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China: travelling down a bumpy road

In January 2009, the Chinese statistical authorities revised the GDP figures for 2007 upwards from 11.9% to 13%. Two weeks later, they announced that year-on-year growth in the fourth quarter of 2008 was only 6.8%, thus dragging GDP growth for the whole year down to 9%: the first single-digit rate of growth in China since 2002. A cooling down of the overheated economy, something that had initially been considered desirable, evolved into a 'hard landing'. The fact that the slowdown was faster than expected was attributable to waning foreign demand as the global economic crisis took a turn for the worse, triggering a significant slowdown in industrial production and related services. In an endeavour to check the downward trend, the government adopted a EUR 400 billion stimulus package at the end of the year, together with a broad swathe of other measures to support the economy.

The received wisdom is that exports will remain sluggish and may even deteriorate more, especially in the first half of 2009, while government policies will only have a significant positive impact on consumption and investment later in the year. It is thus assumed that GDP in 2009 will grow more rapidly than in the fourth quarter of 2008, but significantly less than in 2008 as whole; it will attain a rate of about 7%, a figure that is considered to be on the high side. As a matter of fact, given the deterioration of various economic indicators over the past few months, many forecasters have significantly reduced their growth projection figures for China in 2009. Estimates currently range between 5% (Roubini Global Economics Monitor), 5.5% (Morgan Stanley), 6.7% (International Monetary Fund) and 8% (Chinese government), 8.2% (Asian Development Bank) and 8.3% (Chinese Academy of Social Sciences)¹

In 2010, we expect the Chinese economy to pick up again and the growth rate to reach 8%, provided the global economy recovers somewhat and exports rebound. However, growth in 2011 is expected to remain below pre-crisis levels, probably approaching 8.2%, since the capacity and willingness of the United States and Europe to absorb Chinese imports may still remain below previous levels.

In recent years, China's exports of goods ranged close to 30% of GDP: a very high export share for a country the size of China. However, more than half of the country's exports can be classified as 'processing trade', major components of which are imported; hence, the value-added of exports and

¹ Generally, growth forecasts of investment banks range between 7% and 8% (Bank of Finland, *BOFIT Weekly*, 30 January 2009).

the contribution of net exports to GDP is markedly less.² That notwithstanding, in recent years, the swift expansion of net exports (2007: 30%) has contributed significantly to GDP growth, something that will not occur this year – nor probably in the next two years either. Export and import growth remained high throughout the first nine months of 2008, only to collapse at the end of the year. In November and December 2008, both exports and imports contracted year-on-year. This was a reflection of the ever broader and deeper global financial and economic crisis, making it increasingly difficult for China to offset the weakening demand among its traditional trading partners, in particular the USA, by adopting an aggressive approach to tapping new markets in Asia, Africa and Latin America³. We expect the grim situation to continue throughout the first three quarters of 2009 with only a slight improvement in the fourth quarter of the year. This will lead to a decline in Chinese exports and imports (in US dollar terms) of the order of 3-5% over the year as a whole. Starting from a much higher level of exports than imports, this development will yield yet again a high trade surplus of about USD 280 billion (EUR 212 billion) and a corresponding current account surplus in 2009 – although lower than in 2008. In 2010 and 2011, export growth is expected to pick up once again, should the global crisis have come to an end by that time.

Over and above the direct effect on final demand, the export slowdown has had a disproportionately negative impact on employment and hence on private consumption, as labour-intensive products account for a higher share in exports than in manufacturing as a whole. Furthermore, it also has a significant impact on both upstream (suppliers) and downstream activities (such as transport services), a trend that is already quite noticeable. Viewed from a longer term perspective, the export slowdown will also curb investment, including foreign direct investment, in those sectors.

With a share of more than 40% in GDP, investment has been the major driver of economic growth over the past few years in China. Unfortunately, the official demand-side data for 2008 have not been released yet. Drawing on those indicators available, however, we can hazard a guess that domestic investment activity still ran high, with total investment in fixed assets rising 25% in nominal terms and 17% in real terms. However, a certain slowdown was to be observed towards the end of the year. Shrinking profits and overcapacities in manufacturing and real estate, as well as a deterioration of the business climate and confidence indices, all point to things getting worse in 2009. Based on the data available (equity investment in the non-financial sector only)⁴, foreign direct investment increased substantially over the first three quarters of 2008, but dropped in the final quarter compared to the same period in the previous year; it reached EUR 62.3 billion (USD 92.4 billion) for the whole year. This decline will continue in 2009, should the general

² In 2007, when net exports (exports of goods and services minus imports of goods and services) reached a record height, their share in GDP was 9% (2006:7.5%).

³ Over the first 10 months of 2008, Chinese exports to India, for instance, rose by 35%, those to Indonesia by 40%, to Iraq by 84%, to Brazil by 75% and to Angola by 134% (China Monthly Statistics, 12/2008).

