TD Economics

Topic Paper

May 20, 2004

CHINA: SHORT-TERM PAIN, LONG-TERM GAIN

China's remarkable economic performance over the last several years has made it one of the hottest topics in financial circles today. The country has become a favoured destination for portfolio and foreign direct investment, as investors and companies alike have sought to gain a toe-hold in the emerging new global economic powerhouse. Yet, enthusiasm has become tinged with concern in recent months, as the Chinese economy's impressive performance has led to fears that it may be over-heating. Policy authorities have taken a number of steps to rein in growth in those sectors perceived to be most at risk, but skepticism about their ability to translate these directives into action has prompted concern that the Chinese economy may be poised for a 'hard landing'. In our view, these concerns are overstated. We believe that the Chinese government will succeed in shifting the economy onto a more sustainable growth path – and, looking further down the road, China appears well positioned to enjoy an extended period of stable and healthy economic growth. However, the country does face several significant structural challenges that it will have to address if it is to complete its transition to a market-based economy with a minimum of social and political upheaval.

Signs of over-heating hard to dismiss

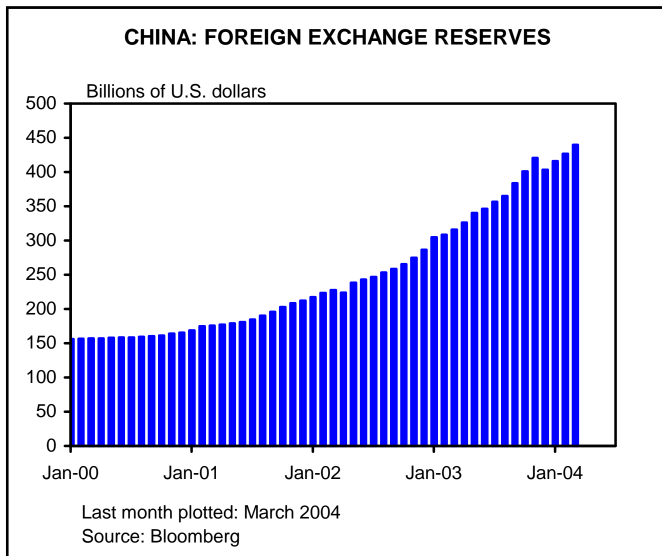
As we discussed in a recent topic paper, *"Profiting from China's economic boom"* (available on the TD Economics website), China's rapid economic growth over the last 10-15 years has seen the country rise to sixth place in the ranking of world economies by size. This robust performance has been both cause and consequence of China's growing integration into the world economy – evident in the explosive growth in the country's trade sector, as well its emergence as a top destination for global foreign direct investment (FDI). But, while one of the main attractions China holds for foreigners is its massive and still largely untapped consumer base, the principal driver of the latest leg of the expansion has not been consumer spending, but rather fixed investment, which has been growing at a sizzling pace.

CHINA: GROWTH IN FIXED ASSET INVESTMENT, 2003

	Y/Y % change
Total	**27.6**
Primary Industries	3.7
Secondary Industries	39.1
Manufacturing*	39.0
Steel	96.6
Electrolytic Aluminum	92.9
Cement	121.9
Vehicles	87.2
Textiles	80.4
Coal	52.3
Tertiary Industries	24.2
Real Estate	29.7
Commercial Real Estate	34.1

*Sub-categories include projects worth more than 5 million yuan
Source: National Bureau of Statistics of China

Public and business investment in China has been expanding at double-digit rates for the last four years, with the pace of growth accelerating to an unprecedented 27.6 per cent year-over-year in 2003. Moreover, as the above table makes clear, this overall tally masks even more dramatic growth in a number of individual industries. The sources of this investment boom are twofold: China's large pool of domestic savings – at 40 per cent of GDP, its national savings rate is one of the highest in the world – and a tide of inward FDI. Yet, the investment boom is now in danger of turning into a bust due to the distortions engendered by a fixed exchange rate regime and a financial system that prices credit risk poorly. FDI inflows have put upward pressure on the Chinese yuan (also known as the renminbi), forcing the central bank to accumulate ever-



