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CHINA'S OVERRATED SERVICE SECTOR

Missing dynamics threaten growth target

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Main findings and conclusions:

- China's economy is facing tough times. Long-standing growth drivers, in particular export-oriented mass production and low wages, are no longer pulling their weight. So far the shift to lower economic growth has been mild, but the downward pressure will intensify.

- The structural transformation of China's economy has only just begun. The desired industrial modernisation and boost to China's innovation capacity will only be seen in the long term. Fearing mass layoffs, the Chinese government only hesitantly initiates urgently needed reforms.

- To remedy the situation, the Chinese government is betting on the service sector. As a new driver for economic growth and jobs, it should fill the void created by a decline in industrial growth. This makes the service sector a bottleneck for structural transformation.

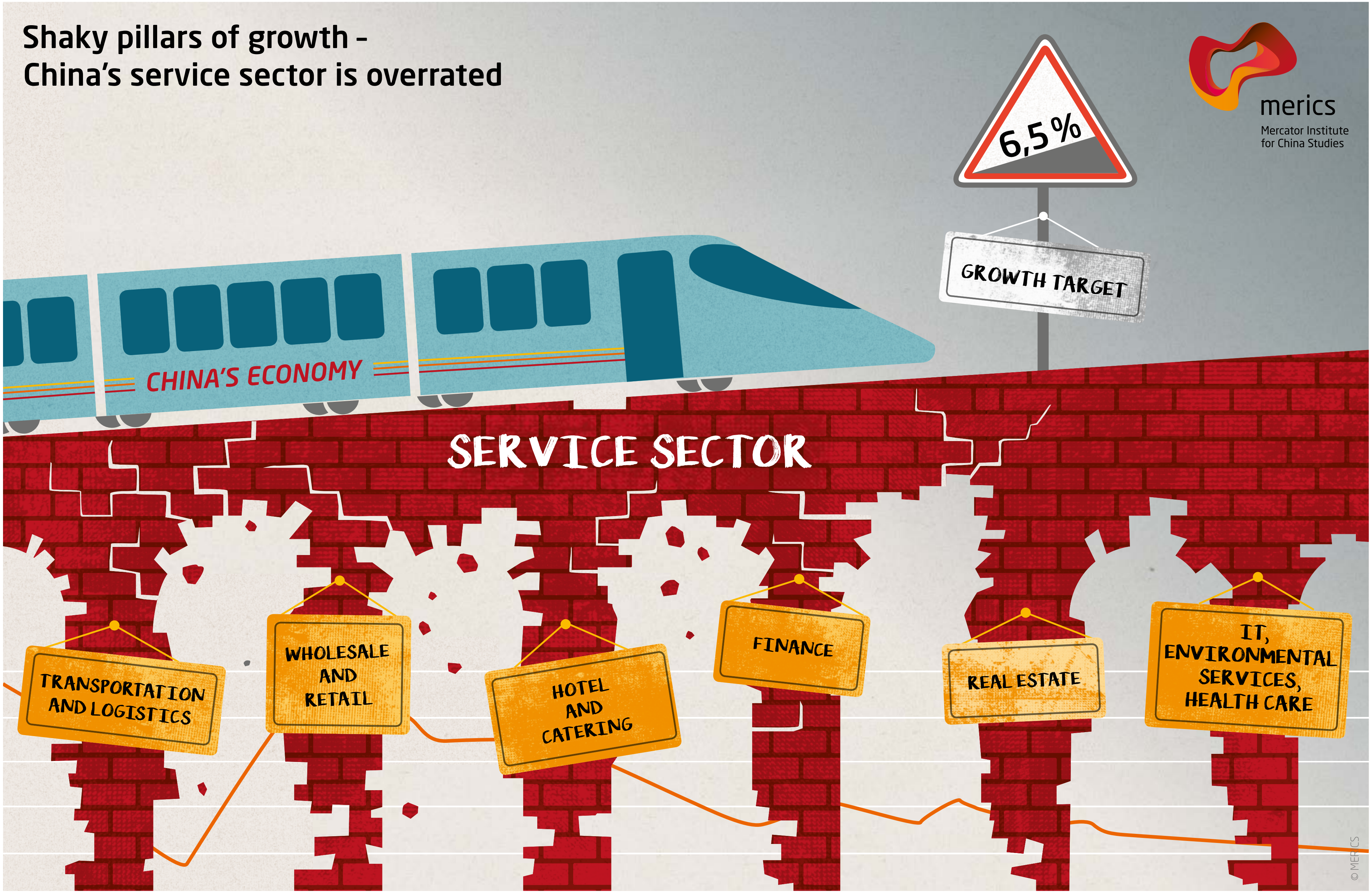
- The service sector lacks the strength to be a strong growth driver. At present, service sector growth is merely having a stabilising effect on the economy as a whole. Were it not for growth bubbles in the finance and real estate sectors, overall growth would be lower.

