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# China: rapid growth, but some signs of cooling down

During the first quarter of 2005, the Chinese economy continued to grow fast, at a rate of 9.4% – nearly the same as in the previous quarter and in 2004 on average, but somewhat slower than in the same period of last year (9.8%). However, the rate of growth is still well above the government's target rate of 8% for this year.

Investment in fixed assets, the major driving force of last year's growth, and output in some over-heated sectors of the economy have cooled down significantly, but private consumption has picked up and (net) foreign trade expanded faster than expected. For the rest of the year, the main trends will continue, although exports may lose momentum. We thus expect the Chinese economy to grow by about 8.5% in the whole year 2005 and to keep its pace in 2006.

Growth of fixed asset investment reached 22.8% (in nominal terms) in the first quarter of this year; this was much less than in the same period of last year (43%) and remained also below the average growth rate in 2004 (25.8%). That deceleration was a consequence of various government measures (such as credit restraints and limitation of operating licences) aimed at cooling down investment growth, which in certain sectors (e.g. real estate development, steel industry) was considered unsustainably high, but was also due to emerging over-capacities (e.g. in car production). Thus, the structure of investment has changed, too. The growth of investment slowed down, for instance, in various branches of the metal and the vehicle industries, but accelerated in so-called 'bottleneck' industries supported by the government, such as agriculture (70%), oil refining (46%), coal (80%), electricity, gas & water (44%) and railways (300%). Investment in the steel sector fell by 1.4% year-on-year, compared to an increase of 106% in the first quarter of 2004; investment in ferrous metal smelting and in non-metal mining decreased by 9% and 7.7% respectively in the first two months of this year. But investment in real estate development remained high (27%), despite government measures to restrain growth. (Credit restrictions have been tightened further and a tax on profits from house sales, if owners sell the house within two years of purchase, has been introduced.) Overall, investment growth is significantly above the official target of 16% and the danger of a rebound of investment activity and unbalanced growth is not banned yet. Thus the restrictive measures of the government will remain in place. Still, we expect investment to continue to grow at a similar pace as in the first quarter for the rest of the year.

Data on aggregate private consumption are not available for the time being, but retail sales of consumer goods (in real terms), which may be used as a proxy for private consumption, expanded by 12.1% year-on-year in the first quarter, at a similar rate as during the last few months of 2004 and significantly faster than in the first quarter of 2004. The relatively strong growth of private consumption was supported by a robust increase in personal incomes: in real terms, per capita urban incomes rose by 8.6% and per capita rural incomes increased by 11.9% year-on-year in the first quarter of 2005. With overall economic growth remaining high and continuous support of the agricultural sector, growth of personal incomes and thus of private consumption can be expected to remain high for the months to come.

Consumer price inflation reached a peak in mid-2004 and decelerated thereafter. In the first quarter of this year it stood at the same level as in the same period of last year (2.8%). The rise in producer prices has likewise decelerated, but increases are still high (5.6%) because of price hikes for many raw materials, fuels and electricity. Thus a surge in consumer prices with some delay cannot be excluded. However, retail fuel prices and prices for electricity are regulated. For the year as a whole, we expect the CPI to increase by 3%. Property prices are not included in the CPI and continued rising rapidly: real estate prices rose by 10% as compared to 7% in the last quarter of 2004; land leasing costs were up 8% on average but skyrocketed in some cities, such as in Dalian (50%), reflecting government efforts to rein in real estate development through restricting land supplies. But demand is staying high: in a recent survey, over a fifth of households in urban areas are planning to purchase a new apartment within the next few months.

Chinese exports reached USD 155.9 billion in the first quarter of 2005 while imports came up to USD 139.3 billion, resulting in a massive trade surplus of USD 16.6 billion, which is in marked contrast to the trade deficit of USD 8.4 billion in the first quarter of 2004. While exports rose at a similar pace as last year, import growth decelerated sharply to 12.2% as compared to 42.3% in the first quarter of 2004. Exports increased strongly in all main sectors such as electronic products, machinery, textiles, clothing and shoes. A very strong acceleration of exports could be observed in steel and steel products (220%), with world market prices higher than domestic prices. However, for the reason of saving energy and to avoid supply bottlenecks on the domestic market, the Chinese government intends to curb exports of these product categories to a certain extent: thus, it reduced export tax rebates in April and introduced a ban on iron and steel processing trade in May. By the latter measure, processors in China will be prohibited from making goods for overseas clients with imported iron ore, pig iron, steel, steel scraps, etc. provided by these customers (for similar reasons, rare earth and phosphorite processing trade will be banned as well).