Last month plotted: March 2004
Source: Bloomberg

larger foreign exchange reserves in order to maintain the yuan's peg to the U.S. dollar. The resulting explosion in money supply growth has been churned into fresh new loans by China's banks, further stoking growth in industries that were already expanding at a rapid clip. Now, as the buildup in industrial capacity threatens to outstrip demand, concern is mounting that a bubble is forming – the eventual bursting of which could bring down the financial system and derail China's market-oriented reforms.

Chinese government attentive to the risks

While undeniably bleak, it is important to recognize that this scenario is far from inevitable. Chinese policy authorities are well aware of the risks that an asset bubble would pose to the country's fragile banking sector and have been working to dampen investment spending for almost a year. Last June, the central bank introduced stricter lending criteria for the real estate sector, where evidence of over-heating has been most pronounced – in cities like Beijing and Shanghai, for example, real estate prices are rising by more than 20 per cent per year. In August, it moved to dampen credit growth more broadly, raising the reserve requirement on bank deposits by a full percentage point. And, this spring, not satisfied with the results of its efforts, the central bank hiked its refinancing and rediscount rates and raised the reserve requirement twice more, adding a tiered structure, such that the reserve requirement is now 7.5 per cent for all banks, but 8 per cent for banks that fail to meet capital adequacy requirements.

The government has not been idle, either. At the March 2004 10th Peoples' National Congress, it approved a new budget for 2004, which calls for fiscal policy to become less stimulative this year. The retrenchment is being achieved primarily via cuts to infrastructure spending – a welcome development, given that the public sector has been one of the biggest drivers of the recent investment boom. And, in late April and early May, the government announced new restrictions on investment in those industries most at risk of over-heating, such as aluminum, cement, real estate and steel; it imposed a temporary moratorium on banking lending; and, it instituted a regime of partial price controls, ordering provincial and municipal governments to cap further increases in government-administered prices if the consumer price index for their area rises by more than 1 per cent per month, or more than 4 per cent year-over-year, for three consecutive months.

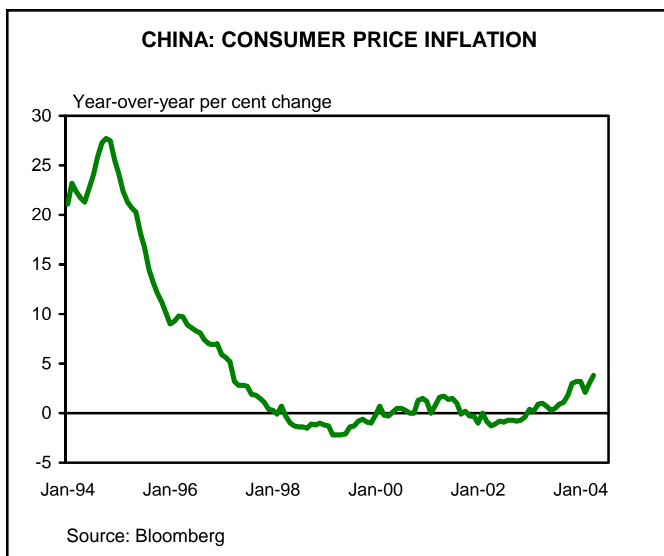
How is the economy responding so far?

