Waltraut Urban

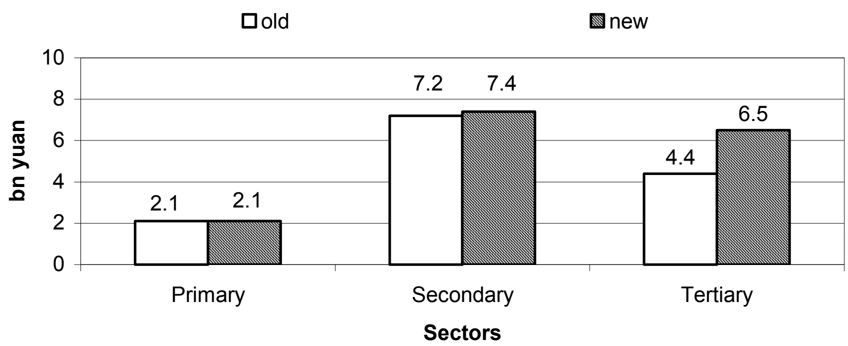
China: economy on a fast track

In 2005, the Chinese GDP rose at a rate of 9.9% – only marginally lower than in 2004, yet faster than generally expected. Investment increased by 26%, slightly less than the year before, and growth of private consumption accelerated moderately. The foreign trade surplus tripled as compared to 2004, reaching USD 103 billion. For 2006 we expect slightly slower growth (9.7%), and probably some further deceleration in 2007.

In December last year, China was in the headlines because of a substantial revision of its GDP data for 2004. According to the first nationwide economic census, the 2004 GDP was yuan (CNY) 2300 billion (or 16.8%) higher than earlier estimated. However, 93% of this amount was due to a significant revision of output of the service sector, which was revised upwards by CNY 2096 billion. Services account for 40.7% of GDP (as against the earlier estimate of 31.9%). Accordingly, the shares of the industrial sector and the primary sector were revised downwards (see Figure 1), which gives a sectoral structure more in line with other economies at a similar stage of economic development.

Figure CN

Sector shares in Chinese GDP 2004, old and new



Sources: China Statistical Yearbook 2005, Table 3-1 and press release of the Chinese National Bureau of Statistics, 20 December 2005.

Another important result of the census is the lower than estimated share of fixed asset investment in GDP (44% instead of 51%) and thus probably a relatively larger contribution of consumer demand to the overall growth of the economy. As consumption is typically fluctuating less than investment, the development of the Chinese economy is now considered more stable than before. Given the higher level of GDP in 2004 and the fast growth rate in 2005, the size of the Chinese economy (at current exchange rates) has surpassed that of France and most probably that of the United Kingdom as well, ranking fourth in the world now, after the USA, Japan and Germany.

The statistical deficiencies brought to light by the recent census have obviously cumulated over many years because of inadequate coverage of the service sector. A provisional revision of GDP data back to 1992, when the last census of services took place, has been released recently showing annual growth rates about 0.5 percentage points higher than originally assumed. These growth rates are indicated in *italics* in the table on 'Selected Economic Indicators' below, but absolute values, single components as far as available and shares in GDP were adjusted for 2004 only. The National Bureau of Statistics has also made an upward revision of the quarterly growth rates for GDP in 2005, arriving at 9.8% for the first three quarters and 10.1% for the fourth quarter. We thus can observe a certain acceleration of economic activity in the last quarter of the year related to higher investment in fixed assets and a surge in the foreign trade surplus.

On average, the growth of fixed assets investment reached 25.7% (in nominal terms) in 2005, showing the limited impact of various government measures to curb investment. However, investment grows faster in sectors whose output is in short supply (e.g. coal mining, supply of electricity, gas and water, railways, accommodation and catering trade, trade) and more slowly in sectors with excess capacities. Within manufacturing, the metal industry topped the list (except smelting and processing of ferrous metals, suffering from over-capacities already), followed by the leather and furniture industry. But investment growth in the transport equipment industry remained significantly above average as well, despite government measures to restrict investment. Real estate investment, also targeted by various restrictive measures such as credit restrictions and the implementation of a special 'business tax', rose below average in the first 11 months of 2005 (22.2%) but showed signs of acceleration at the end of the year. For 2006 we expect investment to remain strong but to expand at a somewhat lower rate than in 2005, probably at 22%, because of foreseeable over-capacities in several sectors of the economy, for instance in clothing & textiles, leather, and certain chemicals, as indicated by falling domestic prices.

