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The sustainability of Chinese growth

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Abstract

China has experienced strong economic growth for over a quarter century. This brisk growth is expected to continue thanks to such factors as China's huge labour reserve, improvements in education levels, further integration of China into the global economy and a high savings rate, which provides China with strong potential for domestic investment. On the other hand, economic development is threatened by other trends, including widening inequality, the growing complexity of the decision-making framework and worsening of the public sector economy due to banking sector fragility and the absence of an adequate pension system.

Keywords: China, economic development, growth

1 China's increasing role in the world economy

China launched its economic reforms in 1978. Since then, annual real GDP growth has averaged close to 9.5 % and nominal annual GDP has risen from $225 billion to nearly $1400 billion in 2003. Chinese GDP is currently the sixth biggest in the world. Annual GDP per capita hit $1,000 in 2002.

The driving force behind Chinese growth has been rapid industrial development, with industry now accounting for close to 50 % of GDP. Meanwhile, agriculture's share of GDP has dwindled to around 15 %. The apparently small role of the service industry (35 % of GDP) is partly due to statistical difficulties. However, it also indicates China today is essentially an industrial economy still awaiting a services revolution.

Recent development trends evidence a victory for the private sector. The private sector's share of industrial production is currently estimated at around 30-40 %. Taking into account foreign-funded companies, the share of exports is much higher and the number of employees working in the private sector is rapidly increasing.

During the past 25 years, China has opened its economy to the outside world remarkably. It joined the WTO in December 2001. The resulting export growth has been essential for China's rapid economic growth and has increased China's role in the world economy substantially. In 1978, China's total imports and exports amounted to $20 billion, less than 10 % of GDP. By 2003, they amounted to $850 billion, or 60 % of GDP, and China had become the third biggest trade partner in the world.

In recent years, China has played a major role in the growth of world trade. However, the role of the export sector in rapid GDP growth should not be overestimated; the value-added that has stayed in China is much less than export figures indicate. A large share of Chinese exports comes from "processing" industries, whereby components and raw materials are imported into China and re-exported after the processing phase. In addition, around half of Chinese exports come from foreign-owned companies. As a result, most earnings from the export sector are channelled outside China. It has even been suggested that the beneficiaries of the efficiency improvements in the Chinese export sector are not the Chinese workers in the form of rising salaries but foreign investors who get higher profits. On the other hand, it is possible that the productivity improvements may also lead to lower prices and thus be beneficial to the Western consumers. Unfortunately, we could not find statistics to test these hypothesis.

China's opening to the world economy is also manifested by strong FDI inflows during the last decade. Cheap labour and huge domestic markets have raised China to the top of the list of FDI recipients. However, compared to many emerging market countries or, for example, the Baltic countries, the relative amount of FDI inflows to China (4-5 % of GDP) is not particularly large given the size of the economy. On the other hand, Chinese investments abroad have remained moderate, so net FDI inflows to China have been relatively high. FDI inflows have been extremely important to China's development because of their positive spillover effects. China's policy has been to attract high-technology production into the country and then augment the benefit from the foreign investment by transferring that efficient technology to domestic factories.

Besides exports, domestic consumption and investment have played an important role in the China's fast growth. China's investment rate has been one of the highest in the world. According to the official figures, the average investment rate in China was 38 % over the last 20 years. Due to statistical problems, however, the actual rate is likely somewhat lower.

2 Mixed messages on economic overheating

Investment growth accelerated rapidly in China in 2003. Investment increased 27 % y-o-y and the investment rate rose to around 45 % of GDP. Investment growth has driven up many raw materials prices considerably. This trend continued in the first months of 2004 as rapidly increasing demand led to scarcity in energy and transport services. Many analysts see this as a sign of overinvestment in certain sectors of the Chinese economy. They fear that the investment boom will ultimately result in oversupply of many goods and a considerable slowdown in growth.

Rapid credit growth has also led to worries over a likely increase in non-performing loans (NPLs) and the central bank has warned about possible acceleration of inflation. Real estate prices have risen considerably in some areas, particularly Shanghai.

Preventing economic overheating presents the central government with a non-trivial task. The government must simultaneously attempt to lock in growth rates high enough to create jobs and retain social stability, while dampen growth in certain sectors to avoid overheating and excessive inflationary pressure. In a strongly regulated and partly underdeveloped environment such as China’s, this task is made even more challenging as any restrictive measures can have unintended consequences.