⁴ Net FDI inflows as reported in the balance of payments statistics also include reinvestments and loans from parent companies, which in 2007 seem to have included a considerable amount of speculative money, in expectation of a revaluation of the yuan versus the US dollar; they are therefore not comparable to other years.

downward trend in FDI persist on account of the heightened degree of uncertainty and financial restraint.

Retail trade turnover as a proxy for private consumption recorded high and steady growth throughout the year, reaching 15.7% (in real terms) on average. Consumption was supported by a marked rise (11%) in per capita incomes in rural households owing to sky-high prices for agricultural products in the first half of 2008. Since then food prices have dropped to the detriment of farmers, but to the benefit of urban consumers. However, given the rural households' relatively low incomes and thus their greater propensity to consume, the combined effect on consumption will be negative. More importantly, however, unemployment is rising rapidly and may have a significant negative impact on private consumption in the months to come. Official estimates claim that 20 million migrant workers (15% of the total) are currently out of work and a recent study by the Chinese Academy of Social Sciences (CASS) estimates that unemployment overall reached almost 10% at the end of 2008.⁵ Wage levels have also started to drop recently.

The rise in unemployment is a consequence of thousands of manufacturing enterprises, in the main producing low-skill labour-intensive goods for export such as clothing, shoes, toys and sports equipment having had to close down for want of demand, while other enterprises are growing more slowly than before. The growth rate of industrial value-added dropped from 14.7% in 2007 to 9.3% in 2008. Service industries also slowed down: from 13.8% to 9.5%. However, the pronounced slow growth in manufacturing (a mere 5-6%) over the final months of 2008 was also due to a massive destocking of material, a process that may have since come to an end. Only agricultural value-added expanded significantly, partly as a result of a record grain harvest, but probably also as a result of the positive impact that government policies in support of the rural population are having. Agriculture may offer some opportunities for the jobless migrant workers as they return home in the hope of earning some income.

In the first half of 2008, government policies had been aimed at curbing excessive demand and inflation. However, from August onwards, monetary policy took an expansive turn and interest rates were lowered five times. Those moves were matched by a significant relaxation of reserve requirements and a stop being put to the creeping revaluation of the yuan versus the US dollar. In November, in the light of the deteriorating global economic outlook and the rapid deceleration of the Chinese economy, the government announced a massive 'stimulus package'. This package will provide additional funds of the order of yuan 4000 billion (EUR 416 billion) over the next two years (equivalent to some 7% of GDP per annum). The funds will be spent mainly on infrastructure and the national health and education systems, as well as on supporting industries such as the automotive and steel industries, which have suffered bitterly on account of the crisis. Of that sum, however, only yuan 1180 billion (EUR 123 billion) will come from the central government; the rest will be put up by local governments, state-owned enterprises and banks. Central government spending thus accounts for 2% of GDP per annum, significantly less than the support the government lent during the Asian

⁵ See Bank of Finland, *BOFIT Weekly*, 6 February 2009. Registered unemployment in the cities, which is only the tip of the iceberg only, increased from 4.0% to 4.2% in 2008; it is expected to rise to 4.4% in 2009.

financial crisis in 1998/99. Moreover, these measures will take some time before they bite. A wide range of additional measures designed to stimulate the economy or certain parts thereof in a more direct manner have been adopted. They include increasing VAT refunds for exporters, the government instructing banks to extend loans to small and medium private enterprises, lowering thresholds on mortgage loans for private households, reducing transaction fees associated with purchases of apartments, cutting the sales tax on cars, distributing vouchers to residents, students and senior citizens on low incomes in certain cities and granting direct subsidies to farming families for the purchase of domestic appliances.

Beyond any doubt, the future development of the Chinese economy will hinge on two factors: (i) the degree to which the problems confronting exporters will have an impact on investment and consumption; and (ii) the effectiveness of government support.