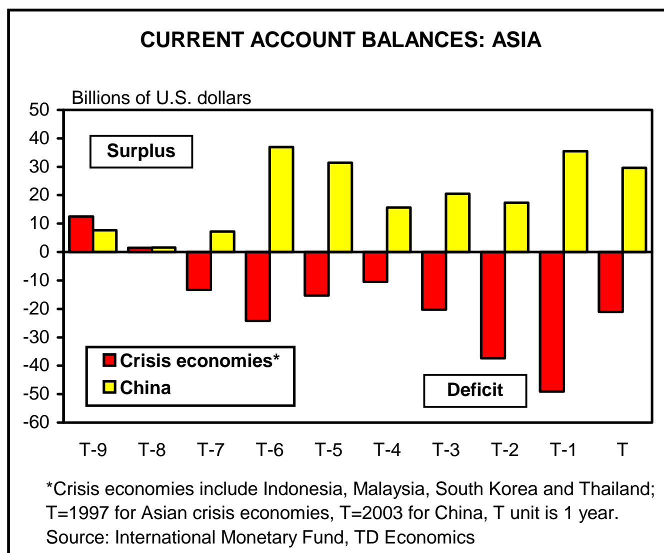
It is certainly too soon to declare victory. Real GDP growth expanded by 9.8 per cent on a year-over-year basis in the first quarter, only a shade slower than the 9.9-per-cent outturn seen in the final quarter of last year – and, the main driver was a 43-per-cent year-on-year increase in fixed investment. Moreover, with industrial value-added having surged at a near-record pace of 19.1 per cent in April relative to a year earlier, business investment clearly began the second quarter with considerable momentum. Some of this strength may reflect a front-loading of investment projects by firms that were anticipating government restrictions. But, a breakdown of the data suggests a deeper problem may be at work. In the first four months of 2004, the value of central government investment projects increased by only 4.4 per cent, but the value of local government projects soared by 53.7 per cent – implying that Beijing may be having trouble getting regional governments to fall into line with its directives.

Still, if Chinese policy authorities are finding their supervisory powers tested, they are clearly fighting back. The new measures introduced since April attest to the central government's determination to cap investment growth. And, an equally hard line is being taken on the credit side. For example, following the release of data showing that loan growth accelerated in the first quarter, the China Banking Regulatory Commission – an independent supervisory body formed last year to regulate China's banking sector – sent inspectors to a number of provinces to conduct onsite assessments of loan quality. And, despite what the recent imposition of price controls might suggest, China does not yet appear to be facing the inflationary spike that typically accompanies an investment bubble. To be sure, primary goods prices have jumped higher. Indeed, even as China continues to be blamed for global deflation in the finished goods sector, it is increasingly being fingered as

the culprit behind higher commodity prices, as rising investment sucks in an ever-larger supply of raw materials. But, these price pressures have not yet fed through into significantly higher consumer price inflation, which is still running at an annual rate of less than 4 per cent – quite low, by Chinese standards.

The implication is that the main squeeze from higher input prices will be on firms' profit margins, and if this takes a bite out of investment, so much the better. Moreover, to the extent that some of the concern about China today relates to perceived similarities between its current situation and the one that precipitated the 1997/98 Asian financial crisis – which was also marked by an investment glut – it is important to note that China differs from the Asian crisis economies in two respects. First, those economies were running massive current account deficits prior to the crisis. By contrast, China's current account is only slightly in deficit, and even that is of very recent vintage – dating back only to the first quarter of this year. Prior to that, China had been running continuous trade and current account surpluses since 1994. Second, while China's currency is pegged, tight capital controls and massive foreign exchange reserves suggest the peg is unlikely to be broken. And, even if it were, the yuan is, if anything, undervalued – a mirror image of the over-valued fixed exchange rates that were the norm across Asia before the crisis.