- A start-up boom initiated by the government glosses over a gloomier picture. Job creation in the service sector is not enough to offset job losses in manufacturing.

- In order to achieve the politically desired annual growth target for gross domestic product (GDP) of at least 6.5 per cent until 2020, the government will need to rely on investment-driven growth.

- Failing to advance structural reforms while artificially maintaining stable economic growth is a dangerous mix. A much harsher slump looms for China's economy after 2020.

Shaky pillars of growth – China's service sector is overrated



1. Slowing growth challenges China

China's lasting double-digit economic growth has been the envy of many Western governments. But times have changed: China's growth has been falling every year since 2011, when it was 9.3 per cent. In 2015, GDP growth was down to 6.9 per cent.[1]

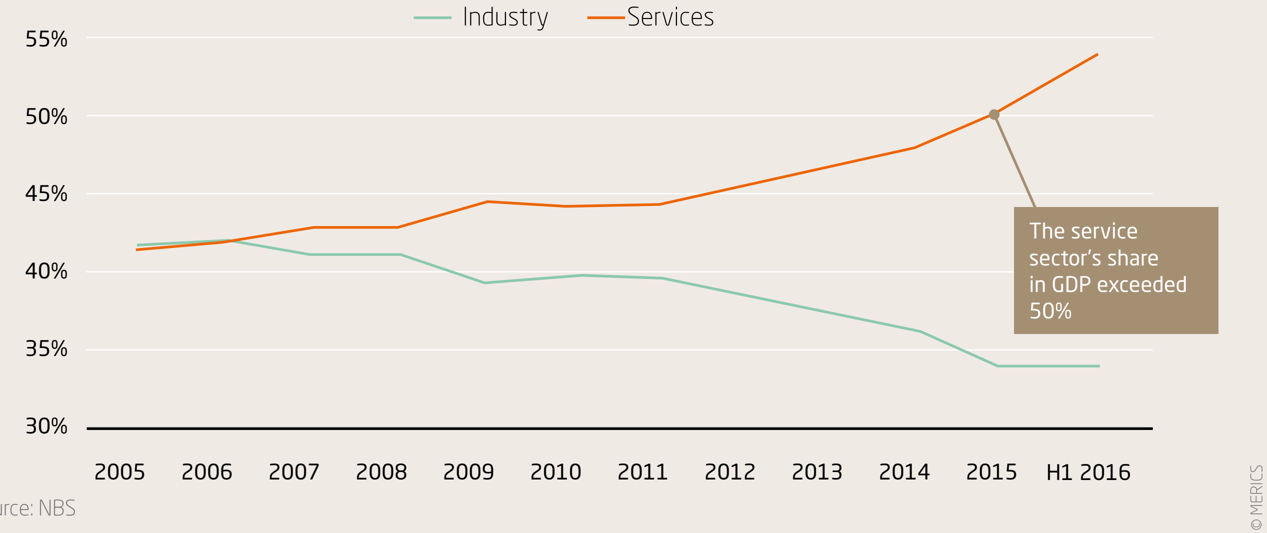
This is more than just a temporary dip but evidence of a structural transition. Export-driven manufacturing based on low wages can no longer pull the Chinese economy forward. Chinese wages are rising rapidly, with some provinces raising minimum wages by up to 20 per cent in recent years. Cheaper labour is available elsewhere, for example in Vietnam. At the same time, technological progress is not rapid enough to compete with advanced economies. China is facing a dilemma similar to that of Brazil, Mexico or South Africa: following periods of rapid economic growth, development stalls. The perils of the middle-income trap loom.

