China on the way to an economic superpower

1. Past economic developments

- Driven by market-oriented reforms, China's growth performance over the last 25 years has been very impressive. Compared to India the Chinese economy has performed much better. Real GDP rose by an average of 9.5 % a year in this period. As in the case of Japan and Korea, China's economic success story is primarily export-based, with double-digit export growth rates the norm. The reliability of Chinese statistics has improved, but they still overstate growth. Nevertheless, the standard of living in China has improved considerably in the last two decades. A growing middle class with significant purchasing power has emerged.

- The economic liberalization and reforms did not follow a straight path but were interrupted from time to time by periods of consolidation – as for instance, in the late 1980s. Chinese economic policy follows a pragmatic and cautious path (two steps forward and one step back). However, the economic reforms have increased the disparity between the prosperous coastal regions...
and the agricultural hinterland. Restructuring of the inefficient state-owned enterprises has driven up unemployment in recent years and hidden unemployment is extremely high. The number of unemployed is rising steadily; roughly 150 million of the workforce are estimated to be effectively unemployed. Hence, the most important challenge for the government is how to cushion the transformation in a socially balanced and acceptable way.

- The Chinese economy survived the Asian financial crisis without any substantial damage. Restrictive foreign exchange and capital controls helped China to isolate itself from external shock. Moreover, China acted as a stabilizing factor for the whole Asian region by not devaluing its currency. In this regard, the Chinese government earned substantial international respect.
- Basically WTO membership since 2001 put China under pressure to proceed with reforms. The government has already reduced import tariffs and has committed itself to removing non-tariff barriers in the banking and insurance sector by 2007. The fulfillment of WTO commitments poses a major challenge. However, if the government deems the pressure to be unacceptable it tends to decelerate reforms even if this breaches settlements laid down in the WTO agreements (capital requirements for subsidiaries and branches of foreign banks)

2. Factors behind the economic dynamism

- China has one of the highest savings rates in the world. The gross domestic savings rate is about 40 % of GDP. The high capital formation allows for rapid expansion of production capacities. On the negative side, high savings countries are particularly susceptible to speculative bubbles, as Japan and the Asian crisis illustrated.
- The dynamism reflects low wages, high international competitiveness and, therefore, a thriving export industry. Only a part of the Chinese workforce is integrated in the market-oriented economy. The substantial rest is employed in SOEs and the agricultural sector. The agricultural sector in particular continues to offer industry a vast pool of potential labor. The ample labor supply will prevent high wage increases, ensuring that China remains a “low wage country”.
- Due to migration workers’ remittance (employed in coastal regions) the purchasing power of the rural population is growing. Moreover, companies are relocating production, for which mainly low-skilled labor is required, to the hinterland. As a result, economic dynamism is gradually spreading to interior provinces.
- China has meanwhile replaced the USA as the world’s largest recipient of FDI. In view of WTO membership, even higher inflows of equity capital from abroad are likely in the future. However, a substantial part of the equity capital inflow is in fact domestic investment. The entrepreneurial sector shifts capital abroad and reimports it in order to make use of tax rebates granted by the government.

3. Strong external position

- The trade and current account have posted large surpluses in recent years. The capital account is dominated by large inflows of foreign direct investment. In addition, there have also
been substantial capital outflows; in view of the unfavorable investment backdrop on the domestic market Chinese investors looked abroad for higher returns on their capital, particularly in Hong Kong. On balance China’s foreign exchange reserves have risen dramatically. The central bank recently transferred foreign currency assets to the tune of US$ 45bn to two state-owned banks to enhance their books. Nonetheless, reserves currently amount to US$ 380 billion (after Japan this is the highest stock of foreign currency in the world). In general the external debt and liquidity situation is favorable by international standards and the risk that the country will be beleaguered by financial crises is low.

• Despite its large domestic market China is closely integrated into the world economy. Its share of world trade climbed from 3% in 1998 to over 6% in 2003. Exports make up more than 25% of GDP. However, this ratio overstates the role of the external sector as the valued added of this sector is relatively low. Many of China’s export-oriented units act as an assembly or processing arm of international companies whereby the goods to be processed are imported. That is why exports and imports have been moving in parallel, bloating foreign trade.

Exports as % of GDP

![Exports as % of GDP Graph](image-url)
4. Will the renminbi become an international currency?

- Much has been said about China’s currency over the past few months. Debates on revaluation of the renminbi rumble on. We do not see any change in China’s exchange rate policy in the near term. However, it is likely that China will move to a more flexible exchange rate system in the medium term in view of the pending liberalization of capital markets under WTO commitments. If the government abolishes foreign exchange and capital controls a flexible exchange rate is an absolute necessity, firstly because the country needs some isolation against external shocks, and, secondly, to contain capital flight. But the Chinese government has so far failed to react, not wishing to jeopardize booming exports and put related jobs at risk. We believe that a first step towards this end will be a widening of the currency band in the course of next year. Later, the US-dollar would then be replaced as anchor currency by a currency basket, which would also contain the euro and the yen.

- China’s share in world GDP and exports will increase further and the renminbi will become a fully convertible currency in the longer term. Those are the preconditions for the renminbi to gain a strong role as an international currency. We expect this to happen during the next two decades.

5. Medium-term risks ahead

In our view, there are some difficult issues which could pose a significant threat to China’s macro-economic stability and long-term growth prospects. Much depends on how the government manages the fiscal position.

