Waltraut Urban

China: economic growth higher than expected

In 2006, the Chinese GDP rose at a rate of 10.7%, faster than in 2005 (10.4%) and also faster than generally expected. Growth was driven by investment (24%) and an exploding export surplus (USD 177 billion) but supported by private consumption as well. Inflation remained low (1.5%). For 2007, prospects remain good, but a slight deceleration of growth may occur due to the measures taken by the Chinese government to curb excessive investment and its attempts to reduce the trade surplus, together with a certain slowdown expected for the world economy. Thus, China's GDP is likely to grow by 10.5% in 2007 and 10% in 2008.

The economic expansion peaked in the second quarter of 2006, when GDP growth reached 11.3%, the highest rate since 1995. In the third quarter growth slowed down to 10.4%, but it picked up again during the last months of the year, mainly due to accelerating export growth but also to domestic sales gaining momentum. Investment growth, however, decelerated throughout the second half of the year, coming down from 30% in the first six months to a rate of 24% for the year as a whole, which is slightly lower than in 2005 (26%). Nevertheless, with investment growth surpassing that of GDP, the already high share of investment in GDP has risen further and reached an incredible 52% in 2006.

Investment in fixed assets rose fastest in industry (33%), followed by real estate (28%), utilities (17%) and transport services (12%). Within utilities, investment in water supply grew fastest. In the field of transportation, investment in railways more than doubled compared to the previous year. Regarding real estate, the debate continues whether or not there exists an investment bubble. To prevent the build-up of a bubble, the Chinese government started already in 2005 to introduce various measures to curb investment in this sector, introducing special taxes and various regulations limiting the accessibility to loans. Last year, a ban on leasing land from farmers for construction and restrictions on the acquisition of real estate by foreigners were introduced. Finally, a land appreciation tax was announced, to be collected from the beginning of February 2007. However, any potential crash in the real estate sector is unlikely to happen before the Olympic Games in Beijing in 2008 and the World Exhibition in Shanghai in 2010. For the current year, the expansion of total investment in fixed assets is expected to be somewhat slower as the investment cycle seems to have peaked already.

Chinese exports rose by 27% in 2006, reaching USD 961 billion, while imports increased by 20% to USD 792 billion. The resulting trade surplus of USD 177 billion was more than 70% higher than the already huge surplus the year before (USD 102 billion).[1] The current

[1] However, Chinese officials have some doubts whether these data may not exaggerate the trade surplus. Firstly, Chinese companies are suspected to over-report exports in order to get higher tax refunds and, secondly, as the yuan

account surplus amounted to USD 200 billion (7.7% of GDP) in 2006; it increased less than the trade surplus, as the deficit in the balance for services has widened.

Exports soared particularly during the second half of the year, despite several trade disputes with the United States and the EU and a certain revaluation of the Chinese currency. Imports, on the other hand, dragged especially in the last quarter of the year, and one has to wait and see whether this is due to a deceleration of demand for inputs because of less orders for future exports or whether the existing trend for substituting local sources for foreign inputs has accelerated. Although China's largest trade surplus is with the US and the EU, export growth was highest to countries within the region and to various less developed countries such as India (60%), Iran (34%), Angola (140%) and countries in Latin America (52%) – often related to raw material imports from there. Chinese exports expanded particularly fast in product groups such as cotton, steel and copper products, garments and clothing, mobile phones, TV sets, digital cameras, electronic components and various mechanical and electrical equipment. Car exports more than doubled, although from a very small basis.

To contain the excessive trade surplus, the Chinese government has recently propagated a 'program to encourage imports': Existing restrictions on imports will be relaxed and the government promised specific tax and financial incentives (import loans) for certain imports. According to Chinese experts, the imports to be encouraged should include energy, resources and key technologies & equipment. On the export side, the policy of reducing tax incentives for energy-intensive exports and low value-added processing trade (which together make up half of the trade deficit) will be continued. Regarding the revaluation of the Chinese currency, the policy of gradual adjustment of the exchange rate will be maintained. Yet, in 2006 the yuan appreciated by only 3.5% versus the US dollar and even depreciated versus the euro by about 1.5%. However, in case of a mounting trade surplus, a transition to a more flexible exchange rate system is not excluded by the Central Bank. For 2007, taking into account the expected moderate slowing down of the world economy as well as the government's trade policy and probably an increasing number of dumping charges and technical barriers from China's trading partners, a certain deceleration of export growth accompanied by an acceleration of import growth may be expected – but the trade surplus will rise further, although to a lesser degree than last year.[2]

