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China: growth picking up again

In the first quarter of 2007, the Chinese GDP expanded at a rate of 11.1%, faster than in the previous quarter (10.4%) and than in 2006 on average (10.7%). Growth was also higher than expected by most experts – including the government – and the official efforts to prevent overheating have not been successful so far. Growth was driven by a rebound of investment and by a ballooning trade surplus, but supported by a certain acceleration of consumer demand as well. Monthly data available for April and May point to a continuation of the rapid development which may result in a growth rate of the Chinese economy for the whole year between 10.5% and 11%. In 2008, growth will remain strong, but perhaps slow down a bit, taking into account the delayed impact of government measures to cool down the economy and measures taken by important Chinese trading partners to contain the Chinese trade surplus.

The growth rate of fixed asset investment, after reaching a peak in the middle of last year, had decelerated thereafter, reaching a rate of 24% (in nominal terms) for the year 2006 as a whole. This was considered a consequence of emerging over-capacities, but various government measures to cool down ‘excessive’ investment could play a role as well. In March 2007, investments started to rebound, yet their growth rate in the first quarter of 2007 (23.7%) was still below that in the first quarter of 2006 (27.7%). However, investment in *urban areas*, covering more than 80% of total investment in fixed assets and for which data are available on a monthly basis, shows a further acceleration throughout April and May. Also, the total planned investment for new projects rose by 6% in May, reversing the decline during the first four months of the year.[1] Investments bounced back particularly in energy-intensive sectors such as non-ferrous metal mining, metallurgy, construction materials and chemicals, all showing growth rates of fixed-asset investment in the first quarter of more than 50%.[2] These sectors were already targeted last year by the Chinese authorities by restrictive measures such as tighter rules governing land and cash supplies as well as environmental standards, because of the fear of creating over-capacities and putting particular strain on energy consumption and the environment in general.[3] But, obviously, these industries have managed to utilize their capacities for increased exports and high profits have provided the necessary cash for further expansion. Therefore, tightening measures reiterated by the Chinese government recently, should put an emphasis on the enforcement of environmental and energy laws rather than financial restrictions in order to become effective. At the same time, this would support China’s goal of raising the energy efficiency by 20 % and cutting emissions of key pollutants by 10% until 2010.

1 *China Daily*, 18 June 2007.

2 People’s Bank of China (PBC), *China Monetary Policy Report, Quarter One*, 2007, p. 47.

3 See W. Urban, “China: undamped growth of the economy”, *wiiw Research Reports*, No. 328, July 2006, p. 101.

Export growth accelerated and import growth decelerated, widening the already huge trade surplus substantially. In the first quarter of 2007 Chinese exports expanded by 27.8%, reaching USD 252.1 billion, while imports rose by 18.2%, to USD 205.6 billion. The resulting trade surplus of USD 46.5 billion was twice as high as in the same period of last year; it even increased further in April and May to reach USD 88 billion for the first five months of the year, making a significant contribution to the economy's overall growth and, at the same time, increasing the chance that the trade surplus for the whole year may exceed last year's record size. Exports (in value terms) rose particularly fast in commodities such as steel and ferroalloys, up by 120% and 70% respectively, partly due to soaring metal prices.[4] The government measures to curb exports (such as the announcement of a further reduction of tax rebates for certain groups of exporters) may in the short run have even been counter-productive as they probably induced a forward shift of the exports concerned.

The corresponding large bilateral trade deficits (mainly with the USA and the EU) have provoked various counter actions, including complaints to the World Trade Organization (WTO), anti-dumping procedures, and high-level consultations about exchange rate adjustments, subsidies and the protection of intellectual property rights: With the Chinese trade surplus rising further, the USA and the EU will take an increasingly tougher stance which may result in a certain dampening effect on the Chinese trade surplus later on.

In order to accommodate the growing requests by the USA to give market forces a greater role in determining the value of the Chinese currency, the fluctuation band versus the US dollar was widened as of end of May by the Chinese authorities. Now, the yuan can gain or lose 0.5% of its value against the US dollar on any trading day (the earlier range was 0.3%). Between the first quarters of 2006 and 2007, the yuan appreciated (on average) by 3.4% against the US dollar, but depreciated by 5.3% against the euro.