Table CN

China: Selected Economic Indicators

	2003	2004	2005	2006	2007	2008 ¹⁾	2009	2010 Forecast	2011 Forecast
Population, mn pers., end of period	1292.3	1299.9	1307.6	1314.5	1321.3	1328	.	.	.
Gross domestic product, CNY bn, nom.	13582.3	15987.8	18321.7	21192.4	25700.0	30067.0	32800	36100	40000
annual change in % (real)	10.0	10.1	10.4	11.6	13.0	9.0	7	8	8.2
GDP/capita (EUR at exchange rate)	1100	1100	1400	1600	1900	2200	.	.	.
GDP/capita (EUR at PPP - wiiw)	2700	3000	3400	3900	4500	4900	.	.	.
Retail trade turnover, CNY bn	5251.6	5950.1	6717.7	7641.0	8921.0	10848.8	.	.	.
annual change in % (real)	9.2	13.3	12.9	13.8	13.0	15.7	.	.	.
Total investment in fixed assets, CNY bn	5556.7	7047.7	8877.4	10999.8	13723.9	17229.1	.	.	.
annual change in % (nominal)	27.7	26.8	26.0	23.9	24.8	25.4	.	.	.
Industrial value added									
annual change in % (real)	12.8	11.5	11.6	12.9	13.5	9.3	.	.	.
Agricultural value added									
annual change in % (real)	2.5	6.3	5.2	5.0	3.7	5.5	.	.	.
Construction value added									
annual change in % (real)	12.1	8.1	12.6	13.7	12.6	.	.	.	.
Employment total -reg., mn, end of period	744.3	752.0	758.3	764.0	769.9	.	.	.	.
annual change in %	0.9	1.0	0.8	0.8	0.8	.	.	.	.
Staff and workers, mn, end of period ²⁾	104.9	105.8	108.5	111.6	114.3	114.6	.	.	.
annual change in %	-0.7	0.8	2.6	2.9	2.4	2.6	.	.	.
Reg. unemploym.rate (urban), in %, end of per. ³⁾	4.3	4.2	4.2	4.1	4.0	4.2	4.4	4.3	4.2
Average gross annual wages, CNY ⁴⁾	14040	16024	18364	21001	25932	26265	.	.	.
annual change in % (real) ⁵⁾	12.0	10.5	12.8	12.7	13.6	11.0	.	.	.
Consumer prices, % p.a.	1.2	3.9	1.8	1.5	4.8	5.9	2	2	2.5
Producer prices in industry, % p.a.	2.3	6.1	4.9	3.0	3.1	6.9	.	.	.
General government budget, nat.def., % GDP									
Revenues	16.0	16.5	17.3	18.3	20.0	20.4	.	.	.
Expenditures	18.1	17.8	18.5	19.1	19.4	20.8	.	.	.
Deficit (-) / surplus (+)	-2.2	-1.3	-1.2	-0.8	0.6	-0.4	.	.	.
Base rate of NB % p.a., end of period ⁶⁾	2.7	3.3	3.3	3.3	3.3	4.1	.	.	.
Current account, EUR bn	40.6	51.4	128.8	198.8	271.4	270	230	260	260
Current account in % of GDP	2.8	3.6	7.2	9.4	11.0	9.3	6.2	6.6	6.1
Exports of goods total, EUR bn ⁷⁾	387.3	435.5	609.3	771.0	888.9	963.2	.	.	.
annual change in %	11.4	12.5	39.9	26.5	15.3	8.4	.	.	.
Imports of goods total, EUR bn ⁷⁾	364.8	411.9	527.8	629.7	697.8	764.5	.	.	.
annual change in %	15.8	12.9	28.1	19.3	10.8	9.6	.	.	.
Trade balance of goods, EUR bn ⁷⁾	22.5	23.6	81.6	141.2	191.1	198.7	.	.	.
Exports of services, BOP, EUR mn	41.3	45.8	59.5	73.2	89.2	.	.	.	.
annual growth rate in %	-2.7	11.0	29.8	23.0	21.9	.	.	.	.
Imports of services, BOP, EUR mn	48.9	52.9	67.0	80.2	95.0	.	.	.	.
annual growth rate in %	-1.6	8.3	26.6	19.7	18.4	.	.	.	.
FDI inflow, EUR bn ⁸⁾	41.6	40.3	63.3	62.1	101.0	62.3	60	.	.
FDI outflow, EUR bn ⁸⁾	-0.1	1.3	9.0	16.8	12.4	.	.	.	.
Gross reserves of NB excl. gold, EUR bn	319.3	447.7	694.2	810.0	1038.2	1385.3	.	.	.
Gross external debt, EUR bn	153.3	167.8	238.2	245.4	373.0	.	.	.	.
Gross external debt in % of GDP	11.8	11.8	12.6	12.1	11.1	.	.	.	.
Average exchange rate CNY/USD	8.277	8.277	8.206	7.972	7.604	6.958	6.8	6.8	7.0
Average exchange rate CNY/EUR	9.366	11.276	10.261	10.019	10.418	10.315	9.0	9.0	9.5
Purchasing power parity CNY/USD, wiiw ⁹⁾	3.304	3.433	3.45	3.465	3.621	3.783	.	.	.
Purchasing power parity CNY/EUR, wiiw ⁹⁾	3.909	4.077	4.120	4.159	4.357	4.654	.	.	.

Note: CNY: ISO code for the Chinese yuan.

1) Preliminary and wiiw estimates. - 2) Staff and workers (on duty) refer to persons who work in state-owned enterprises, urban collectives, shareholding ownership and foreign invested enterprises. - 3) Ratio of registered urban unemployed in per cent of urban employed and unemployed. - 4) 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. - 5) Staff and workers cost of living index is used as deflator for calculating real wage. For 2008 the consumer price index was used as a deflator. - 6) Overnight rate, 2008: September. - 7) According to customs statistics. - 8) Net investments drawn from the Chinese balance of payments. 2008 data and 2009 estimates are gross equity investments in the non-financial sector as given by the Chinese Ministry of Commerce. - 9) wiiw estimates based on the 2005 International Comparison Project benchmark (Worldbank).

Source: National statistics (National Bureau of Statistics, Central Bank, China Daily etc). Forecasts by wiiw.