---

is under appreciation pressure, some foreign trade enterprises may report lower import prices of raw materials and higher export prices of finished products to inflate their 'official' foreign exchange earnings. But it was difficult to gauge the right figures. Mirror statistics from the US and the EU available so far confirm a strong increase in the trade deficit with China.

[2] Given the already existing huge imbalance between exports and imports, the trade surplus will widen further, even if exports and imports grow at the same rate. If, for instance, both imports and exports rise at a rate of 23% in 2007, the resulting trade surplus will amount to USD 218 billion, 40 billion more than in 2006.

Foreign currency reserves increased by USD 247 billion last year and in February 2006 China surpassed Japan as the world's largest reserve holder. At the end of 2006, Chinese reserves stood at USD 1066 billion. The lion's share of the rise came from the trade surplus, the second largest factor contributing to the increase was foreign direct investment.

Although the 2006 inflow of FDI to China was very high by international standards (USD 69.1 billion), it did not reach the record level of the year before (USD 72.4 billion). By way of contrast, outward investment was more than 30% higher than in 2005. Thus, the net inflow of FDI came down from USD 60 billion in 2005 to USD 53 billion in 2006. A substantial part of Chinese *outward* investment was directed towards the acquisition of natural resources in Africa, Latin America and central Asia, but included investment in the advanced industrialized countries as well.[3] The most prominent deal was probably the take-over of the Hong Kong and Macao retail operations of the Bank of America by the China Construction Bank (CCB), worth USD 1.25 billion, in June 2006. A closer look at *inward* investment shows that the record level of 2005 had been largely due to an investment boom in the financial sector in the run-up to China's opening up the financial sector on 11 December 2006, according to WTO rules. While in 2005 FDI in the financial sector accounted for USD 12.1 billion, it was only 6.1 billion in 2006.

New rules for foreign direct investment: China's attitude towards FDI seems to have turned more choosy recently. In September 2006, new rules for mergers & acquisitions by foreign enterprises were issued, as a reaction to the increasing number of M&As. They allow share swaps in M&As, but stipulate that any M&A which could result in a monopoly must receive government approval. The new rules on foreign-funded banks, effective as of 11 December 2006, are relatively restrictive, e.g. regarding capital requirements. Also in December, as part of the new guidelines for state-owned enterprise reform, a list of 'key sectors' was published, specifying those sectors in which the state should be the sole owner, or have a majority share, such as power generation and distribution, oil, petrochemicals and natural gas, telecommunications and armaments; the state must have a controlling stake in the coal, aviation and shipping industries. Further on, the blueprint for the new five-year plan (2007-2012) puts unprecedented emphasis on the quality of FDI that China should absorb and there were new guidelines issued by the National Development and Reform Commission, putting a preference on FDI in high-tech, advanced manufacturing, in energy saving and environmental protection, modern agriculture and service industries. Finally, the Chinese government has drafted a law to

[3] Such as the joint venture of the China Minmetals Corporation with Chile's Codelco, the World's largest copper producer; the investment of China's National Offshore Corporation in a Nigerian Oilfield; the acquisition by the China National Petroleum Corporation of a 20% stake in a joint oil and gas exploration in Uzbekistan's Aral sea; the acquisition by China's Suntech Solar Holdings of a 67% stake in MSK, the largest solar panel producer in Japan, with the option to acquire more shares later.

unify income tax rates for domestic and foreign companies at a rate of 25%. (So far, a preferential rate of 17% was applied for foreign enterprises as compared to 33% for domestic companies.) The new regulations may deter some but not many potential investors and the trend towards more investment in service industries at the expense of manufacturing will continue. For 2007, a slightly lower inflow of FDI, but a further acceleration of outward investment can be expected.

