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China: limits to growth

Economic development in the first quarter of 2004 was characterized by surging fixed asset investments, stable consumption growth and rapidly expanding industrial exports. With some sectors overheating while unemployment remains high, the Chinese government faces a serious dilemma and will have to choose between cooling the economy down on the one hand or supporting employment on the other. Moreover, given the relative size and openness of the Chinese economy, its future path will have a significant impact on the development of the neighbouring region and that of the world at large, too. China is the second-largest economy in Asia (after Japan), the sixth-largest economy in the world and ranks fourth in world trade.

GDP growth in China reached 9.7% in the first quarter of 2004, after 10.7% in the previous quarter and 9.1% for the whole year 2003; this is one of the highest growth rates of any country in the world and higher than most experts expected. Growth was mainly driven by investment in fixed assets, surging 43% year-on-year in the first quarter of 2004. Investment boomed in the extreme in a number of sectors; the steel industry rose by 107%, with very high growth being recorded in real estate, non-metal mineral products and vehicles as well. This is raising fears of overheating and a build-up of over-capacity. In order to contain growth in those sectors and guard against a boom/bust cycle, the Chinese authorities started last year to control property loans, particular in high-end housing. In the first few months of this year the credit restrictions were also imposed on other sectors displaying disproportionately rapid growth. Soaring profits, however, are undermining this policy. In the first three months of 2004, overall industrial profits were reported to be 44% higher than in the same period last year; major steel companies recorded a rise in profits of 126% and non-ferrous metal producers a rise of 280%!

Both monetary and fiscal policies have become more restrictive. After raising the bank reserve requirement ratio by one percentage point to 7% back in September 2003, the ratio was increased further by 0.5 percentage points as of 1 April 2004. However, the People's Bank of China (PBC), the country's central bank, is still hesitant about raising the target interest rate in order to avoid increasing costs for the less prosperous debtors in the country. As for fiscal policy, the government has announced that the pro-active fiscal policy implemented after the Asian crisis in 1997/1998 will be phased out step by step and the issuance of treasury bonds will be reduced from yuan 140 billion (USD 17 billion) in 2003 to yuan 110 billion (USD 13 billion) this year. The general budget deficit is projected to stay at the same level as last year in absolute terms; however, it will decline further as a percentage of GDP, probably reaching 2.5% in 2004. (As for the size of the Chinese budget deficit, one has to bear in mind that it is not measured in line with international standards and thus may be substantially underestimated.)

Private consumption in the first three months of 2004 was supported by rapidly rising incomes – especially in rural areas (9.2%) where 60% of all Chinese still live and benefit from significant price hikes for numerous agricultural products (wheat prices rose by 19.9%, corn by 21.5%, soybeans by 31.4% and cotton by 47.7%). However, retail trade turnover as a proxy for private demand expanded in real terms at the same pace as last year (9.2%). Measured in terms of the consumer price index, the overall price level rose 2.8% year-on-year in the first quarter. This is still moderate by international standards, but points to significant acceleration if compared to the very low rates of inflation and/or deflation over the past few years in China. Some doubts are also being voiced whether the index correctly captures actual inflation. Producer prices for industrial products rose 3.7% and selected information on the rise of ex-factory prices for important industrial inputs, such as 17-33% for steel, 35.7% for aluminium, 14.5% for copper and 6.7% for crude oil in January, suggest that inflation will accelerate further throughout the year.

Exports continued to grow rapidly in the first three months of the year, up 34.1% over the same period last year. They took advantage of the upswing in the world economy that was particularly pronounced in Asia and the USA, which together absorbed 70% of China's merchandise exports. However, imports rose even more sharply at a rate of 42.3% on account of two factors: a surge in demand for capital goods, raw materials and intermediate inputs; and rapidly rising prices in many sectors (viz. crude oil, ferrous and non-ferrous metals). This development resulted in a (moderate) trade deficit of USD 8.4 billion (exports still cover imports by 93%): China's first trade deficit for many years. Foreign direct investment remained high; actual inflows reached USD 14.1 billion in the first quarter of 2004, slightly higher than in the same period last year. Moreover, contracted foreign direct investment was up 49.2%, pointing to a further increase in FDI in the future.

In the light of the recent trade deficit, the US government relaxed its pressure on China to revalue its currency; it probably relented in the light of a number of Chinese 'shopping tours' to US enterprises and certain statements issued by the Chinese monetary authorities that indicated a more flexible approach towards exchange rate policy in the foreseeable future. (Ever since the Asian crisis in 1997/1998, the yuan has been pegged to the US dollar at a rate ranging between 8.276 and 8.278. In the run-up to the US presidential elections, the low fixed value of the Chinese currency is cited as being responsible for the huge trade deficit with China – and thus for the job losses in US industry.)