The inflow of foreign direct investment was strong, reaching USD 15.9 billion in the first quarter, up 12% from the same period last year. Cumulated investment over the first five months of the year amounted to USD 25.3 billion, up 10% from last year. This indicates an acceleration of FDI inflows also if compared to the whole year 2006. However, end-of-year FDI data and quarterly and monthly FDI data, respectively, are not strictly comparable, as the latter exclude direct investment in the financial sector, which is playing an increasing role in China.[5] Most relevant for foreign investors, the National People's Congress (NPC), a kind of Chinese parliament, has approved a new 'Law on Corporate Income Tax' in March this year. According to this law, to take effect on 1 January 2008, corporate income tax will be unified at a rate of 25%, within a five-year transition period, for domestically as

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4 People's Bank of China (PBC), *China Monetary Policy Report, Quarter One*, 2007, p. 47.

5 In 2006, for instance, USD 8.9 billion were invested in the financial sector.

well as foreign-owned enterprises.[6] However, foreign direct investment qualifying as 'high-tech' investment will continue to pay the lower tax rate of 15%. The NPC also adopted the much-debated 'Law on Protecting Property', affording private property the same protection as state-owned property, but only 'if it was acquired legally'. This amendment was made with a view to exempting from protection, for instance, property that was unlawfully privatized or acquired through corruption. However, given the high degree of uncertainty in the Chinese legal system, this clause could be used for other purposes as well.

The strong rise in foreign currency reserves continued in the first quarter. China's foreign currency reserves, the world's largest since February last year, stood at USD 1202 billion at the end of March 2007 – with an incredible USD 140 billion added alone in the first three months of this year. About USD 60 billion of that increment can be attributed to the foreign trade surplus and the net inflow of FDI. According to the People's Bank of China, China's central bank, the remaining USD 80 billion represented currency purchased through swap contracts with domestic commercial banks and repatriation of Initial Public Offering (IPO) earnings by Chinese companies which recently have listed on bourses outside Mainland China (e.g. in Hong Kong). Speculative foreign currency flows are not believed to have increased.[7] Most of China's foreign currency reserves are invested in US treasury bonds. But, in order to diversify the assets and improve the gains, China has decided to set up a 'state investment company' – following the example of many oil exporting countries – which in a first step should have a portfolio of USD 200-300 billion to invest. Even before being formally established, this new investment arm of the Chinese government moved to acquire a 10% stake in the US-based private equity investor Blackstone Group, for a price of USD 3 billion. The deal will be completed after Blackstone's listing on the stock market on 22 June 2007.

In China, quarterly data on aggregate private consumption are not published. Retail trade turnover – which may be used as a proxy for consumer demand – expanded much faster than last year in nominal terms during the first quarter of 2007. But as inflation picked up as well, retail trade in real terms (deflated with the retail trade index) grew only slightly faster (12.8%) as compared to the same period of last year (12.2%), and approximately at the same pace as in the year 2006 as a whole (12.9%). In April 2007, retail trade turnover accelerated and reached a year-on-year growth rate (in real terms) of 13.3%; provisional data point to a similar growth rate in May. Demand rose particularly fast for product groups such as furniture, construction and decoration material, jewellery, and cars. In fact, the rise in retail trade turnover is surprisingly low, given the strong increase in incomes this year. According to official figures, in the first quarter of 2007 real per capita income of urban

6 So far, the official rate for foreign investment enterprises has been 15% while that for Chinese enterprises 33% – though the effective rates has often been considerably lower.

7 Bank of Finland, Institute for Economies in Transition, *BOFIT Weekly* 16, 20 April 2007.

households rose by 19.2% and that of rural households by 15.2% year-on-year. Also, minimum wages were raised in many provinces as well.