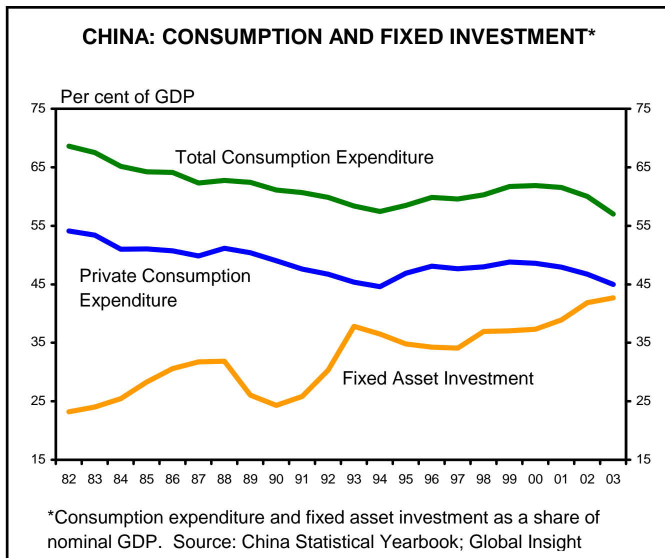




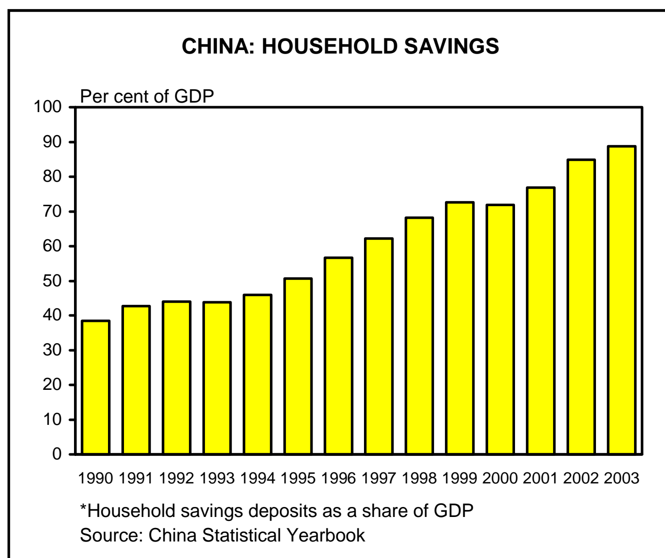
So, if it's too soon to declare victory in the battle against an asset bubble, it is also premature to concede defeat. In its 2004 budget, the central government specified a real GDP growth target for this year of 7 per cent. That's the official definition of the desired 'soft landing' – *i.e.*, a significant slowdown from last year's 9.1-per-cent outturn, but not disruptively so. In our view, policy authorities' willingness and ability to crack down on credit and investment growth means that they are well on their way to achieving the first element of this objective – namely, heading off an asset bubble at the pass. And, the other half of the equation – sufficiently strong growth in other sectors of the economy to offset the anticipated slowdown in investment spending – also looks to be in place. In particular, retail sales growth accelerated to nearly 11 per cent on a year-over-year basis in the first quarter, suggesting that consumer spending is on a firmer footing. And, the export sector continued to expand at double-digit rates, despite a cut in the VAT rebate, which had been expected to put a dent in growth.

Looking further ahead

If the Chinese government's immediate goal is to quell excessive investment, an important medium-term objective is to achieve a more balanced distribution of growth in the economy. The double-digit growth in investment recorded over the last few years has seen total fixed investment soar as a share of GDP, reaching a record high in 2003. By contrast, total consumption has grown much more slowly, sinking back near an all-time low as a share of GDP last year, with personal consumption making a particularly weak showing. This hesitation on the part of China's consumers has resulted in a sharp rise in the household savings rate, reflecting the uncertainty associated with the country's market reforms – a subject we discuss in more detail in the next section. The 2004 budget takes a step toward addressing this problem, by re-orienting spending toward tax cuts and the creation of a stronger social safety net. The goal is to shore up China's consumers and make the economy less reliant on investment growth.