Textiles & clothing exporters have benefited from the global removal of T&C quotas among the World Trade Organization (WTO) members as of 1 January 2005. While overall Chinese textiles and clothing exports increased only 16% during the first three months of the year, exports to the USA and the European Union rose much faster and in certain product groups, export growth reached 2-digit and even 3-digit rates (e.g. T-shirts, cotton trousers, underwear). As a consequence, the US and the EU resorted to the special safeguard measures provided for in China's Accession Treaty to the WTO, to restrict imports from China of these particular product groups. However, in June, an agreement between the EU and China was reached in this matter, restricting the export growth of 10 T&C categories (e.g. pullovers, cotton fabrics, T-shirts, flax yarn) to a range between 8% and 12.5% for the years 2005 to 2007. No such agreement has so far been reached between the USA and China. Instead, the US has unilaterally imposed new quotas on certain Chinese-made garments including cotton trousers, cotton & knitwear shirts and synthetic fibres underwear, to restrict import growth to 7.5% per year.

Likewise, with regard to shoes, all quotas on Chinese trade were eliminated by the end of 2004, in accordance with China's WTO Treaty. In response to the resulting surge in shoe exports to the European Union, the EU Commission announced an anti-dumping investigation only days after negotiating an end to the trade dispute with China over textiles. These cases and other examples in the past illustrate that trade conflicts may become a decisive factor in the future development of Chinese exports.

The low import growth in the first quarter mainly reflects the cooling down of investment and increased domestic production capacities in certain sectors. Machinery imports rose only by 5% year-on-year; imports of oil, steel, steel products, copper and cars showed even negative growth rates. In certain cases, the introduction of licensing regimes, e.g. for iron ore, curbed imports. Moreover, extended refining capacities allowed for a substitution of less expensive raw oil for higher-priced oil derivatives, depressing imports in value terms. However, imports for export processing continued to rise by nearly 20%, pointing to a further expansion of exports in the near future, although probably at a lower rate than in the first quarter. A slowing down of Chinese exports is also supported by forecasts, e.g. of the International Monetary Fund, of slower growth of the world economy in 2005 (4.3%) than in 2004 (5.1%) and in particular of world trade (7.4% in 2005 vs. 9.9% in 2004).

Foreign direct investment (FDI) reached an impressive USD 13.4 billion in the first quarter, but was only slightly higher than in the same period a year earlier. In April and May, the inflow of foreign direct investment even fell year-on-year. This is probably linked to the cooling-down of the economy, mounting risks with regard to possible trade conflicts, uncertainties about the future exchange rate policy and the pending tax reform, which is expected to raise corporate tax rates for foreign enterprises which have so far been privileged as compared to domestic enterprises. A certain saturation of manufacturing investment and greater imponderabilities when it comes to investments in other sectors of the economy may play a certain role as well. In any case, contracted investment, a kind of forward indicator for actual investment, slowed down in the first quarter as well. For the year as a whole, we thus expect FDI inflows to be lower than last year, probably reaching USD 55 billion.

Due to the high trade surplus and supported by the considerable net inflow of FDI, China's foreign reserves increased to USD 659.1 billion, 50% up from the same period last year, and worth more than a year's imports.

On the fiscal front, the government will follow a 'prudent' fiscal policy, including a further reduction of the (central) government's deficit and a reduction of the amount of special government bonds, issued to support infrastructure investment, from last year's yuan 110 billion to yuan 80 billion. Monetary policy will remain tight, with the growth target for money supply and credit expansion set at 14% and 15% respectively.

Regarding the supply side of the economy, the industrial sector remained the fastest growing sector in China, expanding at a rate of 11.1%, followed by the services sector with 7.7% and the agricultural sector and other primary industries with 4.6%. This growth pattern is very similar to that over the year 2004.

Industrial output on average expanded at a slightly lower pace than in the same period last year, but the development differed greatly in the various industries: Basically, the production of raw materials and investment-driven industries expanded very fast. Prominent examples are the extraction of coal, iron ore and oil. In manufacturing, important examples are steel and steel products (20%), aluminium (22%), and electrical power generation equipment (30%). The production of electronic equipment (19%) and of textiles & clothing was fuelled by exports. However, production of the car industry, which was among the fast growing industries in the first quarter of last year, declined by 2.8%, due to a supply glut. For the rest of the year, we may expect the ongoing trade conflicts and re-introduction of quantitative trade restrictions to affect the textiles, clothing and shoe industry negatively.