China's economy must reinvent itself, making large-scale restructuring necessary.[2] Modernisation strategies such as "Made in China 2025" and "supply-side reform" cannot provide short-term boosts to the economy. If successful, the effects will only be noticeable in the longer term. Reductions in industrial overcapacities as well as restructuring or even the closure of inefficient state-owned enterprises are urgently needed, but the process would be accompanied by considerable job cuts. These could trigger protests and political instability. Beijing wants to avoid this at any cost.

In its endeavour to maintain stability, the Chinese leadership has set the target of doubling disposable income between 2010 and 2020 – in time for the 100th anniversary of the founding of the Communist Party in the following year.[3] The 13th Five-Year Plan targets annual GDP growth of at least 6.5 per cent until 2020.[4] Beijing will therefore take all necessary measures to ensure a managed transformation by avoiding a substantial slowdown in growth and rise in unemployment. The Communist Party is under pressure to deliver on its promise to transform China into a modern economic power with a prosperous society. Success is crucial for retaining the legitimacy of its power.

In order to ensure stability despite an inevitable slowdown in economic growth, Beijing has placed great faith in the service sector as a potential lifeline. Services not only need to fill the void in economic growth left by the declining importance of the industrial sector (see illustration on this page), they also need to generate new employment opportunities for those who have lost jobs in manufacturing and agriculture during the economy's structural transition.

China's transition to a service-based economy
Share of economic sectors in GDP



Source: NBS

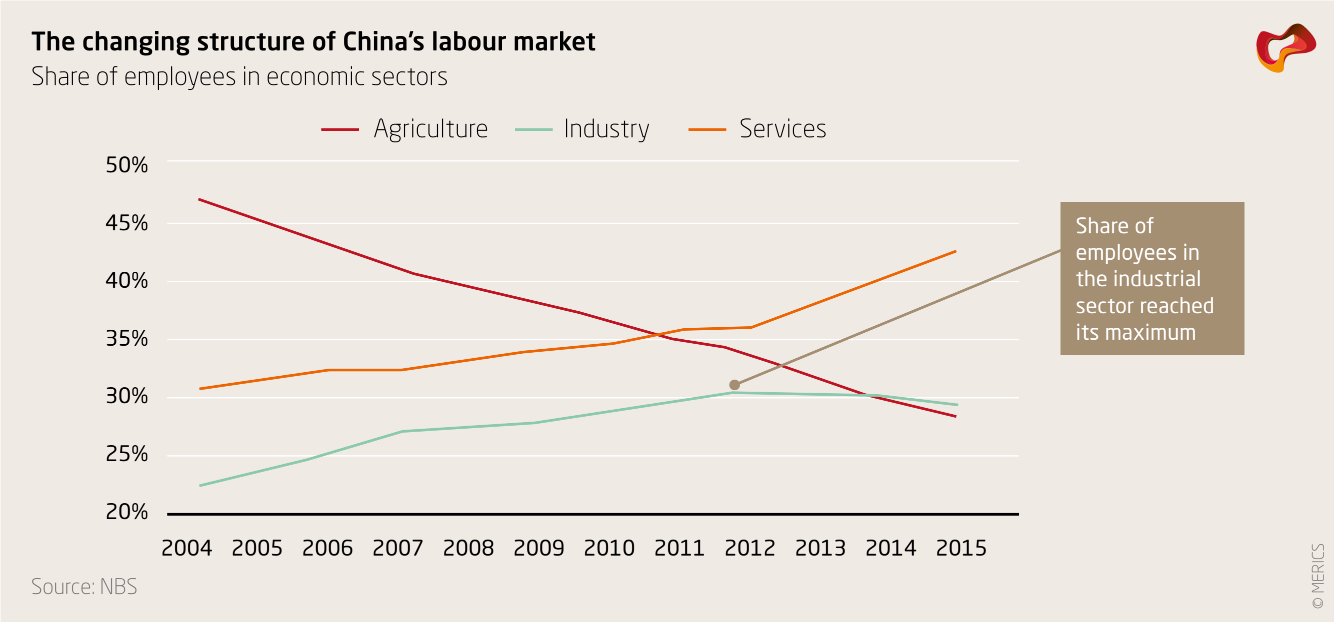
2. Engine for employment? Beijing overestimates the service sector

China's transition to a service-based economy has only just begun. Despite positive developments, the overall momentum generated by the service sector is still too weak. The sector is not yet a substantial enough provider of new jobs.