Data on aggregate private consumption for the year 2006 are not yet available, but retail trade turnover, which may be used as a proxy for consumer demand, expanded at a rate of 12.9% (in real terms), slightly faster than the year before (12.1%). This was supported by a relatively strong rise of incomes, including the low end such as minimum wages and rural incomes. But the gap between the urban and the rural population has widened further. Per capita disposable incomes of rural households rose by 7% and those of city-dwellers by 10%. In 2007, wages will continue to rise rapidly, backed by a further strong increase in productivity.

Government expenditures for the year 2006 have not been published so far, but according to preliminary reports revenues are higher than expected and the deficit will range between 290 and 300 billion yuan (29-30 billion euro); from this we may guess that fiscal policy in 2006 was relatively expansive and it will most probably remain that way in 2007 as well.

Despite rapid growth of the economy, price inflation stayed low, pointing to sufficient production capacities and strong competition on the domestic market. Retail prices rose by 0.8% and consumer prices by 1.5%; producer prices for industrial goods increased by about 3% year on year. The slight acceleration of inflation in the last quarter of 2006 was due to a rise in food prices, in particular food imports, a trend which may continue in 2007. We therefore expect a slightly higher inflation this year.

The monetary authorities coped successfully with the difficult task to neutralize the inflow of foreign currency from the huge current account surplus and to keep money growth (M2) close to the target of 16% (16.9%). For this purpose, the reserve requirement ratio was raised three times and the reference interest rate was increased twice in the course of the year. In 2007, monetary policy will remain restrictive to contain loans and thus investment growth. In fact, the reserve ratio was raised again in January this year.

Proper information on the supply side of the Chinese economy in 2006 is not yet available. However, data on industrial value-added during the first eleven months of the year, including companies with annual sales revenue over 5 million yuan (500,000 euro), reveal a slightly faster expansion of industrial activity (16.8%) than in the same period the year before (16.4%), which is roughly in line with the slightly higher growth of the overall GDP in 2006. We therefore assume no dramatic shifts in the sectoral contribution to growth in 2006.

Summing up, the general character of growth in 2007 and 2008 will not be much different from that observed last year. However, investment growth may somewhat decelerate as the investment cycle seems to have peaked already. The export surplus will remain huge, but will grow less dramatically than this year, due to the expected slowing down of the world economy and certain policy measures to retard exports and promote imports. Growth of private consumption will remain high, based on a continuous high rise of wages backed by strong productivity growth. The fiscal policy will remain expansive, probably focusing less on investment and more on social expenditure. Inflation will not be a problem, but the monetary policy will remain tight in order to contain investment growth. Altogether, we expect the Chinese economy to grow by 10.5% in 2007 and 10% in 2008.