The massive trade surplus and the corresponding explosion of the bilateral trade deficit of the EU and the USA with China, have revived the debate on a revaluation of the Chinese currency. But the stance of the Chinese government has remained the same: stepwise liberalization of the capital account and a reform of the banking sector as preconditions for a more flexible exchange rate. In both regards, certain steps have been taken: In April, the government approved a USD 15 billion capital injection to the state-owned Industrial and Commercial Bank of China (ICBC), following the capital injections at the end of 2003 to the Bank of China (BOC) and the China Construction Bank (CCB). (Out of the four large state-owned banks, the Agricultural Bank of China will thus be the last one to receive a capital injection from the government.) But, it has turned out to be difficult to find strategic foreign investors for these banks as the shares that can be acquired are restricted to 19.9%, and taking into account the recent disclosures of fraud and corruption at several big Chinese banks. However, in June, the Bank of America bought a 9% stake (worth USD 3 billion) in the China Construction Bank, thus becoming the biggest foreign investor in the Chinese banking sector so far.

To further liberalize capital outflows, the monetary authorities began to allow portfolio investments, e.g. for Chinese insurance companies, abroad. Also, increasing amounts of money may be transferred abroad for direct investments, as part of the government's 'going out' policy. Chinese outward FDI is still small, reaching USD 3.6 billion as compared to FDI inflows of USD 60.6 billion in 2004, but it is on the rise. However, the increase in 2004 was mainly due to the acquisition of the IBM notebook section by Lenovo, worth USD 1.8 billion. A large proportion of Chinese acquisitions are in the field of mining but they recently also include medium-sized enterprises in advanced industrial countries, to get access to technology and established brand names. From a geographic perspective, the focus is on Latin America and Asia. Europe's share (mainly Germany and Russia) was less than 10%.

In sum, we expect the Chinese economy to grow slightly more slowly in 2005 than it did the year before, with investment growth lagging significantly behind last year's pace and private consumption remaining strong for the rest of the year. Net foreign trade will lose momentum and foreign direct investment will probably reach the same amount as in 2004. Industrial production will slow down in certain sectors, but remain strong in others. Inflation is expected to stay below last year's level, despite a possible acceleration during the rest of the year. Unemployment will remain high and may even increase if labour-intensive industries were to suffer to a greater extent from trade conflicts and trade restrictions.