The central government’s power in principle is substantial in most sectors. In practice, many regional governments seem to have chosen to ignore orders from the central government to halt on-going investment projects.

To alleviate the overheating of the economy, the authorities have limited investment growth since autumn 2003 by lengthening the process of granting construction and investment permits, as well as delaying public investments and tightening fiscal policy. To slow credit growth, the authorities have raised banks’ reserve requirement and other less-important central bank interest rates. The authorities generally continue to give most of their instructions to the banks as guidelines on desired lending policies and have forbidden new credit to some overheated sectors (e.g. steel, car manufacture, aluminium and real estate), reflecting the character of the planned economy that still exists in China.

The authorities have not relied so much on monetary policy tools commonly used in market economies, particularly interest rates, to cool the economy. There are several good reasons for this. First, higher interest rates would encourage capital inflows to China and thereby further increase liquidity in the market. Second, higher interest rates would likely increase the stock of NPLs. Finally, in China’s strongly regulated financial market, the possible effects of an interest rate hike are almost impossible to predict. Most investment decisions are politically motivated and ignore the costs of the financing.

The latest growth figures of investments, credit and industrial production have shown slight signs of a cooling off, but there are not yet guarantees that the economy will cool down smoothly. Annual GDP growth rates for the first two quarters of 2004 stayed above 9 % and growth in most sectors is still very strong. Due to the Sars epidemic in the spring of 2003, annual growth figures are difficult to interpret. The government also repeatedly issues warnings that the threat of overheating remains and the People’s Bank of China (PBoC) still urges banks to curb credit growth.

3 Inflationary and deflationary pressures

As mentioned, China's rapid investment growth has led to a scarcity of energy, transport services and many raw materials. Currently, China is one of the biggest importers of investment goods and raw materials. Huge demand has led to considerable prices hikes not only in China but also in the world market. For example, the upward spike in steel prices in 2003 and early 2004 was mainly due to China. Aluminium, oil prices and transport costs have also been strongly affected by China's rapid development. Although the rise in prices slowed in the summer 2004, the PBoC reports that producer prices in August were almost 10 % higher than a year earlier.

China's consumer price index has not risen as fast as the producer price index. After deflation in 1998-1999 and again in 2002, inflation rates turned positive at the beginning of 2003. In August 2004, the on-year inflation rate had climbed to 5.3 %, increasing worries over a pick-up in inflation. Much of the acceleration, however, is due to higher food prices. Annual inflation is expected to decline by the end of 2004. Indeed, prices of many manufactured goods continue to decrease. For example, cars and many home appliances are now cheaper than a year ago. The price declines are mainly due to the harder competition (partly caused by China's WTO commitments) and productivity improvements in China. As the domestic market opens up to imported products, Chinese enterprises have to improve their productivity. In addition, the huge reserve of labour has lowered labour costs in China. As a result, cheap Chinese products have increased deflationary pressures around the world.

The low prices of many Chinese products have raised discussion of China's competitiveness in general. In addition to its cheap labour force (which we discuss later), some analysts see China's exchange rate and its possible misalignment as crucial to Chinese competitiveness. The exchange rate for the yuan has followed the movements of the US dollar within a very narrow band for over ten years. Critics of this de facto peg say it has led to severe undervaluation of the yuan in light of China's robust economic growth. China's aim is to introduce more flexibility to the exchange rate policy over the long term. In the short run, however, the exchange rate would stay stable.

Although revaluation of the yuan might ease some pressure on the Chinese economy, there are also strong arguments for keeping the exchange rate stable. First, introducing more flexibility in the exchange rate system is not a trivial matter in China's heavily regulated environment. The financial sector, in particular, is still quite underdeveloped. Second, estimates of just how undervalued the yuan is range from 0 % to 50 %. In other words, even the experts have trouble determining the correct exchange rate level for the yuan, which is e.g. subject to restrictions on capital flows. Third, China has not produced booming trade surpluses in recent years. In fact, in the first half of 2004, China actually ran a small trade deficit. Moreover, the current account surplus amounted to a modest 3 % of GDP in 2003. The growing pressure on the exchange rate comes mainly from large surpluses in the capital and financial accounts. Overall, the favourable exchange rate is only a minor factor behind the competitiveness of China's export products.