2.1 FIFTY MILLION NEW JOBS BY 2020: CHINA FACES A COLOSSAL TASK

According to the current five-year plan, China needs to create fifty million new jobs by 2020 in order to keep its unemployment rate at around four per cent.

Reaching this target would require a boom in the service sector. Even in the absence of fundamental reform of bloated



state-owned enterprises, mass redundancies in China's manufacturing industry are imminent. Since 2012, the proportion of employees in the industrial and construction sectors (secondary sector) has been declining. Between 2012 and 2015 a total of 5.5 million workers lost their jobs in the secondary sector, with 4.1 million redundancies last year alone (see chart on this page).

Rather than being a temporary downward shift, the decreasing importance of the industrial sector is a long-term trend. The declining role of the sector in the overall economy is compounded by increasing automation as the country tries to escape the middle-income trap. Greater automation depresses demand for workers, particularly threatening low-skilled labourers.

Restructuring state-owned enterprises will result in additional job losses. Massive industrial overcapacities, particularly in state-owned enterprises in heavy industries, have become particularly evident as China's economic growth slows. The government estimates that up to six million workers would need to be made redundant in the process of restructuring such "zombie" enterprises by 2019. A more rigorous restructuring of a broader range of state-owned enterprises would affect significantly more workers.

On top of that, the continued population shift from rural to urban areas will intensify the need for employment growth within China's cities. Government plans envision that by 2020 around 60 per cent of the population will live in urban areas. The latest figures for 2015 put the share at 56.1 per cent. In absolute numbers this translates into an additional 60 million people moving from rural areas into cities.

It is unlikely that the service sector alone will be able to create sufficient jobs suitable for the urban labour force's new arrivals, whose qualification level will mostly be low.

2.2 THE SERVICE SECTOR IS THE BOTTLENECK FOR STRUCTURAL REFORMS

The Chinese government will only dare to push for economic restructuring if the labour market remains stable. This can only be achieved if the service sector creates enough jobs to accommodate workers who are no longer needed in manufacturing or agriculture.

This makes the service sector the bottleneck for overall structural reforms. As China's leaders fear nothing more than social unrest caused by mass unemployment, a slowdown in the service sector will limit the government's willingness to implement ambitious elements of the restructuring process. China's transformation towards a new growth model hence depends on the service sector's ability to create enough new jobs.

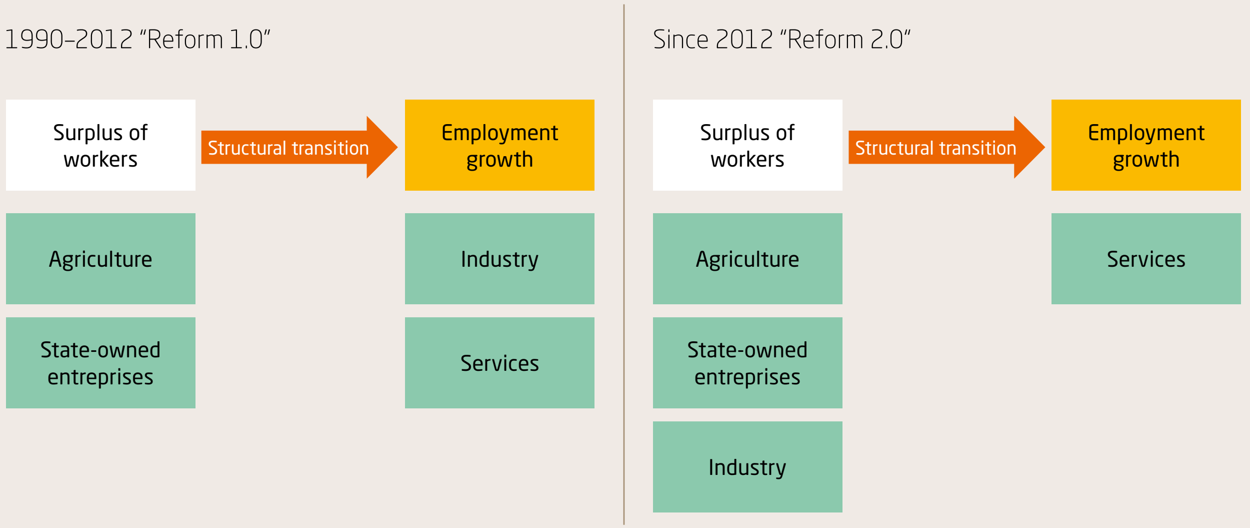
2.3 SERVICE COMPANIES ARE RELUCTANT TO HIRE

