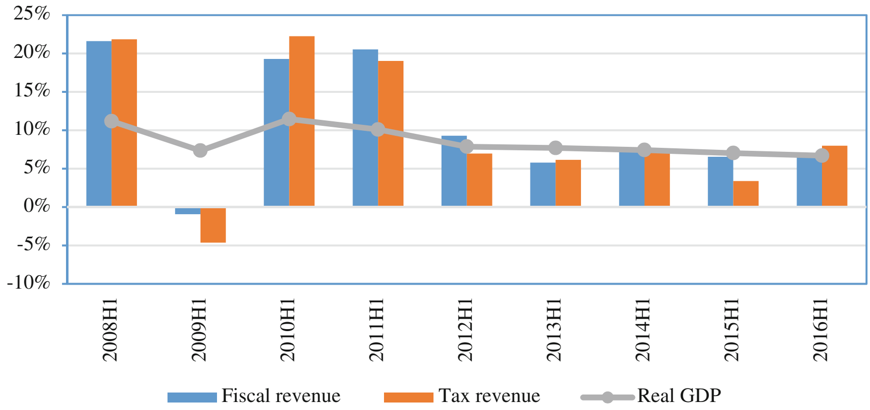

Fig. 1.18 Fiscal revenues growth accelerated YoY. *Source* CQMM team calculations on CEIC data

China expanded the pilot program of replacing business tax with value-added tax (VAT) on May 1, 2016. Such a move was implemented due to the following three reasons:

- To avoid repeat tax levy to promote specialized division of labor.
- To link together the broken tax chain between the industrial sector and services while the two sectors have become more closely interwined.
- To reduce the business cost by relieving the tax burden, where the move is considered as part of the supply-side structural reform.

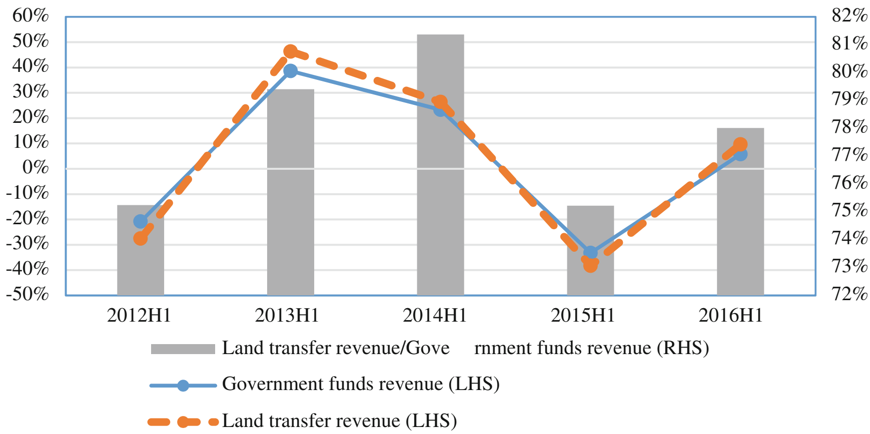

Fig. 1.19 Fast-growing land concess fee increased goverment funds revenues YoY. *Source* CQMM team calculations on CEIC data

It will take time to evaluate the real effects of such a tax reform. It's now the case that, in the first half of 2016, the domestic VAT increased by 8.7%. In terms of month, it grew by 20.9% in June, an increase of 15.1 percentage points over the first five months of 2016. In the meantime, as original business taxpayers turned to pay VAT, business tax dropped by 86% in June, while the total business tax went up by 15.6% in the first half of 2016.

The change in tax structure reflects that China's industry structure is being upgraded. In the first half of 2016, tax from the services industry rose 10.9% YoY, accounting for 58.2% of total tax revenues, 2.2 percentage points higher than that in the same period last year. In addition, tax from newly-emerging services sectors grew rapidly. Of this, tax from software and information technology services rose 39% YoY, where tax from leasing and business services sectors increased by 27.7%, suggesting that it is an important driver to boost tax growth in the services industry. Furthermore, tax from high-end manufacturing saw fast growth as well, suggesting the effects of innovation improved. Of this, tax from space equipment manufacturing climbed 11.1%, tax from pharmaceutical manufacturing and automobile manufacturing grew by 12.2 and 7.2% respectively.

In terms of region, in the first half of 2016, the growth rates of tax from the eastern region, the central region and the western region, are 12.2, 4.9, and 4.4% respectively. As modern services industry and high-end manufacturing are mainly located in the eastern regions, from which more tax revenues can be created by these fast-growing industries, making the growth rate of tax from the eastern region is persistently faster than those from the central and western regions.