Foreign direct investment inflows remained high, reaching USD 60.3 billion, nearly the same amount as the year before. FDI in service industries, particularly in financial services (banking), is gaining importance. This has to be seen in the context of the envisaged opening-up of the financial sector as of the beginning of 2007, according to China's commitments to the World Trade Organization (WTO). To mention a few examples: The Australia & New Zealand Banking Group (ANZ) has recently bought a 19.9% stake in Tianjin City Commercial Bank; the Royal Bank of Scotland (RBS), leading a consortium that included investment banker Merrill Lynch and Hong Kong billionaire Li Ka-shing, acquired a 10% stake in the Bank of China, the second biggest Chinese bank; Standard Chartered Bank acquired a share of 19.99% of Bohai Bank; and HBSC took 19.99% of the Bank of Communications.

Data on aggregate private consumption are not available yet, but retail trade turnover, which may be used as a proxy for consumer demand, expanded at a rate of 12% (in real terms), faster than in 2004 (10.5%). However, household savings rose at a similar rate, bringing the savings amount up to CNY 14.1 trillion (USD 1.7 trillion), equivalent to 77% of GDP.

The gap between urban and rural incomes widened further despite various government measures to support the rural population. Urban per capita incomes reached CNY 874 and rural per capita incomes came up to 271 per month. Probably a more significant positive impact on consumption may be expected from nearly doubling the personal income threshold for taxation from CNY 800 to CNY 1500 (USD 183) a month and a significant rise in public sector salaries. We thus expect private consumption in 2006 to remain strong and growth to even accelerate slightly.

However, fiscal policy will be somewhat less expansive in 2006 than in the years before, with a planned reduction of the budget deficit by CNY 5 billion. Also, the amount of 'special' government bonds, introduced during the Asian financial and economic crisis, will be further reduced to CNY 60 billion in 2006, after issuing CNY 80 billion in 2005.

Consumer price inflation came down significantly, from nearly 4% in 2004 to below 2% in 2005. Yet producer prices continued to rise by about 5%, due to rising costs for many inputs, putting a strain on profits. We thus expect consumer price inflation to go up again in 2006, also because of rising food prices and planned hikes in administered prices (e.g. water, electricity). In fact, the CPI, after remaining very low in September-November last year, displayed a certain acceleration in December.

The spectacular tripling of China's trade surplus is a consequence of low import growth rather than of fast export growth. Exports increased by 28.4%, compared to 35.4% in 2004, but imports rose by 17.6% only, after a 36% rise in 2004. This may reflect increasing import substitution, particularly in the field of intermediate inputs. The steel industry, for instance, became a net exporter in 2005, after having been the largest importer of steel in 2004. Also, imports of unwrought aluminium and aluminium products, paper & paperboard, yarn of synthetic fibres, and all kinds of woven fabrics declined in absolute terms. But also at higher stages in the production chain, such as in the production of automotive parts and electronic components, local suppliers are increasingly substituting imports and at the same time pushing exports because of improved quality. Import substitution is often due to foreign direct investments as their foreign suppliers follow the important customers to China, to save costs, but also for reasons of logistics ('just in time' delivery). A good example is the Austrian company AT&S, producing HDI-Microvia printed circuit boards for mobile phones, which has followed its major customer, Nokia, to China. There was also a significant decline in imports and a substantial increase in exports of grain and cereal products, because of very good crops over the past two years.[1]

Export growth, although lower than the year before, was still impressive and caused frictions with China's major trading partners, the EU and the USA, in certain fields such as clothing and shoes. However, in both product categories, total Chinese exports do not seem to have grown excessively. Growth was heavily concentrated on exports of a few important product groups. In the case of clothing, this was a consequence of the phasing-out of the 'Agreement on textiles and clothing' (ATC), leading to an abolishment of all quotas in textile and clothing trade among WTO members by the end of 2004. With regard to shoes, a bilateral quota agreement between the European Union and China ended in 2004 as well. Faced with a flood of Chinese clothing, the EU and the USA responded with special safeguard measures provided in China's accession treaty to WTO, to contain imports. Finally, in July, an agreement between China and the EU was reached, to restrict the import growth of ten important product categories until the end of 2007.[2] In November, after arduous negotiations, a similar agreement was reached with the USA, covering 21 product groups and extending until the end of 2008. In the case of shoes, the EU has opened an anti-dumping procedure according to WTO regulations and is considering new import quotas as well.