On the supply side, the industrial sector remained by far the fastest growing segment of the economy, with industrial value-added expanding at a rate of 17.7% (compared to 17.2% in

the same period last year).¹ However, driven by fixed investments, industrial production growth is highly concentrated in a few sectors, primarily steel and other metals, cement and vehicles. Production growth, however, is also above average in certain export-driven sectors such as electronics. Growth was less impressive, for instance, in the production of silk and silk textiles, garments, some white goods (e.g. freezers) and certain types of consumer electronics (e.g. colour-TV and hi-fi sets). Value-added of agriculture expanded by 4.5% and VAD of the services sector by 7.7%, up 1 and 0.1 percentage points respectively from the growth rates in the first quarter of last year.

Despite the rapid expansion of the economy, unemployment remains high. The unemployment rate is probably close to 15% on account of the ongoing restructuring of state-owned enterprises, rural migration and pressure attributable to young people entering the labour market. (According to Chinese labour statistics, the number of young people – i.e. those under the age of 35 – entering the labour market peaked during the period 2001-2005.) Quite remarkably, China has no reliable data on unemployment. The current official unemployment rate of 4.3% refers solely to registered urban unemployment; this is known to be but a fraction of the actual overall unemployment rate. However, a new system for compiling unemployment data, based on surveys in line with international practice, will be gradually introduced. A survey has been launched in 66 cities as a first step.

The difficult task facing the Chinese authorities as they strive to contain economic growth and secure employment, whereby conflicting interests between central and local governments also play a certain role, is best illustrated by the example of the automotive industry: According to a study by the Development Research Centre, a think tank linked to China's State Council, for every job created in China's automotive industry, seven more appeared elsewhere in the economy; the industry accounted for 1.5 percentage points of GDP growth last year. Moreover, exploding car sales (2002: 80%; 2003: 36%) attracted huge amounts of investment capital (domestic and foreign) to the industry; car-making capacity is projected to outstrip demand in 2005. When this occurs, the crowded market will set off a shakedown process, winnowing out the less competitive – probably smaller domestically owned enterprises located in the poorer provinces of China. Back in February this year, vehicle manufacture rose by 18% and outstripped sales. At the end of April, China's 13 largest car makers were sitting on unsold stocks some 28% larger than last year.

On the political front, some major amendments to the constitution were adopted at the annual meeting of the People's National Congress in March this year, pertaining to the protection of private property rights, social security and human rights, and incorporating the

¹ Comprising industrial enterprises with annual sales revenue above yuan 5 million (USD 604,000) only, VAD of the total secondary sector (including construction) expanded at a rate of 11.6%.

principle of the so-called 'Three Represents' in the preamble. The latter is an ideological construct, going back to former President Jiang Zemin, designed to broaden the basis of the Communist Party of China beyond workers and peasants so as to include private entrepreneurs as well.

Prospects: On the assumption that the world economy will peak this year and that the measures to cool China's overheated economy in various sectors will take effect without any serious impact on overall growth, wiiw expects the Chinese GDP to expand at a rate of 8.5% in 2004 and at 8% in 2005.

In a longer-term perspective, however, the Chinese government envisages average GDP growth of around 7%, putting the emphasis on 'qualitative' rather than 'quantitative' growth. This should be more in balance with existing natural resources and help to reduce both social and regional disparities.