The service sector will not be able to deliver millions of jobs in China at such a fast pace, despite being able to create more jobs than the manufacturing sector when at comparable growth rates. A closer look reveals that employment growth in China's service sector is struggling as business confidence is deteriorating. According to the Purchasing Managers Index, service companies' willingness to hire new staff has fallen for nineteen consecutive months. Even China's internet giants Alibaba, Tencent and Baidu have announced that they have ceased hiring. Overall labour demand for low-skilled workers, who strongly rely on new service sector employment, shrank by 27.7 per cent in the last quarter of 2015. The situation improved slightly in the second quarter of 2016, but demand continued to contract (-14,2 per cent).

Nonetheless, China managed to create 13.1 million new jobs within a challenging economic environment in 2015. If growth were to continue at this pace, the targeted 50 million jobs would be easily reached by 2020. But it is important to

China's labour market as a catalyst for structural reforms

Reallocation of jobs into new sectors



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more closely examine the underlying figures: new company registrations soared by 21.6 per cent in 2015 compared to the previous year in response to Prime Minister Li Keqiang's initiative for mass entrepreneurship and innovation. Many new jobs were created within the 4.4 million new start-ups. Assuming each of the new companies has just two employees, they would have created a total of 8.8 million jobs. This would correspond to two-thirds of all new jobs created in 2015. The trend has continued in 2016: in the first half of the year an additional 2.6 million new companies were registered, an increase of over 28 per cent compared to the same period last year. Hence hiring at new companies will account for a large share of the 7.2 million jobs created since the start of the year.

It is unclear though whether all the jobs created during the start-up boom are going to last. Most of the young and mostly unprofitable companies have yet to prove their viability in an increasingly difficult economic environment. The boom could be extended through additional government policies, but then the new enterprises would represent little more than a job creation scheme. The increasing caution of institutional investors is a source of concern: by the end of 2015 venture capital investments had dropped by 29 per cent compared to the previous year.

Modern manufacturing requires services and a knowledge-based economy

The service sector has a much greater role to play than just creating jobs for simple industrial workers. Without a highly capable service sector, no innovative industrial sector will establish itself in China. A sophisticated service infrastructure is an essential driver of high-tech production: research and development, design, and the increasing digitisation of information technology are fundamental to upgrading manufacturing. Transforming the world's workbench and enabling China to move up the value chain therefore requires the strengthening of the knowledge-based economy, or the so-called quaternary sector. A resulting further increase in demand for highly skilled workers will compound the shortages that are already evident. This will do little for basic steel workers, as they will not be able to transition into jobs such as software engineer. Presently, the emerging knowledge economy is clustered within the economic centres of Beijing, Shanghai, Guangzhou and Shenzhen. In the short term, the sector will not be able to act as a growth driver for the overall economy.

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3. Growth driver? Beijing overestimates the service sector's impact on the economy

3.1 THE SERVICE SECTOR REMAINS STABLE, BUT GROWTH IS TOO WEAK

The Chinese government tends to overestimate the progress made in transforming the economy towards strengthening the service sector. As evidence, it highlights that the service sector accounted for more than 50 per cent of GDP in 2015 for the first time. Expanding by 8.3 per cent, it was also the only sector of the economy growing faster than overall GDP. Growth in services outperformed the secondary sector (industry and construction) as well as the primary sector (agriculture). Consumption accounted for 66.4 per cent of economic growth, an increase of 15.5 percentage points over the previous year.