In 2006, with the Chinese economy already on a fast track, one may expect imports to rise somewhat faster than in 2005, probably at a rate of 28%. Export growth may be slightly slower, perhaps at 26%, under the assumptions that the world economy remains in good shape and taking into account several trade restrictions in place and a certain 'creeping' revaluation of the Chinese currency throughout the year as well.[3] However, this would again result in a high trade surplus of USD 115 billion for 2006 and a large current account surplus as well, which is likely to further provoke negative reactions and repercussions on the part of China's trading partners.

China's exploding trade surplus and the corresponding high and rising trade deficits of the USA and the EU with China have increased the pressure on the Chinese authorities, especially from the US side, to allow a revaluation of the yuan by making its exchange rate system more flexible.[4] In a first step, in July 2005, the long-standing dollar peg was

1 During the past two years, grain production increased by 50 million tons, reaching 484 million tons in 2005.

2 This agreement was then adjusted in September to solve the problem of blocked deliveries of goods ordered before the agreement already.

3 In January 2006, China cut tariffs on more than 100 categories of products, including cars and automotive spare parts as well as certain food products and chemicals, in line with its WTO commitments. But as China had implemented most WTO tariff reduction commitments already before, that step will have no significant effect on the overall trade development. (The average tariff rate is 9.9% now.)

4 The bilateral trade deficit of the USA with China is likely to top USD 200 billion in 2005, according to US sources (*International Herald Tribune*, 17 January 2006); according to Chinese statistics, the country's trade surplus with the USA was only USD 114 billion. The difference may partly be explained by Chinese exports via Hong Kong and different

abandoned and China shifted to a managed float with reference to a basket of currencies, allowing daily fluctuations of ± 0.3% against the central parity defined in US dollars and ± 1.5% against other important currencies such as the euro, yen etc. (this band was then further extended to ± 3% in September 2005). The new exchange rate, set on 21 July 2005, was CNY 8.110 per USD, down from CNY 8.277 per USD, corresponding to a 2.1% revaluation versus the US dollar. The composition of the currency basket was not revealed in detail, but was said to comprise the currencies of China's major trading partners such as the US dollar, the euro, the yen, the Korean won etc. In order to bring the exchange rate closer to a market rate, 13 big banks were selected as 'market-makers' by the Chinese central bank at the end of the year, and were allowed to trade the yuan directly with each other, starting on 4 January 2006. The central bank will then guide its daily fixing by the rate determined in the interbank trading the day before. On 22 January 2006, the yuan stood at 8.0648 per USD, reflecting a slight revaluation compared to the new rate fixed in July 2005. We expect a further 'creeping' revaluation of the Chinese currency, giving an average exchange rate of around CNY 7.8 per USD for 2006 – which will be of little help in containing the Chinese trade surplus.

The ongoing reforms of the exchange rate system have lowered the speculations of a sudden, sharp revaluation of the yuan: the corresponding speculative inflows of foreign currency seem to have stopped in the second half of 2005. Nevertheless, the foreign currency reserves of the Chinese central bank have ballooned – due to the large trade surplus and continuous FDI inflows. They stood at USD 819 billion by the end of 2005, only second to Japan's (USD 828 billion). As a consequence, the efficient use of China's currency reserves has come up for discussion, raising fears that a sudden restructuring of the reserves from either USD to other currencies or from US treasury bonds to other investment forms may shake the global financial system. So far the Chinese government has been trying to slow down the accumulation of foreign reserves and to use them more productively – by relaxing foreign exchange controls and by promoting outward investment. The ceiling on the amount of foreign currency that can be held by Chinese companies has been raised and private individuals may now buy larger amounts of foreign currency for foreign travel purposes. Portfolio investments abroad are permitted now, e.g. for Chinese insurance companies, and increasing amounts of money may be transferred abroad for direct investments.