Table CN

China: Selected Economic Indicators

	2000	2001	2002	2003	2004	2005	2006 [1)]	2007 forecast	2008 forecast
Population, mn pers., end of period	1267.4	1276.3	1284.5	1292.3	1299.9	1307.6	1315.5	.	.
Gross domestic product, CNY bn, nom.	9921.5	10965.5	12033.3	13582.3	15987.8	18308.5	20940	23600	26400
annual change in % (real)	8.0	7.5	8.3	9.5	9.5	10.4	10.7	10.5	10
GDP/capita (USD at exchange rate)	946	1038	1132	1270	1486	1706	1990	.	.
GDP/capita (USD at PPP - wiiw)	4506	4966	5475	6161	6933	7822	8893	.	.
Industrial value added [2)]									
annual change in % (real)	9.9	8.9	9.9	12.5	11.1	11.4	.	.	.
Agricultural value added									
annual change in % (real)	2.4	2.5	2.9	2.5	6.0	5.2	.	.	.
Retail trade turnover, CNY bn	3415.3	4305.54	4813.6	5251.6	5950.1	6717.7	7638	.	.
annual change in % (real)	11.1	10.9	10.6	9.2	10.5	12.1	12.9	.	.
Total investment in fixed assets, CNY bn	3291.8	3723.4	4350.0	5556.7	7047.7	8877.4	10987	.	.
annual change in % (nominal)	10.3	13.1	16.8	27.7	26.8	26.0	23.8	.	.
Employment total, mn pers., end of period	720.9	730.3	737.4	744.3	752.0	758.3	.	.	.
annual change in %	1.0	1.3	1.0	0.9	1.0	0.8	.	.	.
Staff and workers, mn pers., end of period [3)]	112.6	107.9	105.6	104.6	105.8	108.5	109.5 I-IX	.	.
annual change in %	-4.3	-4.2	-2.2	-0.7	0.8	2.6	3.7 I-IX	.	.
Unemployment rate (urban) in %, end of per. [4)]	3.1	3.6	4.0	4.5	4.2	4.2	4.1	4.3	4.5
Average gross annual wages, CNY [5)]	9371	10870	12422	14040	16024	18364	18626 I-IX	.	.
annual change in % (real) [6)]	11.1	15.2	15.5	12.0	10.5	12.8	12.1 I-IX	.	.
Retail prices, % p.a.	-1.5	-0.8	-1.8	-0.1	2.8	0.8	0.8	.	.
Consumer prices, % p.a.	0.4	0.7	-0.8	1.2	3.9	1.8	1.5	1.8	1.6
General government budget, nat.def., % GDP									
Revenues	13.5	14.9	15.7	16.0	16.5	17.3	18.0	.	.
Expenditures	16.0	17.2	18.3	18.1	17.8	18.4	19.4	.	.
Deficit (-) / surplus (+), % GDP	-2.5	-2.3	-2.6	-2.2	-1.3	-1.1	-1.4	.	.
Refinancing rate of NB % p.a., end of per. [7)]	3.2	3.2	2.7	2.7	3.3	3.3	3.3	.	.
Current account, USD bn	20.5	17.4	35.4	45.9	70.0	161.0	200	250	280
Current account in % of GDP	1.7	1.3	2.4	2.8	3.6	7.2	7.6	7.9	7.5
Gross reserves of NB excl. gold, USD bn	165.6	212.2	286.4	403.3	609.9	818.9	1066	.	.
Gross external debt, USD bn	145.7	170.1	171.7	194.0	223.0	280.0	.	.	.
Gross external debt in % of GDP	12.2	12.8	11.8	11.8	11.5	12.5	.	.	.
FDI inflow, gross, USD bn	40.7	46.9	52.8	53.3	60.6	72.4	69.1	.	.
FDI outflow, gross, USD bn	2.2	7.1	2.8	1.8	2.1	12.3	16.1	.	.
Exports of goods total, USD bn [8)]	249.2	266.2	325.6	438.4	593.4	762.0	969.1	.	.
annual change in %	27.8	6.8	22.3	34.6	35.4	28.4	27.2	.	.
Imports of goods total, USD bn [8)]	225.1	243.6	295.3	412.8	561.3	660.1	791.6	.	.
annual change in %	35.8	8.2	21.2	39.9	36.0	17.6	20.0	.	.
Trade balance of goods, USD bn [8)]	24.1	22.6	30.3	25.5	32.1	101.9	177.5	.	.
Average exchange rate CNY/USD	8.278	8.277	8.277	8.277	8.277	8.206	7.999	7.5	7.1
Average exchange rate CNY/EUR	7.648	7.347	7.753	9.366	11.276	10.261	9.971	.	.
Purchasing power parity CNY/USD, wiiw [9)]	1.737	1.730	1.711	1.706	1.774	1.790	1.790	.	.
Purchasing power parity CNY/EUR, wiiw	1.975	1.983	1.982	2.016	2.104	2.134	2.202	.	.

Note: CNY: ISO code for the Chinese yuan.

1) Preliminary. - 2) Including construction. - 3) Staff and workers (on duty) refer to persons who work in state-owned enterprises, urban collectives, shareholding ownership and foreign invested enterprises. - 4) Ratio of registered urban unemployed in per cent of urban employed and unemployed. - 5) 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. - 6) Staff and workers cost of living index is used as deflator for calculating real wage. - 7) Overnight rate. - 8) According to customs statistics. - 9) 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.; wiiw forecasts.