A closer analysis of the service sector reveals a more sober picture: rather than accelerating, growth merely remained stable. The fact that the sector accounted for a higher share of GDP growth was not the result of a sudden boom in services, but of deteriorating momentum in other sectors. For instance, growth in industry has been slowing markedly since 2012. Services, on the other hand, were able to maintain similar growth rates despite the weakening economic environment.

3.2 FINANCE BUBBLE-INFLATED GROWTH

Financial services substantially contributed to service sector growth in 2015. Their 15.9 per cent expansion was considerably higher than the five-year average growth of 9.3 per cent. This development was to a considerable extent the result of the stock market boom that took place during the first half of the year. More than 30 million securities accounts were opened in the first six months of 2015 by private retail investors hoping to take advantage of rising stock prices. At its peak, more than three million new accounts were being registered each week. A rapidly expanding P2P banking system contributed to the boom by providing credit outside of the traditional banking system. In part this credit was used for investment in stocks as well as the real estate market. Therefore, rising share prices affected the real economy by increasing demand for financial services.

The financial sector bubble played a large part in preventing Chinese GDP growth from slowing even further. If the growth rate were adjusted to account for the bubble's effects, growth would have only been 6.5 per cent in 2015. This corresponds to the minimum average annual GDP growth the government wants to achieve until 2020. The outlook for the next five years is more precarious than growth of 6.9 per cent in 2015 would seem to suggest.

Aside from the financial sector, only the obscurely labelled category "other" achieved higher than average growth, expanding by 9.2 per cent. This category encompasses industries in which great hope is placed, including IT, software, environmental services and health care. These sectors play a large role in helping the government reach its economic policy goals such as its digitisation strategy "Internet Plus." But taken together, growth was modest: compared to the category's average growth (8.3 per cent) recorded over the previous five years, growth in 2015 only accelerated by 0.9 percentage points to 9.2 per cent. The impact on overall GDP growth has been too limited to speak of a new driving force for the massive Chinese economy (see illustration on page 6).

3.3 AS A DRIVER OF GROWTH, THE SERVICE SECTOR IS ALREADY DWINDLING

It is already clear that in 2016 dynamics in the service sector will not provide sufficient growth to reach the minimum growth target of 6.5 per cent set out by the government. The foundations of the recent growth are crumbling.

The boom in financial services is over. In the first half of 2016 growth fell to just 6.7 per cent, underlining the weak fundamentals that previous growth was based on. The environment has shifted considerably. Following tumbling share prices during the summer of 2015, confidence in the stock market has been shaken, leaving private investors more hesitant. In addition, growth in the flourishing P2P lending business will take a hit. Reactions to Ponzi schemes such as the previously heralded Ezubao (e 租宝) [5] further affect the sector's performance. Uncontrolled lending by P2P providers has undermined cooling measures in the real estate market. The sharp slowdown in growth over the first six months of 2016 in financial services was therefore to be expected.

Seeking new investment opportunities, many investors shifted their focus to the real estate market. First-tier cities such as Beijing, Shanghai or Shenzhen recorded sharp price increases, contributing to a new bubble. Increased demand for real estate-related services was reflected in service sector growth during the first half of 2016 (see illustration on page 6).

The growth prospects of service companies are not very promising. Business confidence in the overall service industry has deteriorated noticeably over the past twelve months. Although service companies anticipate expanding business according to the Purchasing Managers' Index, an important benchmark for business sentiment, in February the index dropped to its lowest level since December 2008. Despite recovering slightly since then, the outlook for new orders is poor and sales prices are expected to fall. This does not indicate that optimism about the service sector as a new driver of growth is well founded.

Positive effects resulting from the online industry are limited. The government pins much hope on emerging industries within the internet economy. Successful internet companies such as Alibaba, Tencent or Xiaomi serve as role models of Chinese new growth drivers. But despite their innovative power, their overall impact on the economy is limited as they often only complement or replace existing business sectors. The government likes to highlight the booming e-commerce industry, which has continued to expand rapidly, achieving growth of 28.2 per cent in the first six months of 2016. However, when consumers order more online it increases pressure on traditional retailers. The negative effects of this trend are already emerging in China as demand for labour in the retail sector contracted by 15.8 per cent in the second quarter of 2016 compared to the same period in 2015.