*Consumption expenditure and fixed asset investment as a share of nominal GDP. Source: China Statistical Yearbook; Global Insight



*Household savings deposits as a share of GDP
Source: China Statistical Yearbook

And, what of the longer-term? The Chinese government has set a target of quadrupling the size of the economy by 2020 – something that would require average annual growth of 7.2 per cent over the 2001-2020 period. This seems a reasonable goal. We expect China's labour force to grow by about 0.9 per cent per annum between 2005 and 2020, as a slower rate of overall population growth – in the neighbourhood of 0.6 per cent per annum – is offset by rising labour force participation. At the same time, productivity growth is likely to slow from the 7.9-per-cent average annual pace recorded since 1980 to around 6 per cent over the next two decades, consistent with the maturation of China's economy. Together, those forecasts suggest that the economy could grow by 6.9 per cent per year between now and 2020 – not far off the government's stated target. That would see GDP per capita rise from US$1,090 today to about US$3,000 – a good performance, but still low in absolute terms, implying scope for further rapid growth, as China continues to close the gap with the industrialized world.

Major challenges still ahead

As the Chinese government pursues these objectives, it will also have to face several key structural challenges:

1. Energy security:

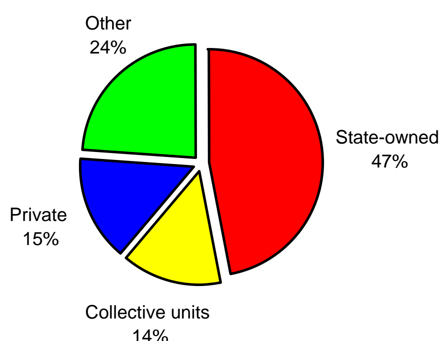
China's rapid buildup of industrial capacity has led to a surge in the country's demand for raw materials, contributing to the sharp rise in commodity prices seen over the last eighteen months. Much attention has been paid to the impact this is having in the industrialized world, where concerns about disinflation have been abruptly supplanted by fears of too-rapid reflation. But, strains are also being felt in China, as growing shortages of raw materials hamper production. In the near term, if this results in a slower pace of industrial activity, that might not be such a bad thing – especially if the higher inflation that typically accompanies such shortages can be averted. But, looking further down the road, China's ability to continue generating the rapid growth needed to support the country's transition to a market economy will hinge on its ability to secure access to a steady supply of raw materials.

Take oil demand – a topical subject, with oil having breached US$40/barrel. Last year, China overtook Japan as the world's second largest oil importer, consuming more than 300 million tons of oil. Chinese sources estimate that that figure will rise to 450-600 million tons by 2020. China also produces oil – 170 million tons' worth last year, making it the seventh largest producer in the world – but by 2020, domestic petroleum output is expected to reach only 180-200 million tons per year. That will leave a gap of 270-400 million tons per year, or about 60 per cent of total demand, which will have to be satisfied by imports. Similar pressures are building in other commodity markets. The Chinese Academy of Geological Sciences predicts that, in the next two decades, China will face shortages of 3 billion tons of iron, 600 million tons of copper and 100 million tons of aluminum. As with oil, China produces many of these commodities, but as demand outstrips production, domestic resource depletion implies that the country will become increasingly reliant on imports.

2. State-owned enterprise (SOE) sector reform:

Weighed down by vast pools of low-quality assets and huge numbers of redundant workers, China's SOEs are a major bottleneck in the economy. In 2001, they accounted

CHINA: FIXED ASSET INVESTMENT, 2001



Source: National Bureau of Statistics of China

for 47 per cent of fixed investment in China and employed 48 per cent of the industrial workforce, yet generated only 21 per cent of industrial output. In addition to being inefficient, they are also highly unprofitable. More than half of China's SOEs are estimated to be losing money today, with some 2000 enterprises thought to be on the verge of bankruptcy. Yet, because the sector remains one of China's largest employers, the government has been hesitant to push forward with radical restructuring, lest the massive wave of layoffs this would entail spark social unrest.