Consumer price inflation began to rise already at the end of last year; it hit the 3% mark in March and reached 3.4% in May 2007. This was mainly due to the rapid rise in food prices (in May food prices increased by 8.3%). Some important items such as pork (25%) and eggs (37%) showed extremely high price hikes, which were at least partly attributable to rising feed prices, in particular of maize, the price of which was pushed up by its extended use for bio-fuel production. The so-called core inflation, excluding items with strongly fluctuating prices such as petrol and food, is said to be around 1% only. Supply measures such as the marketing of 'strategic reserves' of pork, for instance, and a watchful eye on bio-fuel production therefore seem more adequate than a tightening of the money supply to contain current inflationary pressures. Furthermore, the good summer harvest is expected to increase supply and ease price pressure, e.g. on maize. But in June, state-administered electricity prices will be raised and a new, refined oil pricing system – which will gradually phase out oil subsidization – is planned to take effect soon. Both measures will press on inflation later in the year (the PBC wants to keep inflation below 3% this year).

The monetary authorities battled hard to keep money growth in check, despite the rising inflow of liquidity from the widening current account surplus and a strong demand for bank loans. The reserve requirements for commercial banks were raised already five times this year and the reference interest rates were raised twice. As of 26 June, the reserve ratio for commercial banks stood at 11.5% and the reference interest rate for 12-month commercial loans reached 6.25%. However, the rate for 12-month deposits stood at 3.06%, below the rate of inflation in May (3.4%). Given the same target for money growth (M2) as last year (16%), actual money growth was 17.3% in the first quarter, but came down to 16.7% in May.

Excess liquidity and low or even negative real interest rates on saving deposits have among other factors helped to continue the bull run at the Shanghai and Shenzhen stock exchanges. After rising 130% in 2006, the Shanghai composite index gained 48% in the first five months of this year, raising fears of a bubble building up. There are currently 100 million stock accounts in China, with 20 million new share trading accounts being opened in 2007. The price/earnings ratio at the Shanghai exchange now stands at 40, compared to 15 in Hong Kong, and daily turnovers have skyrocketed. With a view to dampening this development, the Chinese authorities have raised the stamp tax on stock trades from 0.1% to 0.3%, This led to an immediate fall of stock prices on 30 May 2007, and although stock prices have largely recovered soon thereafter, the all-time maximum reached on 29 May has not been exceeded yet (as of 16 June 2007), indicating a certain calming down of the bull run.

On the supply side, agricultural value-added rose at a rate of 4.4%, at a similar pace as in the first quarter of 2006. But industrial value-added, growing by 13.2%, expanded half a percentage point faster compared to the same period last year; growth in the services sector was even one percentage point higher than in the first quarter of 2006. However, data for large industrial enterprises, which are available on a monthly basis, show a similar growth rate of value-added in April and May as in 2006. Within the industrial sector, the fastest growing industries include transport equipment, non-metallic mineral products, smelted and pressed ferrous metals (in particular steel) and chemicals, as well as electrical machinery and equipment, fuelled by fast growing investment and surging exports.

To sum up, China's overall economic growth in 2007 will reach between 10.5% and 11%, depending on the effectiveness of government measures to cool down the economy and on the trading partners' success to put a cap on China's huge trade surplus. Development of the world economy, in particular of the US economy, will have a significant impact as well. The expansion of fixed asset investment will remain fast, although to a certain extent contained by government restrictions. The trade surplus will probably be even larger than last year. Private consumption may accelerate further, driven by high income growth. On the supply side, industrial production will continue to expand strongly but services will gain in relative importance.