The service sector is tied down by the dominance of state-owned enterprises. State monopolies and restrictions for foreign companies undermine competitive dynamics in key segments of the service industry. Crucial sectors such as transportation, banking or telecommunications remain in the hands of state-owned enterprises. In contrast to the plan to reform sluggish state-owned enterprises in heavy industries, no such intentions exist for the service sector. A privatisation of state companies or the breaking up of monopolies are not in sight.

People's incomes are rising more slowly than in the past decade. The level of disposable income generally depends on economic development and productivity levels, but China has recorded both slower economic growth and a slowdown in productivity gains. Most recently productivity growth dropped from 6.9 per cent in 2014 to 6.6 per cent in 2015. Similarly, disposable income growth fell from 8 per cent in 2014 to 7.4 per cent in 2015 when adjusted for price effects. In the first half of 2016 growth slowed further, falling to 6.5 per cent. In urban areas growth slowed even more, falling from 6.6 per cent in 2015 to just 5.8 per cent in the first two quarters of 2016.

Recent surveys hint at an even more pessimistic outlook for household incomes. It is just a matter of time until this trend affects consumption and spending behaviour, which would further weaken the service sector.

4. Beijing's dilemma: press on with structural reforms or face long-term risks

The Chinese government has placed excessive expectations on the service sector. The plan to reach the government's growth targets over the next five years by relying on the strength of the tertiary sector is not credible. The service sector will also not be able to deliver miracles in creating new jobs.

The leadership in Beijing faces a difficult decision. It can push forward with painful structural reforms – in the face of high risks. Mass redundancies in the labour force and social instability could lead the population to question the government's legitimacy. The alternative is to postpone the necessary restructuring and modernisation of the economy.

From a strictly economic perspective, it would be reasonable to accept a more severe growth slowdown in the near term while kick-starting significant structural reforms. But current signals from Beijing point in a different direction: the Chinese government is set to defend its growth target of 6.5 per cent until 2020 at any cost. The downward pressure on the economy and a weak service sector will lead to the continuation of tried and tested policies. In recent months infrastructure spending by government and investment by state-owned enterprises have already gone up.

This is problematic, as China's level of debt has already reached 250 per cent of GDP according to unofficial estimates. China can reach its growth targets by 2020 this way, but essential economic restructuring will at best progress slowly. [6]

In the longer term this carries immense risks: similar to the economic development of Japan since the 1990s, China is in danger of entering a spiral of costly government stimulus, increasing debt, the build-up of industrial overcapacities and economic stagnation or even crisis. As this cycle progresses, the chances of a major political crisis increase because growth and prosperity are fundamental elements of the tacit agreement between the Communist Party and China's consumption-oriented middle and upper classes to accept authoritarian rule as long as economic growth is on track.

International observers should not be deceived by stable economic growth figures in China in the coming years. The apparent stability is misleading and increases the risk of a more severe slowdown after 2020.

1 | The economic data presented here are drawn from official Chinese statistics and own calculations based on these figures. http://www.stats.gov.cn/english/PressRelease/201602/t20160229_1324019.html

2 | http://www.worldbank.org/content/dam/Worldbank/document/China-2030-overview.pdf

3 | In 2010, per capita disposable income, i.e. income available for consumption, stood at CNY 19.109 (EUR 2.600) in urban areas and at CNY 5.919 (EUR 800) in rural areas.

4 | http://blog.merics.org/en/blog-post/2016/03/24/chinas-growth-target-bad-for-economic-stability-part-2-of-series-on-the-13th-fyp.html

5 | The peer-to-peer lending scheme Ezubao, set up in 2014, attracted funds of about CNY 50 billion from close to one million individuals. Operating in a largely unregulated area outside the traditional banking sector, the company promised high returns. In February 2016 the scheme was closed down, 21 people were arrested. The investigation brought to light that the company operated as a Ponzi scheme, with deposits from new investors masked as investment returns for already existing investors.

6 | http://www.bloomberg.com/news/articles/2016-02-21/china-s-debt-seen-rising-through-2019-peaking-at-283-of-gdp

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