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China: undamped growth of the economy

In the first quarter of 2006, the Chinese economy kept fast growth (10.2%). The rapid expansion of the economy was mainly driven by a surge of investment and supported by a record foreign trade surplus. Private consumption developed at a stable pace, inflation remained low. In the months to come, certain government measures to dampen growth and to prevent an overheating of the economy may become more effective. We thus expect the GDP growth for the whole year 2006 to reach 9.7%. For 2007, taking into account the predicted cooling down of the world economy, a growth rate around 9.5% is expected.

In the Chinese economy, investment in fixed assets takes an extremely high share by international standards (2005: 49% of GDP). This is a merit but a source of concern at the same time. In the first quarter of 2006, fixed asset investment rose by 27.7% (in nominal terms), significantly faster than in the same period of last year (22.8%) and in 2005 on average (25.7%) – despite several government measures in place to dampen investment (credit restraints, limitation of operating licences etc.). Correspondingly, new loans expanded at incredible rates of 70% during the first quarter and 123% in April alone (the total amount of outstanding loans in the first quarter was up 15%). In response, the People's Bank of China (PBoC) raised the benchmark lending rate (i.e. the one-year lending rate) from 5.5% to 5.85% on 27 April 2006. Within fixed asset investment, the fastest growing segments were investment in coal mining (43%) and in manufacturing (36.3%)¹, despite already existing surplus capacities in these fields. These surplus capacities are a consequence of overshooting investment attracted by high prices and high profits in the recent past. The government has earmarked about ten industries as being plagued by surplus capacities judged by various indicators such as capacity utilization, price developments, stocks etc. and is planning to increase the threshold for these industries by tightening rules governing land and cash supplies as well as environmental standards. Industries which may be affected by these measures include the automotive, steel, ferroalloy, aluminium and coke industries and probably also textiles.²

Investment in real estate development was up 20.2%, or 6.5 percentage points lower than in the same period of 2005. Probably, the various measures to restrict investment in this

¹ *China Monthly Statistics* 3/2006.

² Last year, China produced 348 million tons of steel out of its annual capacity of 470 million tons; the total production capacity of the aluminium industry reached 10.7 million tons, but national consumption stood at 7.12 million tons only; in the automotive industry, annual capacity now stands at 8 million units, already exceeding the projected sales of about 6 million; in the ferroalloys industry, the capacity utilization was only around 50% in 2005. (*China Daily, China Business Weekly*, 8-14 May 2006, p. 5.)

sector, which was considered seriously over-heated already last year, have had some impact. However, in May further rules regarding mortgage down payments and housing transactions were introduced in a bid to cool down the property sector and divert investment from luxury apartments to low-cost housing.³ Given the various measures in place to dampen investment and taking into account a certain time lag for them to become effective, one may expect investment growth to decelerate in the course of the year.

Although exports expanded at a slower pace and imports rose faster than in the same period a year earlier, a record trade surplus of USD 23 billion resulted for the first quarter of 2006, due to the already existing imbalance between exports and imports by the end of 2005. Chinese exporters took particular advantage of the surge in global consumer electronics demand (mobile phones, digital music players etc.). For the rest of the year, the trade surplus is expected to increase further and it will probably reach USD 115 billion for the year as a whole. There are, however, some uncertainties with regard to the effect of pending anti-dumping procedures against Chinese products from the side of the USA and the EU, but the volume of trade potentially affected by these measures is not overwhelming. Also, the likely creeping revaluation of the Chinese currency will have no dramatic consequences for the development of foreign trade.

Foreign direct investment inflows during the first quarter amounted to USD 14.2 billion, up 6.4% from the same period last year. However, these figures do not comprise investment in the financial sector, which is only taken into account in the annual revision of FDI data. While foreign investments in the financial sector had been rather low in the past due to existing restrictions, they increased significantly in 2005 to reach USD 12 billion. For 2006, we may assume a further strong inflow of investment in the financial sector because by the end of this year, all existing limitations on foreign banks doing business in China will phase out as part of China's commitment to the World Trade Organization (WTO).⁴

For the first time, also foreign direct investment outflows, reflecting Chinese investment abroad, were published on a quarterly basis. They amounted to USD 2.68 billion in the first quarter of 2006, up 280%. Chinese outward investment is developing very dynamically from a low base. The total stock of outward investment reported for the end of 2005 was USD 64.5 billion. Outward FDI is promoted by the Chinese government under the so-called 'go-abroad' policy, with the aims to secure raw materials (oil!) on the one hand and to gain better access to technology, established brand names and distribution channels on the

³ As of 1 June the minimum down payment for a new apartment larger than 90 square metres will be raised from 20% to 30%. Also, the period during which a 5.5% transaction tax has to be paid when reselling a property was extended from 2 to 5 years (*China Daily*, 30 May 2006).