Despite continuous assurances from the PBoC of that the exchange rate will remain unchanged, speculative capital flows to China have increased considerably since summer 2003 as revaluation expectations have grown. Although China has many strict restrictions on capital flows, non-FDI net capital inflows amounted to $24 billion (less than 2 % of GDP) in 2003. If the $45 billion used for bank recapitalisation is removed from the statistics, non-FDI net capital inflows rose close to $70 billion (slightly less than 5 % of GDP).

For the first half of 2004, preliminary figures indicate the trend continued. Capital inflows increased China's foreign currency reserves to $471 billion at the end of June. This situation prompted the central bank to sell bonds to soak up the extra liquidity in the market.

4 Problems in the financial sector

China's financial sector is huge compared to that of many other countries of the same income level. It is very much dominated by the banking sector. Total assets of the banking sector amount to 240 % of GDP. Credit growth has been strong in recent years and the total amount of credit was around 140 % of GDP at the end of March 2004. The financial sector is still largely regulated and not particularly subject to market forces.

Interest rates are regulated. During the recent period of low inflation and deflation, for example, real lending rates have been high (from 5 to 10 %). Despite of the large size of the banking sector, small and medium-sized enterprises still lack access to reasonably priced financing. The problem may even have worsened in recent months due to the government's imposed limits on credit growth. According to many analysts, the move has simply increased the share of state-owned companies in the credit stock. This is because the publicly owned banking sector favours state-owned units in their lending policy.

The banking sector also suffers from chronic low efficiency, corruption and inadequate banking knowledge.

All these problems have led to a large stock of bad loans. Officially, the share of non-performing loans (NPLs) is around 18 % of all loans held by state-owned commercial banks. The share is likely much higher for rural credit cooperatives. For example rating companies estimate that the actual figure for the entire financial sector could range as high as 40 %. The government has already recapitalised state banks twice and a large chunk of their NPLs have been transferred to asset management companies. In any case, the cost to the government for rehabilitating bank balance sheets is expected to be substantial in coming years. The good news is that, thanks to rapid GDP growth, the old NPL stock should diminish over time as a share of the economy.

Unfortunately, another more serious problem may already be emerging – many of the loans granted during the boom of the last two years boom could turn out to be non-performing. If the recent investment boom has encouraged extensive unprofitable investment, the NPL problem could become serious enough to threaten systemic stability.

Under China's WTO commitments, the financial sector should open up to foreign companies by December 2006, making banking sector reform an urgent objective of the central government. While the market share of foreign-owned banks is only 1 % and their operations are very limited in China, reforms are underway at two larger state-owned banks. The central government has a program for restructuring these banks and selling ownership shares in them by the end of 2005. However, due to the high NPL ratio and the large size of the banks, it may be very difficult to find strategic investors willing to buy stakes in these banks.

5 Evidence supporting optimistic scenarios

While the current upward cycle may pose a threat on China's economic growth in the short term, China's GDP growth is expected to slow somewhat. Moreover, despite worries over the current investment boom, most analysts are convinced that China's fast economic development can be sustained for the next 20 years. The big difference between China and the Asian tigers of the last century (particularly Japan and South Korea) is China's huge population. Out of China's 1.3 billion inhabitants, 800 million still live in the countryside. Nearly half of these rural rural are estimated to be underemployed. This leaves China with a reserve of 300-400 million people and it has been estimated that the reallocation of labour will last at least another 25 years. This huge reserve could mean that wage levels will not rise significantly for a long time in China. This has been true for the unskilled labour force so far. Enterprises in Hong Kong report that a decade ago, a basic monthly salary for an unskilled worker in Guangdong was around $100. Since then, the supply of labour has increased and wage level has even dropped slightly. However, in the official statistics, the average wage level seems to have risen considerably during the last 10 years. This is probably due to a rapid increase in skilled workers. Many Western enterprises, for example, have said that they have to raise wages currently by almost 10 % annually so that their experienced and trained employees do not leave. In addition, there are reports from some coastal cities that it is already difficult to find cheap labour. The living costs in these cities have risen quickly and partly hampered people from countryside to come to work there. It is very likely that in coming years, more production facilities will be moving from the coast further to inland in search of cheap labour.

Also related to the labour market, the improvements in human capital are likely to support economic growth. Currently, however, the central government emphasizes the role of tertiary education strongly, while comprehensive schools are lacking resources in many regions. Not even the first grades of school are free and in some remote areas, illiteracy is rather common.