To meet demands for ensuring people's livelihood and stabilizing economic growth, fiscal expenditure maintained fast growth in the first half of 2016, up by 15.4% over the same period last year, 8 percentage points higher than the growth rate of fiscal revenues (see Fig. 1.20). The central government general public

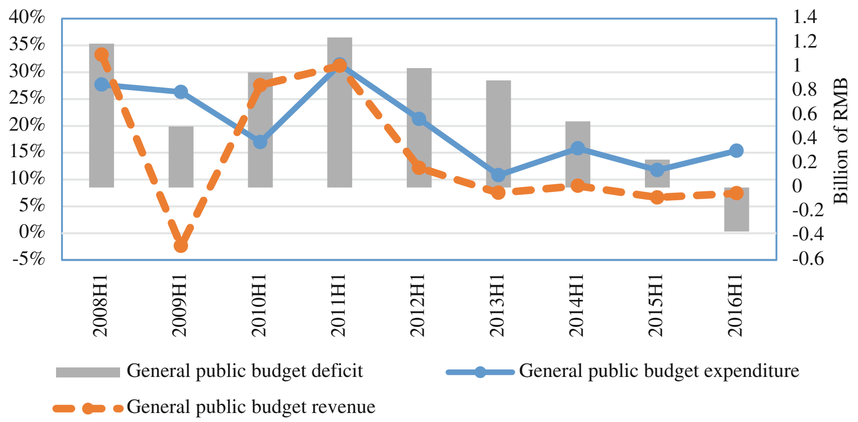

Fig. 1.20 Fiscal expenditure growth overtook fiscal revenues growth YoY. *Source* CQMM team calculations on CEIC data

budget expenditure rose 7.2% YoY, and the local government central general public budget expenditure climbed 16.6. The main target of general public budget expenditure was on satisfying people's livelihood. For instance, expenditures on urban and rural communities went up by 34.5%, expenditures on housing security picked up by 27.5%, expenditures on public health and family planning expanded by 23.7%, expenditures on education increased by 16.7%, expenditures for social security and employment rose 15%, and interest payments on debt climbed 38.1%.

In the first half of 2016, fiscal deficit amounted to 36.51 billion yuan. China's budgetary deficit in 2016 reaches 2.18 trillion, meaning that the room for fiscal deficit is about 1.8 trillion yuan in the second half of 2016. As downward pressure on the economy persists, fiscal revenues is expected to slow down, while fiscal expenditure is expected to expand to support economic growth, suggesting that fiscal deficit in the second half of 2016 increase much more than that in the first half of 2016.

In summary, the first half of 2016 saw the continued slowdown of China's economic growth. Given the relatively steady growth of consumption and persistently subdued foreign trade, the deceleration of total investment growth was the key factor of economic slowdown. Due to measures to curb excess capacity, investment in mining industry dropped sharply, and manufacturing investment growth edged down. High corporate leverage and the decline of profit growth weakened investment willingness among businesses. And the sharp drop of private investment growth reflects the lack of inner motive of endogenous investment growth. For these reasons, the downward trend in total investment growth would not be offset by either the property investment growth supported by credit expansion or the accelerating infrastructure investment growth led by the government, or both. In the second half of 2016, total investment growth is expected to slow down further, and marginal effects of investment on economic growth continue fading.

Since the global financial crises, due to the dramatic changes in the domestic and international economic environment, the previous investment-driven and export-oriented growth pattern, featured by both export and investment driven, has become unsustainable. Given sluggish external demand and increasing costs of production factors, it is urgent for China to change its current growth pattern. China's macroeconomic policy has to make a difficult tradeoff between near-term demand management measures and long-term supply-side structural transformation, while in the meantime addressing financial stability risks.

Nevertheless, during China's transition from a high-middle income country to a high-income country, the domestic demand structure is being updated, and the contribution of consumption to economic growth is rising. All these have brought about not only continuous expansion of the services industry, but constant adjustment of industrial structure to meet the transformation of demand structure. And the impact of decelerating economic growth on labor markets has been so far relatively small due to the continuous expansion of the services industry. Furthermore, measures to cut backward production capacity have come into force.

Supported by various policies to reduce business cost burden, industrial production picked up slightly, and financial performance of enterprises began to improve. Manufacturing structure carries on continuous improvement, and its growth rate of profit tends to be stable. Transformation and upgrading of the industrial structure are accelerating, and the newly-emerging strategic industries grow rapidly.

In the long run, the positive effects of structural transformation would become the fundamental forces to stabilize China's economic growth.