⁴ See, for instance, W. Urban, 'China preparing for WTO deadline in banking', *wiiv Monthly Report*, No. 6, 2006, pp. 15-19.

other.⁵ Outward investment is also backed by China's huge cumulated foreign exchange reserves. In February this year China surpassed Japan as the holder of the biggest foreign exchange reserves in the world. At the end of March, they came up to USD 875 billion, equivalent to more than one year's imports.

Data on aggregate private consumption are not available at a quarterly basis. However, retail sales of consumer goods (in real terms), which may be used as a proxy for private consumption, expanded by 12.2% year-on-year in the first quarter, slightly faster than in the same period last year (12.1%) and in 2005 on average (12%). Private consumption was supported by a relatively strong rise in incomes, also of the rural population, which still takes a share of around 60% of the total.⁶ In real terms, per capita disposable income of urban households increased by 10.8% and that of rural households showed a year-on-year increase in the first quarter of 11.5%. Apart from the fast growth of the economy, this rise was supported by fiscal measures such as the scrapping of the so-called 'agricultural tax' and a doubling of the personal income threshold for taxation from 800 yuan to 1666 yuan with the beginning of the year, as part of the government's strategy to strengthen domestic consumption relative to foreign demand.

Despite high and accelerating GDP growth, consumer price inflation in the first quarter was moderate, reaching 1.2% only, significantly less than in the same period last year and also below that in 2005 on average. This was mainly due to a smaller rise of food prices, which have a big weight in the index. Producer prices rose faster than consumer prices (2.9%), partly because of rising fuel prices, but increased less than last year as well. For the months to come, a certain acceleration of inflation can be expected because of the increase in a number of regulated prices in January which will affect the whole economy with a certain delay (fees for water, electricity and fuels rose by 8.4%). For the year on average we thus expect consumer prices to rise by about 2%.

Fiscal policy will be a mixture of expansive and restrictive measures: The general government deficit is scheduled to amount to yuan 285 billion (USD 36 billion), probably reaching -1.4% of GDP, 0.3 percentage points more than in 2005. However, there will be a certain shift from investment expenditures to social expenditures and measures to support private consumption (incomes), such as the increase in salaries of public servants and tax relief. The amount of special bonds to support infrastructure investment will be reduced further to yuan 60 billion (USD 7.3 billion) in 2006 (2005: USD 9.7 billion). Regarding monetary policy, the growth target for broad money supply (M2, money and quasi-money)

⁵ For details see W. Urban, 'Chinese direct investment abroad: economic and political objectives', *wiiw Monthly Report*, No.1, 2006, pp. 4-7.

⁶ The rise in consumption was particularly obvious in luxury goods such as cosmetics, furniture, catering and accommodation as well as cars. The sales of domestically made vehicles rose 36.9% year-on-year to 1.73 million units from January to March this year.

is set at 16% for 2006, but in the first five months of the year growth rates were in each month higher than that and the amount of new loans during the first quarter (yuan 1.26 trillion) accounted already for half of the central bank's yuan 2.5 trillion loan growth target for this year. One therefore may expect further measures to restrict money supply growth beyond the interest hike in April mentioned above.

On the supply side of the economy, provisional data show an increase in value-added of the primary sector (mainly agriculture and some mining) of 4.6%, nearly the same as the year before. But the prospects for the summer harvest are good and the growth of the agricultural sector may accelerate in the course of the year. The secondary sector (industry and construction) grew by 12.5%, somewhat faster than in the same period last year. The tertiary sector, representing various types of services, expanded by 8.9%.

To sum up, overall economic growth will remain strong throughout 2006. While growth of investment may lose momentum, that of consumption may accelerate due to restrictive measures on the one hand and public support on the other. Inflation is expected to rise moderately. Foreign trade will continue to expand fast and will again result in a huge trade and current account surplus. Foreign direct investment will rise further in the context of a certain restructuring from manufacturing to the services sector, in particular financial services. Chinese outward FDI is gaining importance.