Another major fact mentioned when discussing China's future growth is its high savings rate. China has been able to finance investment from domestic resources. In fact, China is technically net exporter of capital if foreign reserves are included. While the aging of the population is likely to lower the savings rate slightly, China will probably be able to maintain high levels of domestic investment in the future.

The third argument for strong growth in the future is the further opening up of the Chinese economy. So far, the average tariff rate has dropped dramatically, close to 10 %, and the number of import quotas and licences has declined. In addition, China is now open to most foreign direct investment. Foreign companies, through significantly increased competition in the Chinese domestic market, have compelled Chinese enterprises to make efficiency improvements themselves. As a consequence, growth in inventories has significantly slowed and the number of jobs in manufacturing has decreased by 15 % from the mid-1990s. As this integration of China to the world market continues, its impact on China's economic growth will remain significant.

6 Could public sector troubles hinder economic development?

Despite the overall positive outlook, one should not forget that China's long-term growth faces many obstacles.

Consider, for example, the seriousness of environmental degradation and public health problems. These already are having costly economic consequences.

An emerging problem is the rising income disparity in Chinese society. The ever-widening inequality between rich coastal provinces and poor western and northeastern provinces, between urban and rural areas, as well as rising income differences in the cities are, according to many sociologists, likely to increase political tensions in China. Unemployment and the near total lack of a social security system are also possible reasons for dissatisfaction in China. Thousands of illegal demonstrations throughout over China are said to have occurred. The current central government seems to have realised the existing threat to social stability and has made its policies more equality oriented. The strategies of the government focus on regional equality. In addition, the government aims at lower, but more sustainable, economic growth than its predecessors.

The well-intentioned aims of the central government may well be derailed by the mixed decision-making system in China. For example, the position of the central government is openly challenged. During the current investment boom, the central government has repeatedly demanded that the local level (both officials and state-owned banks) curb investment and credit. Nevertheless, credit growth continues. This has raised doubts about the central government's power at the local level. In principle, the tools of the central government to cool the economy should be almost unlimited. However, the ranking in decision-making between the central ministries and the provinces seems to be poorly defined, making it very difficult for the central ministries to issue binding orders to any province. With various commissions and ministries subordinated to the State Council, its power to enforce the demands is disturbed.

Recently, it has been argued that the disputes between localities and centre have been the major hindrance to the effective implementation of sound fiscal and monetary policy. The position of the Communist Party and its ultimate control over all aspects of governance also complicates the decision-making process and hinders professionals in deciding over their area of expertise. This complicated web of decision-making blurs lines of responsibility.

The critical discussion between the central government and local officials is likely to continue over the government's new aim of sustainable growth. Local officials have reasserted their positions by pushing for rapid economic growth in the short run – even at the expense of long-term growth. The central government now aims at slightly slower, but more sustainable, growth in the future and expects local officials to adopt this goal. Many Chinese analysts fear local officials will continue to pursue such short-sighted policies, which in turn could lead to unsustainable development and the rise of serious economic and social problems.

In economic terms, threats to stable economic development could also arise from the sustainability of the public sector economy. Public spending could be dramatically increased, for example, by a crisis in the already ailing banking sector. Estimates of international rating agencies and analysts based on officially reported non-performing loans statistics and the assumption that the recovery rate would remain at the level that has been achieved so far by asset management companies (around 20 %) put potential losses from NPLs at around 35 % of GDP. While the official share of NPLs to GDP has declined since 2002, many analysts put the actual amount of NPLs, i.e. the cost of recapitalising the banking sector, at over 50 % of GDP. Under the more optimistic scenario promoted by Chinese officials, recapitalisation would cost only 11 % of GDP. The current overheating and rapid credit growth is likely to worsen the non-performing loans problem further and most of the analysts expect a significant share of the new loans will prove non-performing in coming years.

Another significant threat to fiscal sustainability is demographic trends. An older population will have to deal with increased pension liabilities. Currently, China's public debt has been estimated at a modest 20 % of GDP. However, public debt has increased significantly since 1998, when the government took up an active fiscal policy. The share of public sector expenditure (local and central government) has risen from 11 % of GDP to almost 20 % of GDP. As tax collection remains spotty and the public sector is small, even relatively low levels of debt can harm the fiscal stability significantly. Even today, interest payments constitute a significant share of public expenditure.

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