Table CN

China: Selected Economic Indicators

	1999	2000	2001	2002	2003 ¹⁾	2003 1st quarter	2004	2004 forecast	2005
Population, mn pers., end of period	1259.1	1265.8 ²⁾	1277.3	1286.0	1292.0				
Gross domestic product, CNY bn, nom.	8191.1	8940.4	9593.3	10239.8	11669.4	2356.2	2710.6	13245	14702
annual change in % (real)	7.1	8.0	7.3	8.0	9.1	9.9	9.7	8.5	8
GDP/capita (USD at exchange rate)	785.7	853.0	907.1	960.5	1091.1	.	.	.	.
GDP/capita (USD at PPP - wiiw)	3717.5	4082.6	4444.3	4818.3	5344.4	.	.	.	.
Industrial value added									
annual change in % (real)	8.8	9.9	8.9	9.9	12.5	17.2 ³⁾	17.7 ³⁾	.	.
Construction output, CNY bn ⁴⁾	1115.2	1249.7	1536.1	1852.7	.	.	.	.	.
annual change in % (nominal)	10.8	12.1	22.9	20.6	.	.	.	.	.
Retail trade turnover, CNY bn	3113.4	3415.3	3759.5	4191.1	4572.5	1110.9	1283.1	.	.
annual change in % (real)	10.1	11.1	10.9	10.6	9.2	9.4	9.3	.	.
Total investment in fixed assets, CNY bn	2985.5	3291.8	3689.8	4283.9	5427.6	615.8	879.9	.	.
annual change in % (nominal)	5.1	10.3	12.1	16.1	26.7	27.8	43.0	.	.
Employment total, mn pers., end of period	713.9	720.9	730.3	737.4	744.3	.	.	.	.
annual change in %	0.9	1.0	1.3	1.0	0.9	.	.	.	.
Staff and workers, mn pers., end of period ⁵⁾	117.7	112.6	107.9	105.6	104.6 ⁶⁾	104.1	103.5	.	.
annual change in %	-4.6	-4.3	-4.2	-2.2	-0.9	-2.3	-0.5	.	.
Unemployment rate (urban) in %, end of per. ⁷⁾	3.1	3.1	3.6	4.0	4.5	4.1	4.3	4.5	4.5
Average gross annual wages, CNY ⁸⁾	8346	9371	10870	12466	12622 ⁹⁾	12701	14318	.	.
annual change in % (real) ¹⁰⁾	13.1	11.1	15.2	15.5	.	.	.	.	.
Retail prices, % p.a.	-3.0	-1.5	-0.8	-1.8	-0.1	-0.2	1.4	.	.
Consumer prices, % p.a.	-1.4	0.4	0.7	-0.8	1.2	0.5	2.8	3.5	3
General government budget, nat.def., % GDP									
Revenues	14.0	15.0	17.1	18.5	.	.	.	.	.
Expenditures	16.1	17.8	19.6	21.5	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-2.1	-2.8	-2.6	-3.1	-2.7	.	.	.	.
Refinancing rate of NB % p.a., end of per. ¹¹⁾	3.2	3.2	3.2	2.7	2.7	2.7	2.7	.	.
Current account, USD bn	15.7	20.5	17.4	35.4	45.9	.	.	.	.
Current account in % of GDP	1.6	1.9	1.5	2.9	3.3	.	.	2.1	1.6
Gross reserves of NB excl. gold, USD bn	154.7	165.6	212.2	286.4	403.3	316.0	439.8	.	.
Gross external debt, USD bn	151.8	145.7	170.1	171.7	194.0	.	.	.	.
FDI inflow, USD bn	40.3	40.7	46.9	52.8	53.3	13.5	14.1	.	.
FDI outflow, USD bn	1.8	0.9	6.9	2.9	.	.	.	.	.
Exports of goods total, USD bn ¹²⁾	194.9	249.2	266.2	325.6	438.4	86.3	115.7	.	.
annual change in %	6.1	27.8	6.8	22.3	34.6	33.5	34.1	.	.
Imports of goods total, USD bn ¹²⁾	165.8	225.1	243.6	295.3	412.8	87.3	124.1	.	.
annual change in %	18.2	35.8	8.2	21.2	39.9	52.4	42.3	.	.
Trade balance of goods, USD bn ¹²⁾	29.1	24.1	22.5	30.3	25.5	-1.0	-8.4	.	.
Average exchange rate CNY/USD	8.28	8.28	8.28	8.28	8.28	8.28	8.28	8.28	8.28
Average exchange rate CNY/EUR	8.89	7.65	7.35	7.75	9.37	8.84	10.34	.	.
Purchasing power parity CNY/USD, wiiw ¹³⁾	1.75	1.73	1.69	1.69	1.69	.	.	.	.
Purchasing power parity CNY/EUR, wiiw	1.91	1.86	1.83	1.83	1.84	.	.	.	.

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

- 1) Preliminary. - 2) Census results from 1st Nov. 2000. - 3) Enterprises with annual sales revenue above 5 million yuan only. - 4) Construction enterprises with independent accounting systems. - 5) Staff and workers (on duty) refer to persons who work in state-owned enterprises, urban collectives and foreign invested enterprises. - 6) End of September 2003. - 7) Ratio of registered urban unemployed in per cent of urban employed and unemployed. - 8) Average gross annual wages of staff and workers, defined as: total wages of staff and workers per average number of staff and workers; since 1998: "staff on duty" only. - 9) Jan-Sep 2003. - 10) Staff and workers cost of living index is used as deflator for calculating real wage. - 11) Overnight rate. - 12) According to customs statistics. - 13) Purchasing power parity, ICP-method; see Ren Ruoan, The Vienna Institute Monthly Report 1996/2.

Source: China Statistical Yearbook; International Financial Statistics; China Monthly Statistics; China Daily; Asian Development Bank (ADB, ARIC Indicators); World Investment Report 2003 (UNCTAD);.