Table CN

## China: Selected Economic Indicators

| | 2000 | 2001 | 2002 | 2003 | 2004 [1] | 2004 | 2005 [1] | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | 1st quarter | | forecast | |
| Population, mn pers., end of period [2] | 1265.8 | 1277.3 | 1286.0 | 1292.0 | 1299.9 | . | . | . | . |
| Gross domestic product, CNY bn, nom. | 8940.4 | 9593.3 | 10239.8 | 11669.4 | 13651.5 | 2710.6 | 3140.0 | 15330 | . |
| annual change in % (real) | 8.0 | 7.3 | 8.0 | 9.1 | 9.5 | 9.8 | 9.5 | 8.5 | 8.5 |
| GDP/capita (USD at exchange rate) | 853.0 | 907.1 | 960.5 | 1091.1 | 1268.3 | . | . | . | . |
| GDP/capita (USD at PPP - wiiw) | 4082.6 | 4444.3 | 4818.3 | 5344.4 | 6105.8 | . | . | . | . |
| Industrial value added | | | | | | | | | |
| annual change in % (real) | 9.9 | 8.9 | 9.9 | 12.5 | 11.1 | 11.6 | 11.0 | 11 | . |
| Construction output, CNY bn [3] | 1249.7 | 1536.1 | 1852.7 | 2308.3 | . | . | . | . | . |
| annual change in % (nominal) | 12.1 | 22.9 | 20.6 | . | . | . | . | . | . |
| Retail trade turnover, CNY bn | 3415.3 | 3759.5 | 4191.1 | 4572.5 | 5395.0 | 1283.1 | 1414.0 | . | . |
| annual change in % (real) | 11.1 | 10.9 | 10.6 | 9.2 | 10.5 | 9.3 | 12.0 | . | . |
| Total investment in fixed assets, CNY bn | 3291.8 | 3689.8 | 4283.9 | 5427.6 | 7007.3 | 879.9 | 1080.5 | . | . |
| annual change in % (nominal) | 10.3 | 12.1 | 16.1 | 26.7 | 25.8 | 43.0 | 22.8 | . | . |
| Employment total, mn pers., end of period | 720.9 | 730.3 | 737.4 | 744.3 | . | . | . | . | . |
| annual change in % | 1.0 | 1.3 | 1.0 | 0.9 | . | . | . | . | . |
| Staff and workers, mn pers., end of period [4] | 112.6 | 107.9 | 105.6 | 104.6 [5] | 104.5 [5] | 103.5 | . | . | . |
| annual change in % | -4.3 | -4.2 | -2.2 | -0.9 | -0.1 | -0.5 | . | . | . |
| Unemployment rate (urban) in %,end of per. [6] | 3.1 | 3.6 | 4.0 | 4.5 | 4.2 | 4.3 | . | 4.4 | . |
| Average gross annual wages, CNY [7] | 9371 | 10870 | 12466 | 14052 | 14453 | 14318 | . | . | . |
| annual change in % (real) [8] | 11.1 | 15.2 | 15.5 | 11.5 | 10.4 | . | . | . | . |
| Retail prices, % p.a. | -1.5 | -0.8 | -1.8 | -0.1 | 2.8 | 1.4 | 1.8 | . | . |
| Consumer prices, % p.a. | 0.4 | 0.7 | -0.8 | 1.2 | 3.9 | 2.8 | 2.8 | 3.0 | 3.0 |
| General government budget, nat.def., % GDP | | | | | | | | | |
| Revenues | 15.0 | 17.1 | 18.5 | 18.6 | 19.3 | . | . | . | . |
| Expenditures | 17.8 | 19.6 | 21.5 | 21.1 | 20.8 | . | . | . | . |
| Deficit (-) / surplus (+), % GDP | -2.8 | -2.6 | -3.1 | -2.5 | -1.5 | . | . | . | . |
| Refinancing rate of NB % p.a., end of per. [9] | 3.2 | 3.2 | 2.7 | 2.7 | 2.9 | 2.7 | 2.9 | . | . |
| Current account, USD bn | 20.5 | 17.4 | 35.4 | 45.9 | 70.0 | . | . | 54 | . |
| Current account in % of GDP | 1.9 | 1.5 | 2.9 | 3.3 | 4.2 | . | . | 3.0 | 2.8 |
| Gross reserves of NB excl. gold, USD bn | 165.6 | 212.2 | 286.4 | 403.3 | 609.9 | 439.8 | 659.1 | . | . |
| Gross external debt, USD bn | 145.7 | 170.1 | 171.7 | 194.0 | 228.6 | 200.2 | 233.4 | . | . |
| FDI inflow, USD bn | 40.7 | 46.9 | 52.8 | 53.3 | 60.6 | 12.2 | 13.4 | 60 | . |
| FDI outflow, USD bn | 0.9 | 6.9 | 2.9 | 2.8 | 3.6 | . | . | . | . |
| Exports of goods total, USD bn [10] | 249.2 | 266.2 | 325.6 | 438.4 | 593.4 | 115.7 | 155.9 | . | . |
| annual change in % | 27.8 | 6.8 | 22.3 | 34.6 | 35.4 | 34.1 | 35.0 | . | . |
| Imports of goods total, USD bn [10] | 225.1 | 243.6 | 295.3 | 412.8 | 561.3 | 124.1 | 139.3 | . | . |
| annual change in % | 35.8 | 8.2 | 21.2 | 39.9 | 36.0 | 42.3 | 12.0 | . | . |
| Trade balance of goods, USD bn [10] | 24.1 | 22.5 | 30.3 | 25.5 | 32.0 | -8.4 | 16.6 | 30 | . |
| Average exchange rate CNY/USD | 8.28 | 8.28 | 8.28 | 8.28 | 8.28 | 8.28 | 8.28 | 8.28 | . |
| Average exchange rate CNY/EUR | 7.65 | 7.35 | 7.75 | 9.37 | 11.28 | 10.34 | . | . | . |
| Purchasing power parity CNY/USD, wiiw [11] | 1.73 | 1.69 | 1.69 | 1.69 | 1.72 | . | . | . | . |
| Purchasing power parity CNY/EUR, wiiw | 1.86 | 1.83 | 1.83 | 1.84 | 1.98 | . | . | . | . |

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

1) Preliminary. - 2) From 2000 according to census November 2000. - 3) Construction enterprises with independent accounting systems. - 4) Staff and workers (on duty) refer to persons who work in state-owned enterprises, urban collectives and foreign invested enterprises. - 5) End of September. - 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 per average number of staff and workers; "staff 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; International Financial Statistics; China Monthly Statistics; China Daily; Asian Development Bank (ADB, ARIC Indicators); World Investment Report 2003 (UNCTAD);