Over the past decade, the government has succeeded in cutting the number of SOEs in half, from 350,000 in the mid-1990s to about 160,000 today. At the same time, industry consolidation and restructuring have improved resource allocation in the sector, while reduced government intervention, increased penetration by foreigners, and rising private sector competition have forced China's remaining SOEs to become more competitive. However, despite this progress, the SOE sector remains a significant drag on productivity. And, given its still-large size in absolute terms, its continuing dependence on state support implies that it will remain a drain on the public purse. Indeed, in addition to having poured money into the SOE sector directly for years, the government has also channeled support through China's state-owned banks, compelling them to extend cheap credit to SOEs to prop up enterprises that would not otherwise have been financially viable. Some estimates suggest that SOE liabilities account for 90 per cent of the bad loans in China's state-owned banks, underscoring the degree to which the sector is implicated in another costly problem facing the government – namely, a banking sector riddled with non-performing loans.

3. Banking sector reform:

At present, China's banking system consists of 104 domestic commercial banks. One hundred of those banks are profit-oriented institutions with a shareholding ownership structure, and credit and risk management systems that increasingly conform to international banking standards. In recent years, the easing of restrictions on foreign ownership has also seen 177 foreign banks set up shop in China. However, collectively, these institutions account for less than 30 per cent of the banking system's total assets. They are still very much dwarfed by China's four state-owned banks, which hold more than 70 per cent of total bank assets – and, which are the source of most of the bad loans crippling the system. Official estimates put the bad loan tally in China at 20 per cent of total bank loans, though private sector analysts think the actual figure is much higher. Either way, the state banks are clearly the worst offenders. The China Banking Regulatory Commission reported that the state-owned banks' bad loan ratio (*i.e.*, bad loans as a share of total loans) averaged 20.4 per cent at the end of 2003, as compared with 7.9 per cent for commercial banks. Moreover, while that was down from 26.2 per cent at the end of 2002, a good chunk of the reduction reflected an increase in new loans, not a more aggressive write-off of prior bad loans.

As with the SOE sector, the poor performance and weak profitability of China's state-owned banks reflect inadequate supervision by regulatory authorities, compounded

INTERNATIONAL COMPARISON OF BANK PROFITABILITY, 1999

	ROA* (%)	**ROE*** (%)
China's state-owned banks:		
China Construction Bank	0.3	4.6
Industrial & Commercial Bank of China	0.1	2.2
Bank of China	0.1	2.0
Agricultural Bank of China	0.0	-0.3
International comparisons:		
Chase Manhattan	2.1	34.0
Citibank	2.2	35.6
Credit Suisse	0.9	25.0
HSBC	1.4	28.0
Standard Chartered (2000)	1.0	16.7
Tokyo Mitsubishi	0.6	15.0

*ROA is return on assets; ROE is return on equity
Source: Standard Chartered, "China's Banking System in Transition", Hong Kong Trade Development Council, April 2001

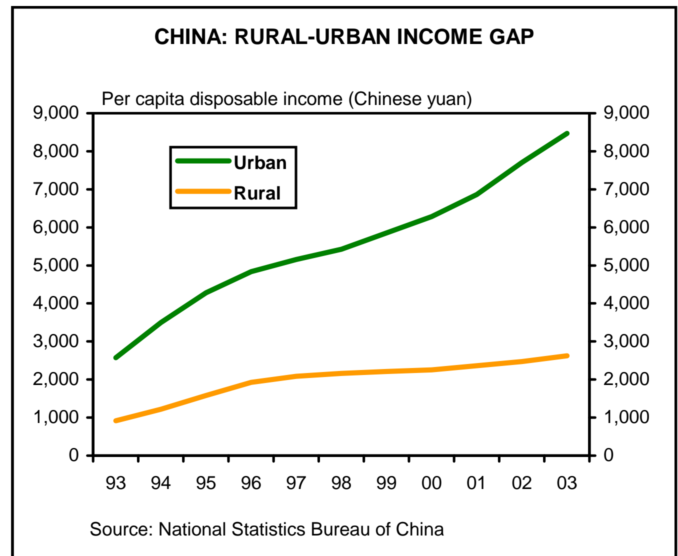
by the government's past practice of using the state banks as an instrument of industrial policy. Policy authorities are now addressing the problem from two angles. In an effort to break the cycle of bad loan formation, the central bank has implemented a number of measures (discussed in more detail above) to dampen credit growth, and so avoid the formation of an asset bubble. And, efforts are underway to continue scaling back the size and market share of the state-owned banks. In particular, the government recently injected another US$45 billion into two state-owned banks – Bank of China and China Construction Bank – and it plans to launch an IPO for both next year, to convert them into partially shareholder-owned firms.