Apart from the efficient use of foreign currency, the 'go-abroad' policy of the Chinese government, promoting outward investment, aims at securing raw materials (oil!), technology transfers and access to established brands and distribution channels as well as

pricing methods applied (CIF versus FOB) by US and Chinese customs statistics – but a certain difference that cannot be explained remains.

to international knowledge networks.[5] It is also part of a more long-term strategy of the Chinese government to build up a number of big Chinese transnational companies, supporting China's role as an emerging global economic power. In 2005, (gross) outward investment jumped to USD 6.9 billion, although mainly as a consequence of China Petroleum Corporation's purchase of PetroKazakstan (worth USD 4.18 billion) and full payment of the Lenovo-IBM deal of 2004 (worth USD 1.75 billion) in 2005.

On the supply side of the economy, provisional data show an increase of 11.4% of industrial value-added (including construction), nearly the same as the year before. The services sector value-added expanded by 9.6%, similar to 2004, taking the revisions of the census into account (10%). The primary sector grew by 5.2%, more vigorous than in past, due to advances in agro-technology mainly, but still somewhat less than in 2004 when a bumper crop inflated output.

Summarizing, the Chinese economy is expected to stay on its fast track but to decelerate slightly, reaching a GDP growth rate of 9.7% in 2006 and 9.5% in 2007.

In 2006, the growth of investment will somewhat decline due to government restrictions and over-capacities in certain sectors, but private consumption may grow slightly faster because of rising disposable incomes; fiscal policy will be less expansive than in the previous years. The trade surplus will remain high in view of the robust state of the world economy, but will decrease to a certain extent because of export growth decelerating and import growth picking up. Inflation will stay moderate but may accelerate to some degree because of planned hikes in administered prices. On the production side, primary production will expand at a similar pace as last year thanks to continuous modernization of Chinese agriculture. Industry growth may slow down in certain sectors because of less demand for investment goods and an oversupply in many consumer goods as well as restrictions put on particular exports (clothing, shoes, etc.). The services sector can be expected to expand faster due to rising consumer demand and also in light of a further opening-up of the sector, in line with China's commitment to WTO and an increasing inflow of FDI (e.g. banks, retail trade) in this field. In 2007, investment growth is expected to slightly decelerate further.

It should be mentioned, however, that for statistical reasons but also in view of the current Chinese government's policy to emphasize qualitative instead of quantitative growth, the official figures may represent the lower boundary of the actual economic development.

[5] For details see W. Urban, 'Chinese direct investment abroad: economic and political objectives', *The Vienna Institute Monthly Report*, No. 1, 2006, pp. 4-7.

