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## **China: maintaining stable and fast economic development**

In 2004, the Chinese GDP rose by 9.5%, slightly faster than in 2003 (9.1%). This is the highest growth rate since the Asian economic and financial crisis in 1997/1998. Thus neither a 'hard landing', as feared by some economists, nor the Chinese government's proclaimed goal to return to a more sustainable growth path has materialized. However, certain structural changes to be observed point in the right direction: the very fast expansion of fixed asset investment and of output in some sectors of the economy has cooled down, private consumption has picked up and growth in agriculture and services, lagging significantly behind the industrial development for the past several years, has accelerated. Foreign trade and direct investment remained strong throughout the year 2004.

Measured in quarterly figures, the GDP growth rate gradually slowed down from the first quarter (9.6%) to the third quarter (9.1%) in response to the various measures implemented by the Chinese authorities to prevent an overheating of the economy, but rebounded again in the fourth quarter (9.5%). This was however due to a much better than expected development of agricultural output, accelerating growth in the services sector and a rising trade surplus, while investment and industrial production continued to cool down. For the year 2005, a certain deceleration of overall economic growth is expected, probably reaching 8.2%, because of the continuously restrictive economic policy of the Chinese government and the predicted slowing down of the world economy. In 2006, a slight acceleration of growth to 8.5% may take place.

The very rapid expansion of the Chinese economy at the beginning of 2004 was driven by investment in fixed assets, surging 43% year-on-year in the first quarter of 2004 and raising fears of overheating and a build-up of overcapacities. To guard against a boom/bust cycle, the Chinese authorities began to restrict loans and to limit operating licences in these sectors. They also followed a tighter monetary policy: the bank reserve requirement ratio was raised from 7% to 7.5% in April 2004, and in October the central bank raised the target interest rate by 0.25 percentage points. Although the effect of these measures was partly undermined by soaring profits, the growth rate of fixed investment declined to about 29% for the first half and to 25.8% for the whole year of 2004 – which is still very high by international standards but below that in 2003 (26.7%). For 2005, we may expect investment growth to slow down further, as government policy will remain restrictive and overcapacities have already become a constraint on growth in certain important sectors, such as in the motor vehicle industry and probably in the steel industry as well. As investment in fixed assets currently takes a share of about 50% in the Chinese GDP, i.e.

much more than in most economies of the world, the impact of this sector's development on overall GDP growth is substantial.

While investment lost momentum throughout 2004, the growth of private consumption remained strong and probably even accelerated during the last few months of the year. Data on aggregate private consumption are not available yet but retail sales of consumer goods (in real terms) as a proxy for private consumption expanded by 10.2% year-on-year during the first 11 months of 2004 (compared to 9.2% in the whole year 2003), with an increase of 11% and 12% in October and November respectively. Rising urban and, in particular, rural incomes stand behind this development: in China around 60% of the population are still living in rural areas, and in 2004, for the first time in many years, rural incomes rose faster than urban incomes. Urban per capita incomes reached 785 yuan (plus 7%) and rural per capita incomes came up to 234 yuan (plus 11.4%) during the first nine months of the year. Rural incomes were supported by a tax reform (the 'tax for fee') on the one hand and rising prices for many agricultural goods on the other. In the last quarter, a bumper crop helped further to raise rural incomes. The latter effect may taper off in 2005, but government support for farmers will continue. As a result, we may expect rural incomes and thus private consumption to remain strong in 2005 but to rise less than last year.

Rising prices in agriculture were the main factor behind consumer price inflation, which reached 3.9% in 2004, after 1.2% the year before. However, price hikes reached their peak already by the middle of the year; in the last two months of 2004, consumer prices were up less than 3% compared to the previous year. For 2005, we thus expect inflation to stay around 3%, barring any dramatic events such as a natural disaster or a strong increase in oil prices.

Supported by the favourable development of the world economy, particularly in Asia and the USA, exports were an important driving force of the Chinese economy. They reached USD 593.4 billion and, with an average growth rate of 35% throughout the year, they expanded at a similar pace as in 2003. However, in the first six months of the year, imports increased much faster than exports (42.3%) because of a surge in the demand for investment goods and inputs for production on the one hand and rapidly rising raw material prices (crude oil, ferrous and non-ferrous metals) on the other, resulting in a (moderate) trade deficit. Yet in the second half of the year, growth of imports decelerated in line with a slowing-down of investment and industrial production, and the trade balance turned positive again. Over the whole year imports came up to USD 561.3 billion and the trade surplus reached a new record high of USD 32 billion, partly compensating for the deceleration of investment. In terms of trade volume, China has now overtaken Japan as a world trading power and ranks third after Germany and the USA. Taking into account the