Cleaning up prior bad loans and fostering a proper credit risk culture is critical to improving the health of China's broader financial system. It is also a necessary precursor to the host of other financial sector reforms that China is committed to making as a member of the World Trade Organization, such as liberalizing its capital account and floating its currency. However, as with the restructuring of the SOE sector, the magnitude of the task means that process will be costly and time-consuming.

4. Income disparities:

Income disparities in China have been widening steadily since the country launched its market-based reforms in 1978. These disparities have a powerful regional dimension, one aspect of which is a gap in living standards between inland and coastal China. A victim of its relative isolation and harsh topography, inland China has been comparatively neglected by the Chinese government and foreign investors over the years. As a result, the region has not benefited from the same degree of technological innovation as the coastal areas. The effects are evident in rates of urbanization and industrialization in inland China that lag far behind the national average. In recent years, prompted by the discovery of rich oil and natural gas reserves in western China, and coal deposits and other natural resources in inland China, the Chinese government has taken steps to promote development in these regions. However, redressing the imbalance with the rest of the country will be no small task. For example, although western China accounts for 29 per cent of the country's total population, its per capita GDP in 2001 was just 5,043 yuan (US$610) – 33 per cent below the national average.

Income disparities in China also show up along rural-urban lines. In 2003, urban residents' per capita disposable income was 8,472 yuan, while that of rural inhabitants – which account for 61 per cent of the population – was 2,622 yuan. Moreover, these figures understate the full extent of the disparity, because urban residents enjoy a range of welfare benefits – like medical care, unemployment insurance, and free public education for their children – that are denied to farmers. If the calculations were adjusted to incorporate these factors, the income gap would be even larger than official figures suggest.



Discriminatory policies toward farmers are one of the most important factors behind China's rural-urban income divide. The country's household registration system divides the population into two categories: urban and rural. Rural residents cannot change their status, even if they move to a city and find work. Instead, they are required to register with local authorities and obtain a temporary residence permit. As a result, China's farmers are effectively tied to their birthplace, creating an untenable situation where 61 per cent of the population is forced to scrape out an existence on the 7 per cent of China's land mass that is arable land. The government recently announced plans to reduce an agriculture tax – which, remarkably, has been in place for nearly 4,000 years – from its current rate of 8 per cent to zero, in stages, between 2004 and 2009. Still, while symbolically important, this gesture will do little to alleviate the plight of China's farmers. At best, it is expected to narrow the gap in per capita rural-urban income by some 40 yuan (US$5) per farmer per year, versus an absolute gap of 5,850 yuan in 2003.

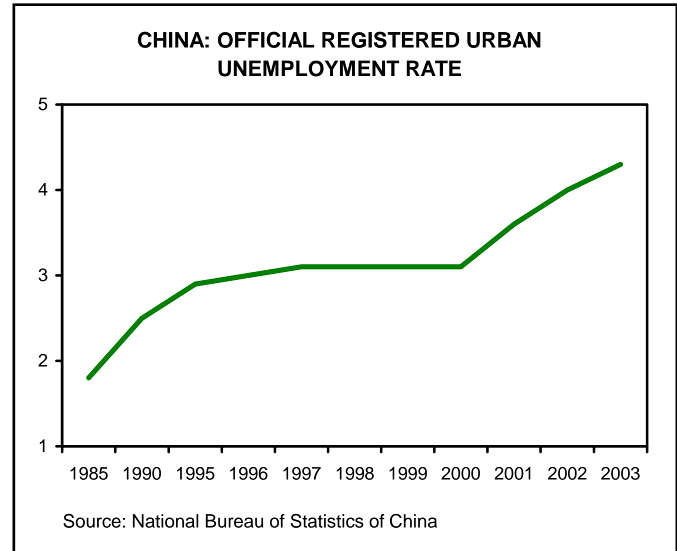
5. Employment pressures:

The pressures enumerated above collide nowhere more forcefully than in China's labour market. Industrial restructuring and SOE reform have resulted in soaring unemployment in China's cities, which are also coping with

an influx of rural residents desperate to escape the harsh conditions of life in the countryside. Despite the rigid mobility barriers they face, 150 million of China's farmers have already fled to the city, and a high rural unemployment rate – which is hardly surprising, given that China still has slightly more than one-and-a-half farmers for every urban resident – implies that urbanization is set to accelerate in the coming years. At the same time, population growth is doing its part to boost the size of the labour force, which is expected to number 940 million by 2020.

This large and growing labour force is both a blessing and a curse for China. On the one hand, the country's virtually unlimited supply of cheap labour has given it a powerful comparative advantage in global manufacturing, making it an attractive location for foreign firms to set up production. On the other hand, job creation has not kept pace with the expansion in the labour force. As a result, the supply of labour now outstrips demand – and, this mismatch is being exacerbated by a rise in structural unemployment, as China's workers find that they lack the skills required in many of the new jobs that are being created.

The need to provide employment for China's burgeoning labour force is one of the reasons why the government has been so intent on keeping the economy growing rapidly. Annual real GDP growth of roughly 7 per cent is thought to be the economy-wide growth rate necessary to keep up with the expansion in the labour force. But, simply targeting an overall rate of growth is not enough. The government needs to emphasize the development of labour-intensive industries that can absorb the expanding workforce. At the same time, China's workers need better education and technical training, to bring their skills into line with those required by employers and to help them move up the value-added production chain. And, last but not least, a stronger social safety net is required, to avoid the creation of a growing pool of dispossessed and unemployed workers. In many respects, China's massive labour force is a double-edged sword. If wielded properly, it will provide a continuous labour cost advantage that will aid the country's development – but, if mishandled, it risks becoming a source of social and political unrest.



Conclusion: The future looks bright

We expect the Chinese government to be successful in achieving its near-term objective of achieving a moderation in the pace of economic growth. That deceleration may be hard to discern in the reported statistics – China has a way of consistently meeting, if not exceeding, its official growth targets – but the evidence should be visible indirectly, in less frothy asset and commodity prices. To be sure, a slowdown in economic growth will exacerbate some of the structural problems the government is grappling with – like cleaning up the banking system, and dealing with the employment pressures stoked by SOE reform and urbanization. However, we believe that these challenges can be overcome. And, they should not obscure the favourable longer-term outlook for the country, which is likely to see it remain one of the world's top-performing economies over the next decade.

That also means that China will continue to be a major preoccupation for financial markets – and, one of the key issues they are likely to dwell on in the immediate future is the fate of China's fixed exchange rate. Of all the measures introduced to stem credit growth over the past year, none has involved any adjustment of the yuan's peg to the U.S. dollar. In our view, that may well be the next step. And, it could involve pegging the yuan to a broader basket of currencies that includes the euro and the yen – something that would effectively achieve the desired upward revaluation in China's exchange rate, given the pronounced appreciation these currencies have sustained versus the U.S. dollar over the last year or two. But, we'll leave a more in-depth discussion of that subject for our next topic paper on China, which will be published in late June.

Gillian Manning, 416-982-2559
Parhat Zunun, 416-944-5729

The information contained in this report has been prepared for the information of our customers by TD Bank Financial Group. The information has been drawn from sources believed to be reliable, but the accuracy or completeness of the information is not guaranteed, nor in providing it does TD Bank Financial Group assume any responsibility or liability.