Table CN

China: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004	2005 [1]	2006 forecast	2007 forecast
Population, mn pers., end of period [2]	1257.9	1267.4	1276.3	1284.5	1292.3	1299.9	1307.7	.	.
Gross domestic product, CNY bn, nom. [3]	8206.8	8946.8	9731.48	10517.2	11739.0	15987.8	18232.1	20400	22700
annual change in % (real) [3]	7.1	8.0	7.5	8.3	9.5	9.5	9.9	9.7	9.5
annual change in % (real) - revised	*7.6*	*8.4*	*8.3*	*9.1*	*10.0*	*10.1*	.	.	.
GDP/capita (USD at exchange rate) [3]	788	853	921	989	1098	1486	1699	.	.
GDP/capita (USD at PPP - wiiw) [3]	3709	4063	4441	4860	5385	6992	7926	.	.
Industrial value added [4]									
annual change in % (real)	8.8	9.9	8.9	9.9	12.5	11.1	11.4	11	.
Agricultural value added									
annual change in % (real)	2.8	2.4	2.5	2.9	2.5	6.0	5.2	.	.
Retail trade turnover, CNY bn	3113.4	3415.3	3759.5	4191.1	4572.5	5395.0	6717.0	.	.
annual change in % (real)	10.1	11.1	10.9	10.6	9.2	10.5	12.0	.	.
Total investment in fixed assets, CNY bn	2985.5	3291.8	3689.8	4283.9	5427.6	7007.3	8860.0	.	.
annual change in % (nominal)	5.1	10.3	12.1	16.1	26.7	26.6	25.7	.	.
Employment total, mn pers., end of period	713.9	720.9	730.3	737.4	744.3	752.0	.	.	.
annual change in %	0.9	1.0	1.3	1.0	0.9	1.0	.	.	.
Staff and workers, mn pers., end of period [5]	117.7	112.6	107.9	105.6	104.6	105.8	105.6 I-IX	.	.
annual change in %	-4.6	-4.3	-4.2	-2.2	-0.7	0.8	1.0 I-IX	.	.
Unemployment rate (urban) in %, end of per. [6]	3.1	3.1	3.6	4.0	4.5	4.2	4.2	4.5	4.5
Average gross annual wages, CNY [7]	8346	9371	10870	12422	14040	16024	16398.4 I-IX	.	.
annual change in % (real) [8]	13.1	11.1	15.2	15.5	12.0	10.5	.	.	.
Retail prices, % p.a.	-3.0	-1.5	-0.8	-1.8	-0.1	2.8	0.8	.	.
Consumer prices, % p.a.	-1.4	0.4	0.7	-0.8	1.2	3.9	1.8	2.0	1.8
General government budget, nat.def., % GDP									
Revenues	13.9	15.0	16.8	18.0	18.5	16.5	.	.	.
Expenditures	16.1	17.8	19.4	21.0	21.0	17.8	.	.	.
Deficit (-) / surplus (+), % GDP	-2.1	-2.8	-2.5	-3.0	-2.5	-1.3	-1.6	-1.4	.
Refinancing rate of NB % p.a., end of per. [9]	3.2	3.2	3.2	2.7	2.7	2.9	2.9	.	.
Current account, USD bn	15.7	20.5	17.4	35.4	45.9	70.0	110.0	100	80
Current account in % of GDP	1.6	1.9	1.5	2.8	3.2	3.6	5.0	3.8	2.6
Gross reserves of NB excl. gold, USD bn	154.7	165.6	212.2	286.4	403.3	609.9	818.9	.	.
Gross external debt, USD bn	151.8	145.7	170.1	171.7	194.0	223.0	267.5 I-IX	.	.
FDI inflow, gross, USD bn	40.3	40.7	46.9	52.8	53.3	60.6	60.3	.	.
FDI outflow, gross, USD bn	2.4	2.2	7.1	2.8	1.8	2.1	6.9	.	.
Exports of goods total, USD bn [10]	194.9	249.2	266.2	325.6	438.4	593.4	762.0	960	.
annual change in %	6.1	27.8	6.8	22.3	34.6	35.4	28.4	26	.
Imports of goods total, USD bn [10]	165.8	225.1	243.6	295.3	412.8	561.3	660.1	845	.
annual change in %	18.2	35.8	8.2	21.2	39.9	36.0	17.6	28	.
Trade balance of goods, USD bn [10]	29.1	24.1	22.6	30.3	25.5	32.1	101.9	115	.
Average exchange rate CNY/USD	8.278	8.278	8.277	8.277	8.277	8.277	8.206	7.8	7.5
Average exchange rate CNY/EUR	8.892	7.648	7.347	7.753	9.366	11.276	10.261	.	.
Purchasing power parity CNY/USD, wiiw [11]	1.759	1.737	1.717	1.685	1.687	1.759	1.759	.	.
Purchasing power parity CNY/EUR, wiiw	2.012	1.975	1.967	1.951	1.977	2.058	2.115	.	.

Note: CNY: ISO-Code for the Chinese yuan.

1) Preliminary. - 2) From 2000 according to census November 2000. - 3) In 2004 data for GDP and GDP per capita revised according to the national census 2005. - 4) Including construction. - 5) Staff and workers (on duty) refer to persons who work in state-owned enterprises, urban collectives, share holding ownership and foreign invested enterprises. - 6) Ratio of registered urban unemployed in per cent of urban employed and unemployed. - 7) Average gross annual wages of staff and workers, defined as: total wages of staff and workers on duty per average number of staff and workers on duty. - 8) Staff and workers cost of living index is used as deflator for calculating real wage. - 9) Overnight rate. - 10) According to customs statistics. - 11) Purchasing power parity, ICP-method; see Ren Ruoen, The Vienna Institute Monthly Report 1996/2.

Sources: China Statistical Yearbook; China Monthly Statistics; China Daily etc.