predicted slowing-down of the world economy<sup>1</sup> in 2005, we may expect overall Chinese exports to develop less dynamically than the year before. But a certain expansive effect will come from the phasing-out of the 'Agreement of textiles and clothing' (ATC) as of end-2004, leading to an abolishment of all quotas in textiles and clothing trade among members of the World Trade Organization (WTO). China is a very competitive producer of textiles and clothing on the world market and T&C take an important share in Chinese merchandise exports (around 15%). The existing import quotas, of the USA and the EU in particular, were considered a severe constraint on the further expansion of exports in this field. However, the major importers have become alert of Chinese textiles flooding their markets and have threatened to use WTO safeguard clauses to protect their T&C industries, which may finally result in new quotas. To prevent such steps, China has imposed (moderate) export taxes on certain textiles and clothing products as of the beginning of 2005 and has signalled its readiness to accept voluntary export restrictions, in order to secure a smooth and predictable development of Chinese T&C exports. Notably, the Chinese government has also introduced export taxes on aluminium, coal and some other metals the production of which is very energy-intensive and domestic demand is high. Import growth will remain strong, due to further tariff reductions and the lifting of quotas (for instance for automobiles), in line with China's WTO commitments. All in all, we may expect the trade surplus and its contribution to growth to diminish in 2005.

Foreign direct investment, as an important source of technology and a major supplier of exports, reached a record size of USD 60.6 billion in 2004 and China is again the second most important recipient of FDI world-wide. The bulk of investment comes from Asian countries, with Hong Kong and the Caribbean tax havens taking a special role: together they account for about half of the total inflow of investment. FDI inflows from the USA and Europe reached approximately the same size and had a share of about 7% each. The continuous strong growth of contracted investment (33.4%) points to a further strong inflow of FDI in 2005; the observed trend towards accelerated investment in the services industries relative to manufacturing may continue as a consequence of the further opening-up of this sector as stipulated in China's WTO treaty.

China's foreign reserves rose to USD 609.9 billion, an increase of USD 210 billion against 2003, due to the high trade surplus (no current account data are available yet) and the strong inflow of FDI, but also fuelled by financial inflows, partly on the expectation of a yuan revaluation.

On the supply side, the industrial sector remained the fastest growing sector of the economy, expanding at a rate of 11%; yet the lead was less prominent than in 2003 and

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<sup>1</sup> According to the International Monetary Fund (IMF), the growth of world output is expected to decline from 5% in 2004 to 4.3% in 2005 and the growth of world trade is expected to fall from 8.8% to 7.2%. (IMF; World Economic Outlook, September 2004, Table 1.1; see [www.imf.org](http://www.imf.org)).

growth decelerated slightly throughout the year. However, growth declined significantly e.g. in the motor vehicle industry, where the number of vehicles produced increased by just 14% in 2004 as compared to 34% in 2003.

Both the primary sector and the tertiary sector expanded significantly faster than the year before. The acceleration of growth was particularly outstanding in agriculture, which dominates the primary sector, reaching an increase of 6% year-on-year after only 2.5% in 2003. This was mainly due to a bumper autumn harvest (the autumn harvest typically makes up about 70% of total agricultural output) pushing up production growth in the fourth quarter. Total grain output in 2004 reached 470 million tons, 9% up from 2003 and reversing the downward trend in grain production prevailing for several years; output of many other agricultural products increased strongly as well. However, as grain consumption rose significantly too, China remained an important net importer. Apart from favourable weather conditions, the good development of the agricultural sector results from various policy measures to support agriculture and raise farmer's incomes.

Growth in the services sector also picked up as against 2003, and remained fairly stable throughout the year. The value-added of the sector was up 8% year-on-year. Growth was strong in both sales and the transport sector.<sup>2</sup> So far, the services sector in China has been relatively underdeveloped as is typical of socialist economies. Acceleration of growth in the services sector may thus be interpreted as a sign of restructuring in the direction of a market economy and has also to be seen in the light of the stepwise opening-up of this sector in line with China's commitments to WTO.

With restrictive policy measures remaining in place, investment in fixed assets is expected to cool down further in 2005 and 2006. Consumption will remain strong but may grow slightly less due to farmers' incomes not reaching a similar income hike as last year. Export growth and the trade surplus – and thus the current account as well – will be smaller assuming a slowdown of the world economy. On the supply side, industrial production in some sectors may continue to lose momentum (e.g. vehicles), but growth may accelerate in others (e.g. textiles and clothing); overall growth of the sector is expected to decelerate. Agriculture, further supported by various policy measures, may continue its positive development although to a lesser degree. The services sector may continue to expand, also thanks to foreign direct investment. Inflation will be lower as imbalances between supply and demand are becoming less. Altogether, we expect GDP growth to decline to about 8.2% in 2005 and to rebound slightly in 2006 along with the world economy, probably reaching 8.5%.