5.1. Banking sector, pension fund and public debt

- The banking sector faces a serious challenge under the WTO. China is required to open up the domestic banking sector to foreign competition within four years. The restructuring of China’s ailing banking sector is a very critical issue. The four big state commercial banks continue to
dominate the Chinese banking sector. They manage almost 90% of total bank assets while state-owned enterprises account for 80% of outstanding loans. In the past there has been a steady deterioration of asset quality and banks have accumulated a huge amount of non-performing loans. In 1998 they transferred NPLs to state-owned asset management companies. The amount involved equaled 10% of total assets of the banking system. Total NPLs (excluding loans transferred to Asset Management Companies) are estimated at 30% of total loans at the end of 2002.

• However, thanks to the high level of household savings and depositors’ continued confidence in the government’s commitment to support the banking system, the big banks are not illiquid. Moreover, banks are unlikely to be confronted with sudden deposit withdrawals due to limited alternative investment opportunities and capital controls. However, the cost to the state of cleaning up banks’ balance sheets and recapitalizing financial institutions is likely to be substantial in future and will place an additional strain on the budget. Non-performing loans therefore reflect the misallocation of resources, placing a drag on growth. Assuming that the recovery rates could cover the new NPLs we estimate that the one-off cost could be 35% of 2003 GDP.

• The government has to conduct a pension reform during the coming years. In the past pensions were paid directly by state-owned firms. In order to push corporate reform forward the government intends to exonerate firms from providing social services to employees. Given unfavorable business conditions, many firms are unable to fulfil these obligations anyway. As a consequence the state and above all the central government will have to provide pension payments in future.

**Budget deficit**

*(% of GDP)*

![Budget deficit graph](image-url)
- Fiscal policy remains accommodative. Public spending (infrastructure investment) has been providing the strongest stimulus to economic growth for years. Government will continue to pump money into the system to maintain planned growth at 7%. With 3% of GDP China's budget deficit does not look particularly high. However, there are many extra-budgetary items which have to be included. If the costs of bank restructuring are equally distributed over 10 years, this alone will add an additional burden of 3.5% of GDP yearly. Public debt remains relatively low at an estimated 25% of GDP. If we add contingent liabilities like clean-up costs for banks' balance sheets (35% of GDP) and unfunded pension liabilities (rough estimate of 30% of GDP) public debt would rise to 80-100% and the budget deficit to 10% of GDP. But a deficit on this scale need not necessarily flag up financial stress – it needs to be seen in the context of the high savings of the country in question. For years Japan has been recording high budget deficits against a backdrop of even higher public debt.

5.2. Growth of money supply accelerated

- The main monetary indicator for China is M2. This grew by 21% (year-on-year) in second and third quarter of 2003, up from 17% in December 2002 and exceeding the official target of 18% for this year. The growth of M2 was 13% higher than the sum of GDP growth and inflation. Part of the expansion has resulted from the strong surge in foreign exchange reserves. Bank lending has also been very aggressive; in the first nine months of last year, bank loans exceeded total lending for the whole of 2002.

### Money aggregates

(%, q-o-q, moving 4-quarter average)

- In the past, the targeted expansion in the money supply far surpassed nominal GDP growth. China enjoys a high savings rate and Chinese households prefer to keep savings as bank deposits. These deposits, the bulk of M2, increased rapidly in the past. Hence, the velocity of money circulation declines over time. The past development suggests that China needs 2%
money growth for 1% GDP growth on average. To this extent, strong money supply growth in China is compatible with stable prices.

Thus we do not expect strong inflationary pressure in the years to come. Inflation should remain at the single digit level. The central bank has already started tightening monetary policy by raising the reserve ratio from 6% to 7% in September last year.

5.3. Threat of a property bubble?

China’s real-estate market is booming in urban areas. High investment in the construction sector by international standards. Lending to real estate industry makes up 17% of total loans. Property developers’ investment in housing projects comes mostly from bank loans.
• Demand is fuelled by investors speculating on a steep rise in property prices. Too much supply is now flooding onto the market, home sales in China grew by 40 % in the first seven months this year. However, demand for living space in the world’s most populous country is very high as household income in the cities increases steadily.
• Residential property prices in the high segment have risen by 30 to 40 % in the past two years, especially in Shanghai and Beijing. Bubbles exist at the high end of the market, especially in the luxury home segment. Supply of commercial estate has also grown rapidly and in some places, like in Beijing, vacancy rates have increased substantially.
• All in all, it can be said that the property market is overheated in some major cities. However, as the bulk of the country is unaffected, it is not correct to speak of a property bubble in China as a whole. Moreover, as the government has already started to counter this development, we think a soft landing is possible. However, a property collapse would have major repercussions on the banking sector.

6. China snapping at the heels of industrial countries
• On balance, many factors point to healthy economic growth in China. Besides input-driven growth (participation of greater share of the population in the division of labor), increasing productivity should also support economic growth. Positive is also the fact that the private sector is steadily increasing its share of industrial output at the expense of state-owned enterprises (SOEs).
• The export sector is benefiting from WTO entry and its dynamism attracts large and growing inflows of FDI. Increasing external competitiveness provides a favorable outlook for China’s export industries. China’s share of world trade should climb further in the coming years, making it the third largest trading nation of the world after the USA and Germany. In view of the rapidly growing income of the urban population, private consumption will contribute more to economic growth in the future.
• All in all, we believe that the Chinese economy will continue its expansion at an annual rate of 7 to 8 %. Against this backdrop, China’s economic weight in the world will rise further. Moreover, according to our calculations, China’s nominal GDP could reach that of Germany in 2012.