Table CN

China: Selected Economic Indicators

	2002	2003	2004	2005	2006 [1)]	2006	2007	2007	2008
						1st quarter		forecast	
Population, mn pers., end of period	1284.5	1292.3	1299.9	1307.6	1315.5	.	.	.	.
Gross domestic product, CNY bn, nom.	12033.3	13582.3	15987.8	18308.5	20940.7	4339.0	5028.7	23800	26700
annual change in % (real)	9.1	10.0	10.1	10.4	10.7	10.4	11.1	10.5	10
GDP/capita (USD at exchange rate)	1132	1270	1486	1706	1997	.	.	.	.
GDP/capita (USD at PPP - wiiw)	5475	6161	6933	7822	8893	.	.	.	.
Industrial value added [2)]									
annual change in % (real)	9.9	12.5	11.1	11.4	12.5	12.7	13.2	.	.
Agricultural value added									
annual change in % (real)	2.9	2.5	6.0	5.2	5.0	4.5	4.4	.	.
Retail trade turnover, CNY bn	4813.6	5251.6	5950.1	6717.7	7641.0	1844.0	2118.8	.	.
annual change in % (real)	10.6	9.2	10.5	12.1	12.9	12.2	12.8	.	.
Total investment in fixed assets, CNY bn	4350.0	5556.7	7047.7	8877.4	10987.0	1390.8	1752.6	.	.
annual change in % (nominal)	16.8	27.7	26.8	26.0	24.0	27.7	23.7	.	.
Employment total, mn pers., end of period	737.4	744.3	752.0	758.3	.	.	.	.	.
annual change in %	1.0	0.9	1.0	0.8	.		.	.	.
Staff and workers, mn pers., end of period [3)]	105.6	104.6	105.8	108.5	111.6	107.9	110.3	.	.
annual change in %	-2.2	-0.7	0.8	2.6	2.9	3.1	2.2	.	.
Unemployment rate (urban) in %, end of per. [4)]	4.0	4.5	4.2	4.2	4.1	.	.	4.3	4.5
Average gross annual wages, CNY [5)]	12422	14040	16024	18364	20846	18776.8	22195	.	.
annual change in % (real) [6)]	15.5	12.0	10.5	12.8	.	.	.	.	.
Retail prices, % p.a.	-1.8	-0.1	2.8	0.8	0.8	0.6	2.1	.	.
Consumer prices, % p.a.	-0.8	1.2	3.9	1.8	1.5	1.2	2.7	2.8	2
General government budget, nat.def., % GDP									
Revenues	15.7	16.0	16.5	17.3	18.0	.	.	.	.
Expenditures	18.3	18.1	17.8	18.4	19.4	.	.	.	.
Deficit (-) / surplus (+), % GDP	-2.6	-2.2	-1.3	-1.1	-1.3	.	.	-1.0	.
Refinancing rate of NB % p.a., end of per. [7)]	2.7	2.7	3.3	3.3	3.3	2.9	3.6	.	.
Current account, USD bn	35.4	45.9	70.0	161.0	250	.	.	270	250
Current account in % of GDP	2.4	2.8	3.6	7.2	9.5	.	.	8.5	6.6
Gross reserves of NB excl. gold, USD bn	286.4	403.3	609.9	818.9	1066.3	875.1	1202.0	.	.
Gross external debt, USD bn	171.7	194.0	223.0	280.0	323.0	.	.	.	.
Gross external debt in % of GDP	11.8	11.8	11.5	12.5	12.3	.			
FDI inflow, gross, USD bn [8)]	52.8	53.3	60.6	72.4	78	14.2	15.9	.	.
FDI outflow, gross, USD bn [8)]	2.8	1.8	2.1	12.3	18	.	.	.	.
Exports of goods total, USD bn [9)]	325.6	438.4	593.4	762.0	969.1	197.3	252.1	.	.
annual change in %	22.3	34.6	35.4	28.4	27.2	26.6	27.8	.	.
Imports of goods total, USD bn [9)]	295.3	412.8	561.3	660.1	791.6	174.0	205.6	.	.
annual change in %	21.2	39.9	36.0	17.6	20.0	24.8	18.2	.	.
Trade balance of goods, USD bn [9)]	30.3	25.5	32.1	101.9	177.5	23.3	46.5	.	.
Average exchange rate CNY/USD	8.277	8.277	8.277	8.206	7.972	8.035	7.761	7.5	7.1
Average exchange rate CNY/EUR	7.753	9.366	11.276	10.261	10.015	9.658	10.167	.	.
Purchasing power parity CNY/USD, wiiw [10)]	1.711	1.706	1.774	1.790	1.790	.	.	.	.
Purchasing power parity CNY/EUR, wiiw	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) Quarterly FDI data exclude investments in the financial sector. - 9) According to customs statistics. - 10) 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.