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<sup>2</sup> *BOFIT Weekly* No. 4, 28 January 2005, Bank of Finland, Institute for Economies in Transition (BOFIT).

Table CN

## China: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004 <sup>1)</sup>	2005	2006 forecast
Population, mn pers., end of period	1259.1	1265.8 <sup>2)</sup>	1277.3	1286.0	1292.0	.	.	.
Gross domestic product, CNY bn, nom.	8191.1	8940.4	9593.3	10239.8	11669.4	13650	15460	17393
annual change in % (real)	7.1	8.0	7.3	8.0	9.1	9.5	8.2	8.5
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	11.0	.	.
Agricultural value added								
annual change in % (real)	2.8	2.4	2.5	2.9	2.5	6.0	.	.
Construction output, CNY bn <sup>3)</sup>	1115.2	1249.7	1536.1	1852.7	2308.3	.	.	.
annual change in % (nominal)	10.8	12.1	22.9	20.6	24.6	.	.	.
Retail trade turnover, CNY bn	3113.4	3415.3	3759.5	4191.1	4572.5	5400	.	.
annual change in % (real)	10.1	11.1	10.9	10.6	9.2	10.5	.	.
Total investment in fixed assets, CNY bn	2985.5	3291.8	3689.8	4283.9	5427.6	7000	.	.
annual change in % (nominal)	5.1	10.3	12.1	16.1	26.7	25.8	.	.
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 <sup>4)</sup>	117.7	112.6	107.9	105.6	104.6	104.5 <sup>I-X</sup>	.	.
annual change in %	-4.6	-4.3	-4.2	-2.2	-0.9	-0.1 <sup>I-X</sup>	.	.
Unemployment rate (urban) in %, end of per. <sup>5)</sup>	3.1	3.1	3.6	4.0	4.5	4.2 <sup>I-X</sup>	4.5	4.5
Average gross annual wages, CNY <sup>6)</sup>	8346	9371	10870	12422	14040	14453 <sup>I-X</sup>	.	.
annual change in % (real) <sup>7)</sup>	13.1	11.1	15.2	15.5	12.0	10.4 <sup>I-X</sup>	.	.
Retail prices, % p.a.	-3.0	-1.5	-0.8	-1.8	-0.1	2.8	.	.
Consumer prices, % p.a.	-1.4	0.4	0.7	-0.8	1.2	3.9	3	2
General government budget, nat.def., % GDP								
Revenues	14.0	15.0	17.1	18.5	18.6	.	.	.
Expenditures	16.1	17.8	19.6	21.5	21.1	.	.	.
Deficit (-) / surplus (+), % GDP	-2.1	-2.8	-2.6	-3.1	-2.5	.	.	.
Refinancing rate of NB % p.a., end of per. <sup>7)</sup>	3.2	3.2	3.2	2.7	2.7	3.0	.	.
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	.	2.2	2
Gross reserves of NB excl. gold, USD bn	154.7	165.6	212.2	286.4	403.3	609.9	.	.
Gross external debt, USD bn	151.8	145.7	170.1	171.7	194.0	223.0 <sup>I-X</sup>	.	.
FDI inflow, USD bn	40.3	40.7	46.9	52.8	53.3	60.6	60	.
FDI outflow, USD bn	1.8	0.9	6.9	2.5	1.8	1.8 <sup>I-XI</sup>	2.5	.
Exports of goods total, USD bn <sup>8)</sup>	194.9	249.2	266.2	325.6	438.4	593.4	.	.
annual change in %	6.1	27.8	6.8	22.3	34.6	35.4	.	.
Imports of goods total, USD bn <sup>8)</sup>	165.8	225.1	243.6	295.3	412.8	561.3	.	.
annual change in %	18.2	35.8	8.2	21.2	39.9	36.0	.	.
Trade balance of goods, USD bn <sup>8)</sup>	29.1	24.1	22.5	30.3	25.5	32.0	.	.
Average exchange rate CNY/USD	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	11.28	.	.
Purchasing power parity CNY/USD, wiiw <sup>9)</sup>	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 1 Nov. 2000. - 3) Enterprises with independent accounting systems. - 4) Refer to persons who work in state-owned enterprises, urban collectives and foreign invested enterprises. - 5) Ratio of registered urban unemployed in per cent of urban employed and unemployed. - 6) Average gross annual wages of staff and workers. - 7) Overnight rate. - 8) According to customs statistics. - 9) 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).