Table CN

China: Selected economic indicators

	2001	2002	2003	2004	2005 ¹⁾	2005 1st quarter	2006 ¹⁾	2006 forecast	2007
Population, mn pers., end of period	1276.3	1284.5	1292.3	1299.9	1307.7	.	.	.	.
Gross domestic product, CNY bn, nom. ²⁾	9731.48	10517.2	11739.0	15987.8	18232.1	3131.9	4339.0	20400	22700
annual change in % (real)	7.5	8.3	9.5	9.5	9.9	9.5	10.3	9.7	9.5
<i>annual change in % (real) - revised</i>	8.3	9.1	10.0	10.1	.	.	.	.	.
GDP/capita (USD at exchange rate) ²⁾	921	989	1098	1486	1699	.	.	.	.
GDP/capita (USD at PPP - wiiw) ²⁾	4441	4860	5385	6992	7926	.	.	.	.
Industrial value added ³⁾									
annual change in % (real)	8.9	9.9	12.5	11.1	11.4	11.3	12.5	11	.
Agricultural value added									
annual change in % (real)	2.5	2.9	2.5	6.0	5.2	4.6	4.5	.	.
Retail trade turnover, CNY bn	3759.5	4191.1	4572.5	5395.0	6717.7	1511.2	1844.0	.	.
annual change in % (real)	10.9	10.6	9.2	10.5	12.0	12.1	12.2	.	.
Total investment in fixed assets, CNY bn	3689.8	4283.9	5427.6	7007.3	8860.0	1099.8	1390.8	.	.
annual change in % (nominal)	12.1	16.1	26.7	26.6	25.7	22.8	27.7	.	.
Employment total, mn pers., end of period	730.3	737.4	744.3	752.0	.	.	.	.	.
annual change in %	1.3	1.0	0.9	1.0	.	.	.	.	.
Staff and workers, mn pers., end of period ⁴⁾	107.9	105.6	104.6	105.8	108.5	104.6	107.9	.	.
annual change in %	-4.2	-2.2	-0.7	0.8	2.6	1.0	3.1	.	.
Unemployment rate (urban) in %, end of per. ⁵⁾	3.6	4.0	4.5	4.2	4.2	.	.	4.5	4.5
Average gross annual wages, CNY ⁶⁾	10870	12422	14040	16024	18238	16440	18777	.	.
annual change in % (real) ⁷⁾	15.2	15.5	12.0	10.5	.	14.8	.	.	.
Retail prices, % p.a.	-0.8	-1.8	-0.1	2.8	0.8	1.6	0.6	.	.
Consumer prices, % p.a.	0.7	-0.8	1.2	3.9	1.8	2.8	1.8	2.0	1.8
General government budget, nat.def., % GDP									
Revenues	16.8	18.0	18.5	16.5	17.4	.	.	.	.
Expenditures	19.4	21.0	21.0	17.8	18.4	.	.	.	.
Deficit (-) / surplus (+), % GDP	-2.5	-3.0	-2.5	-1.3	-1.1	.	.	-1.4	.
Refinancing rate of NB % p.a., end of per. ⁸⁾	3.2	2.7	2.7	2.9	2.9	2.9	2.9	.	.
Current account, USD bn	17.4	35.4	45.9	70.0	161.0	.	.	190	150
Current account in % of GDP	1.5	2.8	3.2	3.6	7.2	.	.	7.3	5.0
Gross reserves of NB excl. gold, USD bn	212.2	286.4	403.3	609.9	818.9	659.1	875.1	.	.
Gross external debt, USD bn	170.1	171.7	194.0	223.0	280.0	233.4	.	.	.
FDI inflow, gross, USD bn	46.9	52.8	53.3	60.6	60.3	13.4	14.3	.	.
FDI outflow, gross, USD bn	7.1	2.8	1.8	2.1	11.0	.	.	.	.
Exports of goods total, USD bn ⁹⁾	266.2	325.6	438.4	593.4	762.0	155.9	197.3	960	.
annual change in %	6.8	22.3	34.6	35.4	28.4	34.9	26.6	26	.
Imports of goods total, USD bn ⁹⁾	243.6	295.3	412.8	561.3	660.1	139.3	174.0	845	.
annual change in %	8.2	21.2	39.9	36.0	17.6	12.2	24.8	28	.
Trade balance of goods, USD bn ⁹⁾	22.6	30.3	25.5	32.1	101.9	16.6	23.3	115	.
Average exchange rate CNY/USD	8.277	8.277	8.277	8.277	8.206	8.280	8.035	7.8	7.5
Average exchange rate CNY/EUR	7.347	7.753	9.366	11.276	10.261	10.930	9.658	.	.
Purchasing power parity CNY/USD, wiiw ¹⁰⁾	1.717	1.685	1.687	1.759	1.759	.	.	.	.
Purchasing power parity CNY/EUR, wiiw	1.967	1.951	1.977	2.058	2.115	.	.	.	.

Note: CNY: ISO code for the Chinese yuan.

1) Preliminary. - 2) In 2004 data for GDP and GDP per capita revised according to the national census 2005. - 3) Including construction. - 4) Staff and workers (on duty) refer to persons who work in state-owned enterprises, urban collectives, shareholding ownership 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, defined as: total wages of staff and workers on duty per average number of staff and workers on duty. - 7) Staff and workers cost of living index is used as deflator for calculating real wage. - 8) Overnight rate. - 9) According to customs statistics. - 10) Purchasing power parity, ICP-method; see Ren Ruoan, The Vienna Institute Monthly Report 1996/2.

Sources: China Statistical Yearbook; China Monthly Statistics; China Daily etc.